Issued: January 2017

MARKET COMMENTARY

Ashmore

Border adjustment

By Jan Dehn

President-elect Donald Trump is threatening US and foreign corporations with new taxes on a daily basis in a clear sign that the risk of US protectionism is rising. Much of the debate about US economic policy revolves around so-called 'border adjustments'.

There is a great deal of misinformation on this subject, wherefore we would like to point out the following:

1. Border adjustment is a euphemism for trade tariffs and export subsidies. From the perspective of any country exporting to the US, border adjustment has exactly the same effect as a tariff in that it reduces US imports. As such, border adjustment is likely to incur retaliation.
2. Contrary to some reports, the US trade balance will not improve as a result of border adjustment.[1] This is because the resulting decline in imports will be offset by a fall in exports due to a rise in the USD.
3. Instead, border adjustment acts like a wedge between foreign and domestic markets, which reduces the overall share of trade in US GDP. This moves the US economy closer to autarchy and undermines well-established gains from international trade. As a result, border adjustment can be expected to further erode the US trend growth rate.
4. Border adjustment will also increase the price of all imports into the US economy by the size of the effective tariff: as such border adjustments are highly inflationary. Inflation will undermine the real incomes of US consumers and force the Fed to hike rates, which could jeopardise the stock market rally and push the economy closer to an overdue recession.
5. President-elect Donald Trump's proposed protectionist measures are part of a broader package which centres on fiscal stimulus, mainly through corporate tax cuts. The net effect of this combination of policies will be to widen both fiscal and trade imbalances in the US and therefore push the US real effective exchange rate even further into overvalued territory. This raises, rather than reduces, the downside risks to US markets, the US economy and especially the USD going forward.
6. Fiscal stimulus and protectionism are extremely inappropriate at this point of the US business cycle, where the economy is at full or near full employment. The USD is overvalued in real terms. The correct policy prescription would be one that depreciated the real exchange rate by improving productivity, lowering domestic production costs and weakening the Dollar. Trump's policies will do the opposite.
7. The effect on EM currencies is likely to be modest due to their extreme cheapness versus the USD. We expect the currency impact to be concentrated in a small number of EM currencies, where investors can easily protect themselves – and even add alpha – by engaging in active management.
8. We remain bullish on EM local markets due to a combination of historically low real effective exchange rates, attractive yields, benign technicals and improving fundamentals.[2] Trump headlines will move markets in the short term, but declining deflation fears in the US and the gradual scaling back of QE programmes are removing powerful tailwinds that have aided fixed income markets in developed economies and hurt them in EM. Developed markets bonds look very unattractive, barring in a recession scenario. Investors will need to own fixed income even as they rotate into stocks, so we expect greater interest in EM fixed income going forward. Indeed, we see the recent return to positive correlation between EM fixed income and US stock markets to be sustained going forward with likely outperformance of EM fixed income during bouts of US stock markets weakness.

Later today Ashmore will publish 'Trump and EM', which is the latest issue in our Emerging View series. This publication examines Donald Trump's polices as proposed in greater detail and spells out the likely ramifications for the US economy and any potential spill-over – positive as well as negative – to EM countries.

---

[1] *"Emerging world in line of fire of US 'border tax'"*, 10 January 2017.
[2] See *"2017 Emerging Markets Outlook"*, The Emerging View, December 2016.

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 1 347 0649

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +91 22 6608 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

Other locations
Lima
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper