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WEEKLY INVESTOR RESEARCH

Ashmore

Erdogan's gamble pays off

By Jan Dehn

The political situation in Turkey looks better after AKP's victory in the parliamentary election at the weekend. China scraps the one child policy. Venezuela completes the main remaining debt services payments of 2015. Macri pulls ahead of Scioli in Argentina as a New York judge recognises the so-called 'me toos'. Brazil adjusts its fiscal targets down and Nigeria looks set to depart the JP Morgan GBI EM GD index this month. In the global backdrop, ECB President Draghi hints at further easing and the Fed hints at tightening.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	-2.38%
MSCI EM Small Cap	11.9	–	-1.51%
MSCI Frontier	9.0	–	1.92%
MSCI Asia	11.3	–	-2.21%
Shanghai Composite	12.7	–	-0.88%
Hong Kong Hang Seng	7.2	–	-3.22%
MSCI EMEA	9.8	–	-3.10%
MSCI Latam	13.0	–	-2.12%
GBI-EM-GD	6.82%	–	-0.36%
ELMI+	4.48%	–	-0.49%
EM FX spot	–	–	-0.42%
EMBI GD	6.02%	385 bps	-0.21%
EMBI GD IG	4.76%	252 bps	-0.50%
EMBI GD HY	8.11%	609 bps	0.18%
CEMBI BD	5.93%	397 bps	-0.01%
CEMBI BD HG	4.49%	254 bps	-0.18%
CEMBI BD HY	8.43%	647 bps	0.28%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.1	–	0.22%
1-3 year UST	0.75%	–	-0.17%
3-5 year UST	1.55%	–	-0.36%
7-10 year UST	2.17%	–	-0.40%
10+ years UST	2.95%	–	-0.27%
US HY	7.80%	642 bps	-0.13%
European HY	5.03%	513 bps	0.49%
Barclays Ag	–	227 bps	-0.25%
VIX Index*	15.07	–	0.61%
DXY Index*	96.87	–	0.01%
EURUSD	1.1018	–	-0.33%
USDJPY	120.59	–	-0.33%
CRY Index*	195.61	–	1.89%
Brent	48.8	–	2.73%
Gold spot	1137	–	-2.40%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions. Data as at 30.10.2015.

Emerging Markets

- **Turkey:** The near-term political outlook for Turkey looks substantially better today following a decisive victory for President Erdogan's AKP in the weekend's parliamentary election. AKP took an absolute majority of seats in parliament – but not enough seats to change the constitution. This removes, for the foreseeable future, the potential threat of lawsuits and other legal measures against senior government officials and thus stabilises the overall political environment considerably. AKP's victory will also strengthen President Erdogan's power within the AKP. The Kurdish HDP party managed to hold on to more than 10% of the votes. This denied AKP the majority required to change the constitution, for example to grant President Erdogan more powers.

Erdogan pursued an aggressive election strategy of confrontation with the Kurds and intervention in the war in Syria and Northern Iraq in a bid to win back defectors from the AKP to the Kurdish HDP and nationalist MHP parties. This strategy appears to have paid off, thus removing the need for a coalition with CHP, the party of Mustafa Kemal (aka Ataturk).

The election outcome is likely to reduce the near-term uncertainty surrounding the political outlook. However, Erdogan's election strategy has left the political environment in Turkey highly polarised, so some mending of fences may now be required, particularly as pertains to relations with Turkey's Kurdish minority.

Markets will now be intensely focused on who gets the nod to run the economy and whether long-promised economic reforms will receive fresh momentum.

On the foreign policy front, the escalation of the Syrian refugee crisis has increased the importance of Turkey to the European Union. This, too, is an opportunity for Erdogan. While Erdogan's domestic political instinct has once again been proven excellent, he has yet to prove that he can design a foreign policy that successfully exploits Turkey's enormous strategic importance to the maximum.

- **China:** Almost every week China takes a major policy initiative. Opposite to the actions of governments in the QE world, China's policy initiatives are mainly structural in nature. This is good. China has a big job on its hands changing its economy from export to domestic demand led growth. But to its great credit, it is positively getting on with the job, while most QE economies wallow in pathetic passivity.

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Emerging Markets

The big announcement this week was the scrapping of China's one-child policy. With one stroke, China can expect to significantly increase its birth rate. Apart from the benefits this will impart to producers of children's goods and services, the new policy will deliver a substantially larger labour force precisely when the demographic profile of China begins to pose challenges for the pension system.

The pension system also received attention last week, when the government announced that pension funds will be allowed to invest up to 30% in stocks starting in 2016. This should result in a significant increase in demand for stocks. More importantly, greater involvement of the pension system in the stock market will raise the level of sophistication of a market which is simply too dominated by retail investors.

Increasing the involvement of institutional investors in the Chinese equity market is absolutely the right policy conclusion to be drawn from the recent episode of stock market volatility. The government is also pushing for greater involvement in the stock market by provincial level pension funds – again, this is important because a more devolved system of institutional players, i.e. more institutional participants, will ensure far more efficient trading.

What China needs to do next is to increase foreign institutional involvement in the domestic market. They can do this by converting more QFII quotas to RQFII quotas and by allowing asset managers with RQFII quotas to allocate the quotas across all their funds instead of confining the quota to China specific funds (the reason being that very few pension funds and insurance companies in the Western world have yet evolved to the point that they buy single country funds in Emerging Markets (EM)).

This week China will likely take an important step towards greater foreign institutional involvement in the local market. The IMF is set to formally decide on the RMB's inclusion in the SDR basket with implementation taking effect from Q4 2016. The US government has already signalled its agreement. China has made progress in converging its FX fixing with spot rates – a move that the market and most of the financial media wrongly interpreted as a deliberate devaluation. Indeed, the profundity of the financial industry's lack of understanding of China was thus embarrassingly displayed. If anything, China is likely to be on its very best behaviour when it comes to FX policy over the coming year precisely because the objective of SDR inclusion is now so tantalisingly close (and valuable). China has made enormous progress in qualifying for SDR inclusion in recent months. It has begun to issue short dated securities on a regular basis in order to provide a liquid short term rates market, while foreign institutions have been given far greater access to onshore interbank markets. Full interest rate liberalisation was achieved in October. The RMB will likely enter the SDR basket with a weight of about 13%, raising the average SDR rate by more than 20bps due to China's more elevated real rates. Institutions will be slow to allocate to China despite the excellent value in its local bond market. They will wait for China's local markets to enter indices, for example. In a sad indictment of the backwards looking nature of the financial industry, many will also choose only to allocate when others do. Meanwhile, the early movers continue to enjoy excellent returns in the government bond market, knowing that the technicals are highly attractive. After all, with a population five times bigger than that of the US, China is destined not only to overtake the US economy in size, but ultimately also to take over the US dollar's status as pre-eminent global reserve currency and the US Treasury market's position as the world's most liquid benchmark bond market.

- Venezuela: Over the past two weeks, the government scaled the main remaining challenge posed by the amortization of the PDVSA 15s and 17s new bonds by paying about USD 5bn in bond amortisations and interest payments. Bond markets have been pricing in default for Venezuelan bonds for most of the year, but Venezuela has continued to pay, despite serious economic difficulties and the pressures of an upcoming election. The next major bond repayments are now in Q1 2016 and particularly in October-November 2016. There will be more political room for Venezuela to take measure to enable it to service debt once the parliamentary election in December is over. Polls continue to show that the opposition will win.

- Argentina: A recent poll published by pollster Elypsis last week shows that Mauricio Macri, runner up in the recent first round of the presidential election, is pulling ahead of Daniel Scioli, a candidate close to current president Cristina Kirchner. Macri secured 47.8% of voting intentions compared to 37.2% for Scioli. This is very good news. Macri is more trusted by the market than Scioli, although in practice the two candidates would likely pursue broadly the same policies. The second round of the election is on 22 November 2015. Kingmaker Sergio Massa, third placed candidate whose support will now be key to the outcome of the second round of the presidential election, set out his policies in a meeting with the media last week. He stayed clear of debt and currency issues knowing that his policies are the same as the other candidates. Instead, he promises to refinance provincial debt, which is a clear message to provincial governors to support him (provincial governors are very powerful in Argentina). His other messages were populist, including promises to fight corruption, increasing pensions, etc. Massa is trying to build his support so he can sell himself (and presumably his votes) to the highest bidder. In our view, he can still end up supporting either Macri or Scioli.

Judge Griesa of the 2nd District Court in New York has granted non-plaintiff holdout investors from the 2001 (so-called 'me toos') the same rights as the plaintiff. This means that this segment of holdout investors can piggy-back on the court's rulings in favour of the plaintiff, NML. The ruling has ambiguous implications for investors in Argentinian debt. On the one hand, it will now be harder for Argentina to divide the holdout investors with a view to striking different deals with each segment. On the other hand, there are now better

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Emerging Markets

prospects for a single deal to resolve the entire issue, thus cutting down the period of uncertainty. All candidates in the Argentinian presidential election have indicated that they will seek a resolution with holdout investors early in the next administration.

- **Brazil:** The government has now formally adopted a less ambitious primary fiscal balance target for 2015 of -0.85% of GDP, revised down from +0.15% of GDP. The miss is due to a sharper than expected downturn in the economy and inability to pass tough measures in congress due to President Dilma Rousseff's loss of political capital due to a corruption scandal.

- **Nigeria:** Nigeria will be fully excommunicated from the JP Morgan GBI EM GD index this month. Nigeria's index weight is 79bps. Nigeria has resisted currency adjustment following the fall in oil prices and has quickly lost the trust of foreign investors. Domestic bond and FX market liquidity has also been severely restricted due to government intervention. This is why Nigeria will now be dropped for the GBI index. This is a very regressive step. Institutional investors will leave the market, so the quality of the foreign investor base will drop sharply, resulting in more volatile markets.

Snippets:

- **China:** The latest manufacturing data out of China has been ambiguous. On the one hand, the PMI was unchanged in October compared to September (49.8).This was marginally softer than expected. On the other hand, Caixin/Markit PMI rose to 48.3 in October from 47.2 in September. Overall, both numbers remain below 50, which indicates expansion.
- **Colombia:** The central bank hiked interest rates by 50bps to 5.25%, responding to strong domestic demand and a much weaker currency due to falling oil prices.
- **Dominican Republic:** The economy expanded by a healthy 7.1% yoy in Q3 2015, taking the ytd real economic expansion in 2015 to 6.7% so far.
- **Indonesia:** Core inflation declined to 5% yoy in October from 5.1% yoy in September. Headline inflation was 6.2% yoy versus 6.4% yoy expected.
- **Kenya:** October inflation was 6.7% yoy compared to 6.0% yoy in September.
- **Mexico:** Banxico left rates unchanged at 3%. Economic activity accelerated to 2.6% yoy in August from 2.0% yoy in July.
- **Russia:** The Central Bank of Russia left policy rates unchanged, but issued a clear dovish message. The policy rate is 11%. The CBR has been decisive, aggressive and prudent in managing the severe external shocks hitting Russia in the past 18 months.
- **Saudi Arabia:** S&P, a ratings agency, has cut Saudi Arabia's sovereign credit rating from AA- to A+ with a negative outlook.
- **South Korea:** Exports declined 15.8% yoy in October, thus confirming the weakness of the 20-day advance export data. Imports also declined more than expected. The trade surplus was USD 6.7bn in October, down from USD 8.9bn in September.
- **Thailand:** For the 10th month in a row, inflation was negative. October's CPI index was down 0.77% yoy. Core inflation was a modest 0.95% yoy.
- **Zambia:** A combination of sharp currency depreciation and rising food prices due to insufficient rain pushed consumer prices sharply higher in October. Yoy inflation almost doubled to 14.3% from 7.7% in September.

Global backdrop

ECB President Mario 'The Oracle' Draghi proved once again his skills as canary in the coalmine when it comes to signalling Fed intentions. His dovish message last week – which included the prospect of more QE and negative rates – presaged perfectly the hawkish message issued from the Fed in its October FOMC meeting.

Recall that the main reason why ECB eases is not economic. Indeed, the economy remains healthy in Europe and when the ECB began QE in 2014 the economy was actually well into a decent upswing. Rather, the purpose of QE is to give the ECB the tools to avoid a European debt crisis if bond yields rise as a result of Fed hikes. QE and negative rates are the instruments by which the ECB hopes to keep yields in check to offset the effects of higher US rates. That is why the timing of Draghi's easing messages is so interesting.

The Fed did indeed hint strongly an intention to hike in December. The Fed is therefore back in full gambling mode, undoubtedly hoping to recover some of the credibility it lost after its latest two U-turns. In our view, it is a gamble, because one single bad employment print is all it will take to push the US stock market down sharply, especially if the Fed is officially in a hiking stance. Should stocks decline sharply the Fed will appear to be out of touch, which will soon force upon Yellen and Co another embarrassing U-turn. Anything that can move asset prices now matters a great deal. The rather uncomfortable truth is that nothing really exciting is happening in the economy, which has been running at a speed of 2% real GDP growth for several years (and will do so again this year), but financial markets, on the other hand, have been on steroids for years due to QE.

