Trade surpluses boost Indonesia before infrastructure boom

By Jan Dehn

Indonesia's trade balance racks up its fifth consecutive monthly trade surplus, but the best news is still ahead as infrastructure spending looks set to ramp up significantly over the next year. Brazil's parliament approves its second austerity package in a week. The Russian central bank replenishes its FX reserves on the back of a strong RUB and a larger than expected trade surplus. Malaysia defies the doom mongers to illustrate the resilience to external shocks of many Emerging Markets (EM) countries today. Modi's setback in India does not derail the story. China's latest lending trends are indicative of the future. Venezuela's reserves are still falling, but the country has untapped resources.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	14.9	–	0.85%
MSCI EM Small Cap	23.0	–	2.29%
MSCI Frontier	11.3	–	-0.10%
MSCI Asia	13.4	–	0.76%
MSCI EMEA	14.1	–	1.79%
MSCI Latam	25.2	–	0.80%
GBI-EM-GD	6.48%	–	1.45%
ELMI+	4.45%	–	1.14%
EM FX spot	–	–	1.05%
EMBI GD	5.47%	330 bps	-0.24%
EMBI GD IG	4.27%	204 bps	-0.26%
EMBI GD HY	7.63%	562 bps	-0.22%
CEMBI BD	5.23%	331 bps	0.23%
CEMBI BD HG	4.21%	227 bps	0.04%
CEMBI BD HY	7.17%	527 bps	0.59%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.7	–	0.38%
2 year UST	0.54%	–	0.10%
5 year UST	1.48%	–	0.21%
7 year UST	1.89%	–	0.16%
10 year UST	2.16%	–	-0.40%
US HY	6.44%	520	0.06%
European HY	4.22%	420	0.20%
Barclays Ag	–	453	0.67%
VIX Index*	12.38	–	-1.08%
DXY Index*	93.50	–	-1.51%
CRY Index*	231.46	–	2.30%
EURUSD	1.1400	–	2.20%
USDJPY	119.69	–	0.33%
Brent	67.5	–	4.01%
Gold spot	1229	–	3.77%

*See last page for index definitions.

Note: Additional benchmark performance data is provided at the end of this document.

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- **Indonesia:** Real GDP growth will probably slow to a (still very respectable) 4.5%-5% range this year from 5% in 2014 and 5.6% in 2013. The slowdown – which is caused by fiscal adjustments, including changes to the energy subsidy scheme – is now beginning to have its intended effect on the Indonesian trade balance. Thus, in April, Indonesia recorded its fifth consecutive month of trade surplus (USD 0.5bn versus USD 0.1bn expected). A sharp slowdown in imports was the main reason for the improvement in the trade balance, which has helped Bank Indonesia (BI) to accumulate reserves. Total foreign exchange reserves now stand at USD 111bn compared to USD 92bn during the Taper Tantrum in 2013 (equivalent to nearly seven months of imports, or more than double the level recommended by the IMF).

Yet, like all other countries, there is a cloud alongside the silver lining. Much of the improvement in the trade balance is due to slowing domestic demand rather than rising exports. Thus the trade balance could swing back to deficit quite quickly if domestic demand picks up. This fact means that much of the focus in the market is on three areas of economic policy that could impact the external balances, namely BI rate cut decisions, the government's commitment to its new fuel subsidy scheme and how quickly President Joko Widodo can get his infrastructure program implemented.

The latest on these three fronts is mixed. BI is under pressure to cut rates as growth has been slowing amidst benign inflation. But a rate cut could quickly weaken support for the currency at a time of potential upward pressure on fuel prices. In turn, this raises concerns in some quarters that foreign investors in the domestic bond market could leave (foreigners own almost 40% of local bonds). Our view is that this risk is overstated. BI has historically been vulnerable to political pressures and sometimes acted late, but it usually acts very decisively once macroeconomic imbalances begin to destabilise markets. Besides, much of the foreign involvement in Indonesia is by institutional investors that are drawn to Indonesia's bond market on account of its high yield (about 8%).

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As for fuel subsidies, the government has made considerable progress in implementing a more rational fuel subsidy system, though there are still concerns about sustainability. The real test of the new regime is whether it will be maintained even as global oil prices rise. A recent decision to cancel one scheduled hike in fuel prices is therefore of concern and could hurt the finances of state owned energy company, Pertamina.

