Issued: 31 July 2017

Like a BAT out of hell

By Jan Dehn

The US Congress and the White House last week officially abandoned plans to implement a Border Adjustment Tax (BAT). This significantly reduces the risk associated with investing in Emerging Markets (EM) local bond markets, in our view. The official balance of power shifted sharply in favour of President Nicholas Maduro following the Constituent Assembly election in Venezuela. US sanctions against Russia are to be enshrined into US Law, but the impact on Russia's ability and willingness to pay is miniscule, in our view. Pakistan's Judiciary demonstrated that it has powers to remove the head of the government. India's government turned to labour market reform as the state of Bihar fell under BJP control. In the global backdrop, the Federal Open Market Committee (FOMC) minutes were dovish and President Donald Trump confirmed that he wants a dovish Fed and a lower Dollar.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.0	–	0.30%
MSCI EM Small Cap	12.3	–	0.02%
MSCI Frontier	10.7	–	2.11%
MSCI Asia	12.7	–	0.37%
Shanghai Composite	12.8	–	0.52%
Hong Kong Hang Seng	7.9	–	-0.23%
MSCI EMEA	10.1	–	0.32%
MSCI Latam	13.2	–	0.27%
GBI-EM-GD	6.15%	–	0.03%
ELMI+	3.74%	–	0.11%
EM FX spot	–	–	0.00%
EMBI GD	5.32%	303 bps	-0.17%
EMBI GD IG	4.08%	175 bps	-0.09%
EMBI GD HY	6.71%	450 bps	-0.24%
CEMBI BD	5.04%	290 bps	0.07%
CEMBI BD IG	4.07%	193 bps	0.01%
CEMBI BD Non-IG	6.44%	428 bps	0.15%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.0	–	0.00%
1-3yr UST	1.36%	–	0.02%
3-5yr UST	1.84%	–	-0.04%
7-10yr UST	2.29%	–	-0.35%
10yr+ UST	2.90%	–	-1.45%
10yr+ Germany	0.55%	–	-0.61%
10yr+ Japan	0.08%	–	-0.01%
US HY	5.41%	349 bps	0.21%
European HY	3.03%	336 bps	0.34%
Barclays Ag	–	249 bps	-0.16%
VIX Index*	10.29	–	0.93%
DXY Index*	93.47	–	-0.51%
EURUSD	1.1733	–	0.77%
USDJPY	110.72	–	-0.34%
CRY Index*	182.12	–	5.46%
Brent	52.9	–	8.77%
Gold spot	1267	–	0.91%

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

Emerging Markets

The single largest risk looming over the outlook for EM local currency debt since US President Donald Trump took office was the possibility of imposition of a so-called Border Adjustment Tax (BAT). BAT is a destination-based tax system, which would have forced US and foreign companies producing goods outside the borders of the US for consumption within the US to pay a 20% tariff. If implemented in its original format, BAT would have pushed the US dollar up by 20%, which would have reduced our expected Dollar return on local currency bonds from about 50% to just 10% over the five-year period from 2017 through to 2021. This in turn would have deterred flows of capital to EM, which would then have made it more difficult to sustain the ongoing recovery in growth. Weaker growth would also have made it difficult to justify an expectation of spread compression for EM's Dollar-denominated corporate and sovereign bonds. It was our base case that the BAT would not be implemented, but it is still good news that the tax has been abandoned. The joint White House and Congress press release stated that "while we have debated the pro-growth benefits of border adjustability, we appreciate that there are many unknowns associated with it and have decided to set this policy aside in order to advance tax reform."

The abandonment of BAT has to be seen in the context of another major development in the US last week, namely Senator John McCain's remarkable revenge against Trump, when he voted against the "skinny" version of the bill to repeal Obamacare.[1] Like the BAT, the whole point of repealing Obamacare was to free up fiscal room to enable Republicans to significantly cut taxes for corporates. Without BAT and the repeal of Obamacare, it now becomes far more difficult to find room to cut corporate taxes without significantly raising the debt burden, which large sections of the Republican Party (the so-called Freedom Caucus) would oppose. Hence, the US is now on track for a small tax cut at best. This means less stimulus, less inflationary momentum and therefore a slower pace of Fed hikes.

[1] A few years ago President Donald Trump attacked McCain's status as a war hero by saying that he preferred heroes "who weren't captured".

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Emerging Markets

The reason why all this matters for EM is that interest rates and growth determine the path for the Dollar. The political impasse in Washington is therefore likely to translate into a softer trajectory for the Dollar than would otherwise have been the case.

Investors should not be complacent, however. Trump and Congress will be desperate to show results ahead of the next year's mid-term elections. One option now is to gut the Dodd-Frank regulatory regime in order to encourage much more aggressive inflation of US asset prices. This could certainly create a short-term boost to asset prices, but probably at the expense of much larger problems in the longer-term.

In general, we expect that the main driver of the Dollar will be flows, which in turn are likely to respond to the sheer force of relative performance of financial assets in the US and abroad, including EM. So far, EM local bonds are returning nearly ten times as much as US bonds of the same duration, while EM stocks are returning twice as much as US stocks. Going forward we expect EM outperformance to become ever greater as the distortion in asset prices in the developed economies and EM caused by Quantitative Easing (QE) gradually unwinds. This will make it progressively tougher to sustain overweight positions in Dollars and developed markets versus EM, especially local markets.

- Venezuela: The official balance of power in Venezuela changed dramatically in favour of the government over the weekend as a result of the election of members of the new Constituent Assembly (CA). As Venezuela's new de facto parliament the CA is completely dominated by pro-government members and vested with great powers, including superseding the erstwhile parliament, the National Assembly, which was completely dominated by opponents of President Nicholas Maduro. The government claims a 41.5% turnout, a figure disputed by the Opposition. However, based on this turnout the government will now claim that it has a legitimate law-making body, which allows it to go about with the business of government. Opponents of the Venezuelan government at home and abroad will undoubtedly characterise the CA as an illegitimate body. Labelling the CA thus opens the prospect of further violence at home and an escalation of pressures against the Maduro Administration from abroad. The focus will therefore now shift to four questions:

Firstly, how will other countries respond to the new CA? The US response will garner particular attention on account of previous threats of sanctions, although the reaction of other Latin American countries will also be important.

Secondly, how will the Opposition in Venezuela respond? The loss of parliamentary representation will confront many members of the Opposition, who have previously supported peaceful protest within the existing institutional framework with the difficult question of whether to take up active civil disobedience or even violent protect.

Thirdly, how will President Nicholas Maduro use his new powers? Will he immediately seek to clamp down on the Opposition or will he now, having achieved a degree of institutional backing, reach out to the Opposition in a bid to try to achieve of degree of governability?

Finally, how will the country's financing situation change? Venezuela cannot tap global markets, but the country has been adept at exploiting tensions between Russia and China on the one hand and the US on the other to secure new bilateral financing. These questions are likely to find answers in the coming days and weeks, but the bigger picture in Venezuela has not changed. The Maduro Administration remains extremely weak on account of a failing state, low oil prices and extremely low popularity. The CA election does not change these facts and so the possibility of regime change remains extremely high.

- Russia: Russia has ordered the US to reduce the number of staff at its diplomatic missions in Russia by more than 750 in order to bring the number in line with the number of staff employed at Russian diplomatic missions in the United States. This decision was made in response to news that the US Senate has enshrined sanctions against Russia into US law.[2] The sanctions were imposed on the back of allegations of Russian interference in last year's US presidential election. Sanctions have largely symbolic value; they are almost entirely neutral in terms of their impact on the Russian sovereign's ability and willingness to service debt, in our view. Still, US-Russia relations will clearly not improve meaningfully for the foreseeable future now that sanctions have been made more permanent. The reduction in diplomatic staff reflects that fact. We think President Donald Trump will have little choice but to sign the sanctions bill after the US Senate voted 98-2 in favour. This illustrates how Trump, a Russophile, has been severely weakened over the Russia issue. To the extent that the sanctions impact sentiment towards Russian assets negatively in the short term we think investors should look to take advantage. Negative sentiment of this kind has traditionally been the friend of value investors in Russian assets. After all, if asset prices soften in the short term against a backdrop of no material impact on Russia's ability and willingness to pay then it pays to add into weakness. The broader backdrop looks positive: Russian bonds have rallied in line with broader EM local markets in the past twelve months. Still, Russian bonds seem to offer good value. Core inflation is only 3.5%, while 10-year bonds yield nearly 8%. The high real yield on offer on Russian bonds exceeds the average real yield on EM local bonds, which is currently about 220bps. Most developed markets bonds have much lower or even negative yields. Russian FX reserves continue to rise – they now stand at USD 415bn – and oil prices have been stable to increasing of late. We believe that Russia can comfortably handle the sanctions in question and at current oil prices the Russian sovereign should be very comfortable, especially given the macroeconomic adjustments

[2] By enshrining sanctions in law it means that the sanctions can no longer be unilaterally revoked by the US president.