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Global backdrop

Asset prices are elevated relative to the state of the underlying economy and this means that even modest fundamental developments can have an amplified effect on asset prices. In turn, this can force the Fed to react. This is the main difference in the policy environment today compared to the pre-QE era. Before QE, the Fed could ignore the markets a bit more easily, because they were not overvalued. Today, with markets so inflated the Fed is forced to react to market moves to avoid collapsing a bubble of its own making. The Fed's hiking intensions will now push US Treasury yields higher and the US dollar up, but this will weigh on stocks and risk appetite. At the margin, the data will determine where we end up. If US data weakens the market will discount Fed hikes, expect another Fed U-turn and push down the US dollar. On the other hand, if the data gets stronger the market will believe that it is possible to have both growth and rate hikes the combination of which pushes up the US dollar.

Recently, the US data has been disappointing. US growth slowed sharply in Q3 to 1.5% qoq annualised from 3.9% qoq annualised in Q2. The Q3 growth rate was 0.1% below the expected value. The only major upside surprises in the data of the past week was the US trade balance, which added about 0.3% qoq annualised to the Q3 GDP number and Chicago PMI. The rest of the US data continues to be discouraging, including new home sales, which collapsed by more than 11% mom to the lowest level for more than two years and durable goods spending that declined 1.2% mom in September, with weakness particularly concentrated in the orders component. Consumer confidence also weakened along with services PMI.

Fortunately, the US Congress found a solution to the debt and spending ceiling challenges. Congress Republicans have continuously failed to make political hay from playing the debt ceiling game, so they finally opted to remove the issue entirely from the agenda by extending the debt ceiling until Q1 2017. This allows them to focus on the upcoming election campaign, while President Obama – and global financial markets – can look forward to one less source of risk and irritation. Indeed, the election of Paul Ryan, a parliamentarian with strong technical credentials, as House Speaker is good news, in our view. There is much to do to fix the fiscal situation in the US and Ryan understands all the issues.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	7.14%	-9.22%	-14.23%	-2.56%	-2.47%
MSCI EM Small Cap	5.92%	-4.31%	-8.41%	1.61%	-1.81%
MSCI Frontier	3.67%	-10.44%	-17.98%	7.67%	2.01%
MSCI Asia	7.96%	-5.38%	-6.98%	2.90%	1.70%
Shanghai Composite	10.83%	6.21%	41.97%	20.96%	5.11%
Hong Kong Hang Seng	10.54%	-10.58%	-0.34%	3.25%	-1.14%
MSCI EMEA	5.41%	-7.79%	-18.20%	-6.89%	-4.76%
MSCI Latam	6.11%	-24.66%	-34.68%	-15.53%	-12.21%
GBI EM GD	4.53%	-11.06%	-17.42%	-7.53%	-2.94%
ELMI+	2.39%	-5.27%	-9.96%	-4.46%	-2.72%
EM FX Spot	2.38%	-14.34%	-20.56%	-11.66%	-8.87%
EMBI GD	2.74%	2.67%	0.39%	2.12%	4.90%
EMBI GD IG	2.57%	0.43%	0.05%	1.03%	4.11%
EMBI GD HY	2.97%	5.72%	-0.06%	3.70%	6.08%
CEMBI BD	2.23%	3.10%	0.93%	2.95%	4.65%
CEMBI BD HG	1.36%	2.55%	1.82%	3.00%	4.87%
CEMBI BD HY	3.71%	3.95%	-1.18%	2.95%	4.31%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	8.44%	2.70%	5.19%	16.21%	14.31%
1-3 year UST	-0.17%	0.78%	0.71%	0.52%	0.67%
3-5 year UST	-0.54%	2.15%	2.35%	1.42%	1.56%
7-10 year UST	-0.72%	2.80%	4.34%	1.78%	4.10%
10+ years UST	-0.51%	-0.06%	6.04%	2.76%	7.62%
US HY	2.51%	0.19%	-2.30%	4.27%	6.62%
European HY	2.87%	3.04%	3.71%	8.48%	9.84%
Barclays Ag	0.63%	0.33%	1.30%	2.80%	4.31%
VIX Index*	0.00%	-21.51%	7.41%	-14.33%	-30.13%
DXY Index*	-0.08%	7.31%	11.45%	20.19%	26.26%
CRY Index*	0.00%	-14.94%	-28.08%	-33.08%	-35.86%
EURUSD	0.11%	-8.94%	-11.75%	-14.16%	-21.50%
USDJPY	-0.02%	0.63%	5.83%	49.93%	49.39%
Brent	-1.45%	-14.81%	-43.12%	-53.79%	-42.82%
Gold spot	-0.47%	-4.31%	-3.01%	-32.25%	-16.20%

*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. Data as at 30 October 2015.
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

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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