On the infrastructure side, implementation has been slow, which is typical of infrastructure programs everywhere. Nevertheless, the outlook is good, in our view. We expect execution rates to rise sharply over the next twelve months. Stable Indonesian politics helps. All Indonesia's main political parties support Indonesia's infrastructure program, which will also benefit them in the event they win a future election. And that is really what matters the most – more than short-term BI policy or the fuel subsidy scheme it is infrastructure development that holds the real key to the outlook in Indonesia. The greater productivity due to better infrastructure would boost domestic demand without creating inflation and trade deficits. The longer-term outlook for Indonesia also remains extremely bullish due to excellent demographics, a high potential growth rate and low debt level.

- Brazil: The lower house has passed a second austerity bill in a week as Finance Minister Joaquim Levy's efforts to restore Brazil's government to financial sustainability continue. The latest reform curbs abuse of public pensions and is scheduled to save the government some BRL 7.5bn. The measure still needs to be approved in the Senate in order to become law. Last week the lower house approved a bill that curbs unemployment benefits by BRL 14.5bn. In both cases, parliament diluted the reforms somewhat, but without materially blunting the effectiveness of the measures. In another sign of change for the better in the quality of policy, Levy last week urged the central bank to remain vigilant on inflation. This would never have happened under misguided and damaging policies of Levy's predecessor, Guido Mantega. The cost of adjustment continues to weigh on ordinary Brazilians, who reduced their retail spending by 0.9% in March (compared to -0.4% mom expected).

- Russia: The central bank (CBR) commenced USD purchases last week. The purpose is to rebuild reserves following last year's RUB convulsions and lower oil prices. As the RUB has appreciated below 50 to the USD, the CBR is now in a position to buy USD 100m - USD 200m per day. The intervention is a clear sign that the CBR thinks the stress of last year is a thing of the past. The main risk associated with the interventions it that they fly in the face of a fully flexible RUB. We think this risk is somewhat overstated. Most EM central bank intervention is not to maintain a particular level for the exchange rate, but to prevent excessive volatility around a sensible level or trend determined by macroeconomic fundamentals. Given the often fickle nature of cross-border portfolio flows in EM, this seems a perfectly sensible thing to do, in our view. We believe that Russia will continue to be committed to a floating exchange rate regime, which has successfully insulated the public finances in Russia against oil price fluctuations. On an annual basis, Russia's intervention could increase reserves by anywhere between USD 20bn and USD 40bn in the next 12 months. Russia's FX reserves stand at roughly USD 360bn. The trade surplus in March was USD 15bn, nearly 23% higher than expected, while the economy contracted 1.9% yoy in Q1, which was also better than expected (-2.6% yoy).

- Malaysia: The economy expanded at a rate of 5.6% yoy in Q1 2015. This was marginally faster than expected (5.5% yoy). Malaysia was one of the few Asian economies deemed vulnerable to last year's fall in oil prices on account of oil's share of the country's total exports. However, Malaysia has been able to cope with the shock remarkably well due to solid domestic demand. Private consumption was 10% higher in Q1 2015 than in Q4 2014, while investment is 8% higher than last quarter (seasonally adjusted annualised rate). Meanwhile, Malaysia has forged ahead with implementation of a new tax regime (Goods Service Tax), which will improve economic efficiency. This is complemented by an ambitious, multi-year public investment program that will further enhance productivity. Malaysia's experience last year underlines a point often missed by EM watchers, namely that vulnerability to external shocks is falling sharply across the EM universe as domestic economies deepen and broaden on the back of better policies.

- India: The government of Prime Minister, Narendra Modi, suffered a setback last week, when parliament voted to send a proposed land reform and a bill to harmonise taxes (GST) back to parliamentary committees for review. This will delay, but most likely not derail the bills, which we think are critical to the economic outlook for India. Meanwhile, CPI inflation softened to 4.9% yoy in April from 5.3% in March. As recently as January 2014, India's inflation rate was 8.6% yoy. Industrial production (IP) rose 2.1% yoy in March. This takes the 12 month cumulative increase in IP to 2.8% compared to 0.1% at the same time last year. The trade deficit narrowed to USD 11bn in April due to lower imports, notably gold and refined petroleum. In March, the deficit was USD 11.8bn.

- China: Financial data issued last week points to a further slowdown in lending. New loans to corporations were softer than expected, but at the same time lending to households rose, while overall lending slowed. We should expect these trends to continue. First, the government is pushing for future lending to be conducted via publicly traded bonds instead of non-tradable loans. This requires new procedures and market infrastructure that will take time to put in place. Second, the government is strongly promoting a change from investment to consumption led growth, which should result in greater use of credit by households. Chinese households have some of the

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highest savings rates in the world. The emergence of better savings options and more credit instruments have the potential to unleash a huge increase in consumption-led growth in China. According to newswires, MSCI, the main EM equity index provider, will announce on 9 June whether China is eligible for inclusion.