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Global backdrop

of the last few years. Russia continues to maintain extremely prudent macroeconomic policies. Case in point: Last week the Russian Central Bank opted for caution by keeping the policy rate unchanged at 9% in light of ongoing tensions between the US and Russia, despite low inflation. The economic news is also improving. The Ministry of Economy informed markets last week that the Russian economy expanded at a rate of 2.9% yoy in June, which is higher than expected.

- **Pakistan:** The Supreme Court has asked the Prime Minister Nawaz Sharif to step down after leaks of financial information in the so-called Panama Papers Scandal led to charges of corruption against Sharif and his children. It is fundamentally healthy that Pakistan's institutions are in a position to hold politicians accountable, even to the point that a sitting prime minister can be removed from office. It seems unlikely to us that this development will lead to curtailment of foreign aid critical for Pakistan economic and financial well-being. Pakistan remains as strategically important as ever, regardless of the current political noise. As for the future, the key insight is that Sharif's Pakistan Muslim League (Nawaz) (PML-N) party controls the parliament and will choose the next prime minister. Based on recent polls PML-N would likely win if there were an election today, perhaps even increase its majority. This means that Sharif's brother or some other person close to Sharif could take over as prime minister. Political alliances tend to be sticky in Pakistan, based on long-standing loyalties, economic interests, etc.

- **India:** The Cabinet has approved a labour market reform, which may shortly be presented to Parliament for approval. India's labour market is segmented into an expensive, rigid formal labour market and a highly flexible, but completely unregulated market. The labour reform would streamline the labour code by condensing 44 separate labour laws into a single labour market code. Odds that the reform can pass have increased after the ruling BJP recently took control of the state of Bihar.

- **China:** China racked up solid PMI numbers for the month of July, especially taking into account very inclement weather (too hot, too wet) during the month of July. The official PMI number was 51.4, which was just shy of expectations (51.5), while the non-manufacturing PMI was very strong (54.5 versus 54.9 in June). Other activity data also points to healthy levels of economic activity. For example, industrial profits rose 2.0% in the month of June alone, which was equivalent to 19.1% on a yoy basis. Industrial revenues also improved. Industrial activity has been rising steadily since early 2016.

Snippets:

- **Argentina:** The central bank left the main policy rate unchanged at 26.25%. The trade deficit widened to USD 748m in June from USD 644m in May as real GDP expanded at a rate of 3.3% yoy in May.
- **Brazil:** The central bank cut the main policy SELIC rate by 100bps to 9.25% amidst signs that credit markets are recovering. Total outstanding credit increased 0.4% in June with increases in both household and corporate credit. Unemployment declines to 13.0% in June from 13.3% in May.
- **Colombia:** The central bank cut the policy rate by 25bps to 5.50%, a slowdown in the rate cutting cycle (the previous rate cut was 50bps).
- **El Salvador:** The Supreme Court struck down a law approved by the congress that private pension funds should increase their allocations to government debt to 50% from 45%.
- **Hong Kong:** Exports and imports both beat expectations in June by a factor of two. Exports increased at a yoy rate of 11.1%, while imports were 10.4% higher than in the same month last year.
- **Mexico:** The trade surplus was USD 62m in June 2017 versus an expected deficit of USD 318m.
- **Saudi Arabia:** Saudi Arabia's FX reserves are now rising again. Total reported FX reserves are USD 500bn. The government raised USD 4.5bn in its first ever Sukuk bond issue. The government reported demand of USD 13.6bn.
- **Singapore:** Unemployment declined to 3.1% of the workforce in Q2 from 3.2% in Q1. Industrial production increased strongly in June (+9.7% mom).
- **South Africa:** Producer prices increased at a rate of 4.0% in June versus 4.4% yoy expected.
- **South Korea:** Industrial production disappointed at 0.3% yoy in June versus 1.1% yoy expected, but may have been impacted by base effects. GDP expanded at a rate of 2.7% yoy in Q2, in line with expectations.
- **Sri Lanka:** Sri Lanka has extended a 99-year concession to China to operate the Hambantota port for USD 1.2bn. The port should bring about major efficiency improvements, increase FDI and also increase China's geopolitical influence in the region.
- **Taiwan:** The economy expanded at a rate of 2.1% yoy in Q2 2017. This is a deceleration from the growth rate in Q1 2017 (2.6% yoy).
- **Turkey:** The central bank left the main policy rate at 8.0%.

