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WEEKLY INVESTOR RESEARCH

Ashmore

Business as usual in Emerging Markets as year-end market dynamics begin to make themselves felt

By Jan Dehn

Breath-taking pace of reform in Mexico, 10% rates in Brazil, scorching growth in the Philippines, a resolution to the YPF dispute in Argentina, the government survives a no-confidence vote in Thailand, South Korea's big BOP surplus surprise, Nigeria set to overtake South Africa as the continent's largest economy, Ukraine plays both sides, and India starts to debate moving local bonds to Euroclear settlement. In short, business as usual in Emerging Markets (EM). Global market sentiment produced headwinds for EM fixed income, but support for EM and Frontier Market equities. Year-end market dynamics – fast money squaring positions – may already be making themselves felt. US data was mixed to marginally positive, and Germany moved towards a grand coalition government. The main global market focus this week will be US payrolls before attention switches to December's FOMC meeting.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,020		0.94%
MSCI FM	581		0.27%
GBI-GD	6.78%		-0.62%
ELMI+*	4.42%		-0.24%
EMBI GD*	5.87%	311 bps	-0.28%
EMBI GD IG*	4.96%	219 bps	-0.18%
EMBI GD HY*	9.53%	703 bps	-0.51%
CEMBI BD*	5.61%	337 bps	0.01%
CEMBI BD HG*	4.76%	251 bps	-0.01%
CEMBI BD HY*	7.53%	534 bps	-0.02%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,806	0.10%
VIX Index	13.70	11.75%
5 year UST	1.41%	7 bps
10 year UST	2.79%	6 bps
10 year Bund	1.73%	0 bps
EURUSD	1.3575	0.45%
USDJPY	102.77	1.07%
Brent	$110	-1.73%
Copper	$326	-0.56%
Gold	$1239	-0.19%

*Data as at 27 November 2013

Emerging Markets

- Mexico: Mexico continues to reform at a breath-taking pace. Last week the government passed an important financial sector reform, which should help to raise Mexico's very low private credit to GDP ratio (just 15% compared to a Latin American average of 40%). Inter alia, the reform streamlines bankruptcy procedures, eases issuance procedures, strengthens the Financial Stability Board and other regulatory agencies, introduces various consumer protection measures, and redefines the role of development banks to foster improved access to credit and financial services. Financial sector development is the handmaiden of growth, necessary to ensure capital is allocated to areas of the economy requiring investment. This reform will increase Mexico's trend growth rate. Next week we expect political reform followed by a reform of the energy sector, which will introduce private sector participation in the oil sector.
- Brazil: Brazil's central bank raised policy interest rates to 10% last week and signalled that the pace of hikes may slow from 50bps to 25bps, provided the data supports such a moderation in the pace of tightening. A small number of large EM countries have inflicted the need for macroeconomic adjustment upon themselves in the past few years by over-stimulating domestic demand. When these policies undermined domestic and external confidence earlier this year Brazil and other governments responded to restore macroeconomic balance. Thus, in Brazil IPCA inflation has declined from a peak of 6.7% in June to 5.8% today in response to policy rates, which have risen from 7.25% in April to 10% today. The only thing that is worse than slower growth is higher inflation; the central bank is responding accordingly.
- Philippines: The economy of the Philippines expanded by 4.5% in real terms in the Q3 2013. This quarterly expansion means that the economy is now 7% greater than in the same quarter last year. Domestic demand is driving growth, but unlike earlier this year private consumption and investment have now replaced government spending as the main source of expansion. Exports continue to be a drag on growth. Undoubtedly, the recent typhoon related damage will dampen Q4 growth, but reconstruction spending will then begin to add to GDP growth numbers in subsequent quarters.
- Argentina: The on-going dispute between a Spanish oil company and the Argentinean government following the April 2012 nationalisation of YPF Repsol looks to be drawing to a close, when the two parties announced progress on negotiations for a settlement. This is positive development. The lack of a resolution to the dispute has prevented Argentina from attracting investment into its massive shale gas deposits, which are estimated by the US Energy Information Administration to be the third largest on the planet.