- Venezuela: The central bank's FX reserves continue to decline. Reserves are now USD 17.8bn, down by 25% since February 2015. The culprit is excess demand. Among the world's oil exporters, Venezuela was the worst placed to handle the recent downturn in oil prices on account of excess demand stimulus, excess borrowing and a failure to save during the good times. Despite these circumstances, we think Venezuela will continue to service debt. Venezuela has some USD denominated assets other than those reported as part of the central bank's foreign currency reserves and relatively modest policy adjustments would have a material impact on its ability to pay. Adjustment, however, will be politically costly in an election year so, as the Q4 parliamentary election draws nearer, Venezuela will try to adjust as little as possible, but by enough to continue to pay debt. To draw an analogy, Venezuela is like a tree with only one branch left. The governments of Chavez and Maduro have deliberately sawn off the other branches through Dutch Disease and nationalisations. The only branch left is crude oil production and Maduro is sitting on this branch. A failure to sustain production – for example through a default on PDVSA bonds – would be the equivalent of cutting off Venezuela's last remaining branch, plunging Maduro to the ground. We do not believe Maduro wants to fall.

Snippets:

- Argentina: The government has officially published the election dates: Primary election on 9 August, Presidential election on 25 October and, if needed, a second round on 22 November.
- Czech Republic: The real economy expanded at a rate of 3.9% yoy in Q1 2015. This was dramatically faster than expected (2.0% yoy). The Czech economy is likely to have been buoyed by lower oil prices and the recent upturn in the business cycle in Western Europe. The policy rate is 0.05%, while inflation is 0.5%, up from 0% in June 2014.
- Ghana: The Bank of Ghana (BOG) hiked interest rates 100bps to 22%, but has not yet broken the inflation dynamic, even as growth slows down. Ghana's problems are due to failures on the part of successive governments to avoid election-related fiscal splurges. Each successive splurge was not adequately unwound in the period following each election with the result that the underlying fiscal situation progressively worsened. This is a very Ghana-specific problem. The IMF is now supporting Ghana and BOG's rate hikes are part of the required medicine.
- Mongolia: Narendra Modi indicated that India will support infrastructure investment in Mongolia to the tune of USD 1bn (a sizeable commitment given Mongolia's GDP of USD 11.5bn). Larger reserve holders in EM are increasingly committing to infrastructure investment in EM - a sensible alternative to developed market bonds, in our view.
- Nigeria: Q1 GDP was up 3.96% yoy, which represents a significant slowdown from the growth rate of 5.94% achieved in Q4 2014. Following the recent election, Nigeria is now catching up on a much needed adjustment to lower oil prices.
- Poland: The current account surplus of EUR 1.9bn in March was twice as high as expected. Growth was also stronger than expected at 3.5% yoy (consensus was 3.3% yoy). Challenger, Andrzej Duda, won the first round of the presidential election against incumbent, Bronislaw Komorowski. The second round will be on 24 May.
- Singapore: Non-oil domestic exports – a good indicator of regional trade activity – rose 2.2% yoy in April versus -5.0% yoy expected.
- South Korea: The Bank of Korea (BOK) kept rates unchanged at 1.75% with just one single dissenter wanting to see rates cut. The Korean economy has recently experienced a mild domestic recovery, but exports have been hurt badly by currency intervention in Japan, a major competitor in the export markets. The BOK has generally acted prudently, cutting less than expected.
- Thailand: The rate of real GDP growth in Q1 accelerated to 3.0% in Q1 2015 from 2.1% yoy in Q4 2014. This was partly due to base effects – on a sequential basis growth slowed in Q1, though the qoq growth rate was still higher than expected (0.3% qoq sa versus -0.6% qoq sa expected).
- The Philippines: The central bank left rates unchanged at 4%. Growth in the Philippines remains strong amidst modest inflation. Exports rose 4.9% during the month of March, which pushed the growth rate of exports to 2.1% yoy (far stronger than the -3.9% yoy rate expected).