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Global backdrop

The minutes of the FOMC June meeting were more dovish than expected. They failed to specify the exact timing for scaling down the Fed's balance sheet and highlighted soft inflation. Investors should be open to the notion that Fed policies are endogenous to the performance of the stock market and the underlying economy. After all, the Fed has helped to push asset prices so high that material tightening could cause a major equity market correction, which in turn could hurt the real economy at a time when the Fed's ability to cure a recession is close to exhausted. In this situation, asset prices may be safer than real economy investments. After all, it is easier to support asset prices than the real economy in the event of a downturn. This interpretation has disturbing implications: one is that investors perceive themselves to be safer if they keep their money in financial assets than if they invest the funds in the real economy. Bad news should therefore drive stock prices higher. Larger bubbles in turn make it harder for the Fed to normalise monetary policies. This dynamic creates a trap for capital; escape from which becomes ever more challenging. For more thoughts on the Capital Markets Trap please see *'The Capital Markets Trap',* Market Commentary, 27 July 2017. In related news, President Donald Trump was asked about his views on the Fed Chair succession. He stated explicitly that he would "like to see rates stay low" and he credited current Fed Chair Janet Yellen with keeping the US dollar "not too strong". For these reasons, he said, Janet Yellen was "in the running to stay" at the Fed after her term expires next year. US inflation remains muted and the economy expanded at an annualised rate of 1.9% in H1 2017, which is below the 5-year average US real GDP growth rate of 2.1%.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	5.70%	25.34%	24.61%	2.22%	5.28%
MSCI EM Small Cap	3.31%	19.87%	16.26%	1.42%	6.24%
MSCI Frontier	3.24%	19.24%	21.94%	-2.84%	9.02%
MSCI Asia	4.85%	28.86%	25.90%	5.73%	9.31%
Shanghai Composite	3.03%	6.76%	10.87%	16.56%	11.51%
Hong Kong Hang Seng	5.54%	18.72%	23.06%	2.81%	6.84%
MSCI EMEA	6.65%	12.20%	15.63%	-3.44%	-0.25%
MSCI Latam	8.06%	19.22%	20.03%	-5.55%	-2.68%
GBI EM GD	2.14%	12.72%	9.10%	-2.33%	-0.70%
ELMI+	1.60%	8.92%	6.76%	-1.75%	-0.28%
EM FX Spot	1.66%	6.15%	2.52%	-8.65%	-6.56%
EMBI GD	0.75%	6.99%	5.05%	5.38%	5.25%
EMBI GD IG	0.85%	6.62%	2.30%	4.40%	3.62%
EMBI GD HY	0.65%	7.45%	8.25%	5.94%	7.46%
CEMBI BD	0.71%	5.75%	5.86%	4.97%	5.28%
CEMBI BD IG	0.57%	4.95%	3.14%	4.19%	4.42%
CEMBI BD Non-IG	0.92%	6.98%	10.23%	5.86%	6.83%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.13%	11.67%	16.31%	9.98%	14.66%
1-3yr UST	0.20%	0.65%	0.21%	0.79%	0.64%
3-5yr UST	0.36%	1.59%	-0.56%	1.86%	1.19%
7-10yr UST	0.39%	2.79%	-3.41%	2.86%	1.51%
10yr+ UST	-0.54%	4.95%	-8.71%	4.81%	2.18%
10yr+ Germany	-0.68%	-4.50%	-11.52%	5.41%	5.00%
10yr+ Japan	0.01%	-0.62%	-6.91%	5.23%	4.76%
US HY	1.10%	6.08%	10.82%	5.02%	6.81%
European HY	0.85%	4.23%	7.81%	5.10%	9.09%
Barclays Ag	0.74%	3.90%	2.20%	3.95%	4.22%
VIX Index*	-7.96%	-26.71%	-13.31%	-39.29%	-45.64%
DXY Index*	-2.26%	-8.56%	-2.16%	14.74%	13.11%
CRY Index*	4.20%	-5.40%	0.61%	-38.15%	-39.19%
EURUSD	2.69%	11.53%	5.12%	-12.37%	-4.64%
USDJPY	-1.47%	-5.37%	8.14%	7.70%	41.73%
Brent	10.31%	-6.97%	24.49%	-50.14%	-49.62%
Gold spot	2.04%	9.94%	-6.38%	-1.22%	-21.52%

*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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