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Emerging Markets

- Thailand: Premier Yingluck Thaksin survived a non-confidence vote as the domestic political dispute between the government (which holds a commanding majority in parliament) and the opposition continued. We do not expect this noise and protracted conflict to abate anytime soon. The divisions run deep and long, largely along income and rural-urban lines. The king, a unifying force, is in ailing health with no popular heir. The opposition has little chance of getting power via the ballot box, but if social unrest escalates to the point where the military takes power the government could be temporarily unseated. Previously, coups have quickly given way to fresh elections with little permanent impact on Thailand's attractiveness as a destination for portfolio investors and tourists. Thailand averages two coups each decade, but that does not mean that it will happen again. Still, in light of the continuing political impasse the central bank cut rates from 2.5% to 2.25%.
- South Korea: Current account surplus rose to USD 9.5bn in October compared to USD 6.5bn in September and USD 5.7bn in August. The goods trade account surplus was USD 7.0bn, up from USD 5.7bn in September. The services balance also improved. Investment in securities increased by USD 4.5bn, but loans, deposits, and currencies recorded outflows. Overall, the balance of payments recorded a surplus of USD 4.7bn in October, up from USD 2.9bn in September. On a 12-month rolling basis the balance of payments surplus rose from USD 8.5bn in September to USD 11.7bn in October (0.9% of GDP).
- Ukraine: The Ukranian government remains non-committal in its relations with Russia and the European Union. The former offers immediate financial relief, but likely in exchange for 'a pound of flesh', i.e. loss of sovereignty, while the European Union offers greater independence, but in exchange for political and economic concessions, which Ukraine's administration does not appear ready to satisfy ahead of elections scheduled for March 2015. Tensions with Russia often peak in mid-winter, when Russia's energy-based leverage over the country reaches a peak. Promises of independent sources of fresh finance, such as the recent commitment by two international oil companies to invest in Ukraine's shale gas fields, allow Ukraine to continue toeing the tightrope between Russia and the European Union (for further background refer to Weekly Investor Research, 11 November 2013).
- Nigeria: The Nigerian Bureau of Statistics announced that it will rebase its GDP figures based on 2010 data, rather than 1990. The emergence of whole new sectors in the economy, such as telecoms and significant growth in private consumption in the country will result in a significant upward revision to current USD GDP levels. As a result, Nigeria's GDP – currently USD 270bn – may overtake that of South Africa after the revision. The projected GDP level for Nigeria after the revision is in the range of USD 340bn to USD 420bn. Nigeria is expected to grow some 6-7% in 2013. South Africa's GDP in 2012 was USD 384bn.
- India: Indian officials indicated last week that the government is looking into moving local currency bonds to Euroclear settlement. This would be a very positive development. India's USD 700bn domestic fixed income market is difficult to access for foreign investors due to archaic settlement procedures. In addition, the market remains excluded from major EM benchmark indices on account of quotas, which limit free trading by foreigners. We expect India eventually to open its market to foreign fixed income investors (the equity market is already freely accessible). Given the size of India's domestic market this would move India's index weight in the JP Morgan GBI-EM Global Diversified Index from zero to 10%, in our view.

Global backdrop

There are signs of the usual year-end global market dynamics are beginning to take root, meaning position squaring and reluctance on the part of short-term investors and banks to take directional views ahead of what is usually a period of declining liquidity leading up to the New Year. Global market liquidity was also low in a holiday shortened US trading week. This global backdrop produced headwinds for EM fixed income and currencies, but the environment was stronger for EM stocks. Valuations in EM equities remain at a significant discount to DMs, at roughly 40%. Earnings are already beginning to recover in EM equities as the market recognises the resilience of EMs to tapering risk, stable inflation and a strong consumer market.

Fundamentals in the developed world did not change materially. US data releases were mixed to slightly positive. Labour markets improved, but the data should be discounted somewhat due to the Veteran Day holiday. Core household durable goods spending was weaker than expected, housing sector data was mixed, with bigger than expected house price rises in major cities, but lower than expected house price appreciation in a broader sample of destinations. This discrepancy probably reflects a gradual transmission of inflation of financial asset prices due to QE into non-financial investment prices, such as housing in larger cities with big financial industries. Mortgage applications declined, but manufacturing was strong in Illinois and Richmond. Two releases of consumer confidence data gave conflicting results.

Looking ahead, the focus this week will be on US payrolls, ISM, and new home sales. Further ahead, the FOMC meeting of 17-18 December will command attention as some commentators believe that the Fed could taper in

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Global backdrop

December (for our views see *"Fed Captain and the World of Tomorrow",* The Emerging View, November 2013). Early 2014 will see extended unemployment benefits expire for 1.3m claimants, which could reduce consumption by 0.4% of GDP unless the benefits are extended. The resulting 0.2%-0.5% decline in the unemployment rate could undermine the credibility of a lower unemployment rate as a threshold for raising interest rates in the context of a renewed attempt by the Fed to taper QE.

Elsewhere, Germany's two largest political groups reached agreement on the basic pillars of a grand coalition, while Italian parliamentarians ousted former Prime Minister Silvio Berlusconi from the Senate. Officials at the Bank of Japan indicated that further easing could be necessary if the market loses confidence in the current anti-deflation strategy fails. USDJPY rallied sharply as a result.

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