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Global backdrop

Following weaker than expected factory orders for March, the US economy is now tracking -1.1% qoq annualised growth in Q1, while the Atlanta Fed's tracking forecast for Q2 is down to 0.7% qoq annualised following a soft retail sales number. One bright spot has been initial jobless claims, which continue to fall, but note that the sharp fall in the participation rate in the US labour market means that the 'equilibrium' turnover rate of claimants is now also lower. In other words, labour markets are still some way away from producing inflation. Global markets are still trying to determine what this weak US growth data means from a trading perspective. The strongly held consensus (backed by huge positioning) of a stronger US economy and early Fed hikes has been shattered, but has yet to find a replacement. This makes for volatile, directionless markets. And given these positions the 'pain trade' is clearly that US stocks continue to trade lower, weakening the USD and pushing oil prices and long-end yields higher. In our view, the current volatility is mainly a technical adjustment, not a genuine change in consensus. The world has not changed much. Countries do not escape business cycles, even when their trend growth rates are lower and their central banks print money. Thus, both the European upturn – IP was up 3.7% qoq annualised in Q1 2015 – and the US downturn are nothing other than cyclical undulations around largely unchanged weak growth trends. We still have low growth, low inflation and low rates in developed economies. Hence, the global backdrop is more or less the same.

What has changed, however, are valuations. Endless Quantitative Easing from the Western world and near-religious faith in a strong US economy regardless of the strength of the Dollar and rate hikes prospects led investors to push German yields to zero and the USD so high that the US economy began to hurt. Clearly, valuations had moved out of line with fundamentals. This is what precipitated the unwinding of consensus trades over the past few weeks, including USD weakness, higher German term yields and higher oil prices. It is likely, however, that this adjustment will be relatively short-lived – barring further serious deterioration in the US economy. Indeed, the price action of the past week suggests some reversal already. The global consensus bullish view of the US economy remains strong among the majority of global investors and should take hold again after prices have adjusted a little. This raises the prospect that we will soon see another clash of fundamentals and valuations, i.e. more volatility. The greater, sustained unwinding of the Dollar long is likely to happen only after inflation resurfaces in the US economy.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.35%	9.73%	4.13%	6.18%	4.49%
MSCI EM Small Cap	0.55%	13.62%	9.22%	9.67%	5.45%
MSCI Frontier	-1.01%	-0.93%	-8.08%	12.10%	5.69%
MSCI Asia	-1.12%	11.18%	13.42%	11.36%	8.34%
MSCI EMEA	1.16%	11.97%	-5.06%	2.48%	2.26%
MSCI Latam	2.89%	2.70%	-15.44%	-4.68%	-3.25%
GBI EM GD	1.12%	-0.05%	-10.07%	-1.53%	1.89%
ELMI+	1.08%	1.73%	-7.00%	-1.00%	0.29%
EM FX Spot	1.05%	-2.73%	-15.95%	N/A	N/A
EMBI GD	-0.25%	3.42%	3.83%	5.64%	7.33%
EMBI GD IG	-0.55%	2.44%	4.79%	4.55%	6.57%
EMBI GD HY	0.20%	4.68%	1.67%	7.38%	8.46%
CEMBI BD	0.39%	4.52%	4.70%	5.91%	6.53%
CEMBI BD HG	-0.12%	3.09%	5.05%	5.56%	6.44%
CEMBI BD HY	1.35%	7.19%	3.60%	6.82%	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	1.93%	3.89%	15.76%	19.36%	15.72%
2 year UST	0.13%	0.85%	1.10%	0.62%	0.88%
5 year UST	0.06%	1.70%	2.65%	1.13%	2.88%
7 year UST	-0.26%	1.51%	3.92%	1.71%	4.47%
10 year UST	-2.50%	-2.71%	4.95%	1.54%	6.18%
US HY	0.22%	4.03%	1.73%	7.57%	9.13%
European HY	-0.10%	3.88%	4.64%	12.52%	11.45%
Barclays Ag	0.14%	-0.74%	-4.14%	0.08%	2.83%
VIX Index*	-12.23%	-33.49%	2.65%	-49.12%	-61.94%
DXY Index*	-1.16%	3.58%	16.81%	15.02%	7.27%
CRY Index*	0.86%	0.65%	-24.34%	-20.31%	-9.21%
EURUSD	1.57%	-5.77%	-16.84%	-10.81%	-6.57%
USDJPY	-0.26%	-0.01%	-15.20%	-33.98%	-22.94%
Brent	1.09%	17.76%	-38.49%	-36.99%	-9.30%
Gold spot	3.74%	3.70%	-4.98%	-22.87%	0.29%

*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.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Beijing
T: +86 10 5764 2601

Bogota
T: +57 1 347 0649

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Sao Paulo
T: +55 11 3556 8900

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

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