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WEEKLY INVESTOR RESEARCH

Ashmore

Cold War echo

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Events in Ukraine are a reminder of just how damaging the Cold War was for Emerging Markets. The silver lining is that superpower tensions are much less prevalent today and we think economic constraints make it unlikely that the problem will spread beyond a few strategically misfortunate EM countries such as Egypt and Syria. Indeed, elsewhere the 'Fragile Five' are gradually turning into the 'Frugal Five'. We also discuss currency volatility in China and the situation in Venezuela. The US data was better last week, but still consistent with an inventory correction rather than just bad weather. Europe's credit system remains highly ineffective although the Eurozone continues to grow slowly and steadily.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	954		-0.48%
MSCI EM Small Cap	1,015		0.54%
MSCI FM	612		-0.08%
GBI-GD	6.98%		0.22%
ELMI+	3.92%		-0.11%
EMBI GD	5.69%	320 bps	0.87%
EMBI GD IG	4.79%	212 bps	0.71%
EMBI GD HY	7.91%	574 bps	1.18%
CEMBI BD	5.48%	323 bps	0.38%
CEMBI BD HG	4.57%	233 bps	0.44%
CEMBI BD HY	7.36%	511 bps	0.23%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1859	0.68%
VIX Index	14.00	-1.62%
5 year UST	1.47%	-8 bps
10 year UST	2.61%	-13 bps
DAX	9501	-2.14%
10 year Bund	1.57%	-11 bps
EURUSD	1.3771	0.26%
USDJPY	101.33	-1.15%
Brent	110.45	-0.20%
Copper	329.11	-0.45%
Gold	1344.36	0.55%

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

Emerging Markets

Ukraine is an unpleasant reminder of the Cold War

Ukraine's problems echo the serious challenges the Cold War used to present in EM countries. Today, however, the effects should be limited to a tiny proportion of EM countries. Economic constraints on the part of large countries, including the US and Russia, make it unlikely that the Cold War problem will spread beyond a few strategically misfortunate EM countries. As for Ukraine itself, we primarily focus here on Kiev's efforts to build economic stabilisation, while media attention will likely focus on Crimea and the potential for military confrontation – the escalation of which could clearly change conditions materially. Investors should expect the situation in Ukraine to remain volatile and fluid for some time.

In the past few days, Russia sent troops to Crimea, the location of a major Russian naval base. This happened despite assurances from Russia's President Vladimir Putin that Russia would maintain Ukraine's territorial integrity. Crimea now looks set to remain in Russian hands, much like Guantanamo in Cuba is controlled by the US. The EU/US responded with strong rhetoric, but so far without indications that there is appetite for military escalation. The obvious potential downside risk in Ukraine is the outbreak of violence between EU/US and Russia via local proxies, especially in Eastern Ukraine. This is why it is so important to move towards elections quickly and that a consensus candidate emerges.

This is classical Cold War stuff. Ukraine's problems are a potent reminder how damaging the Cold War era was for EM countries. During that time, the internal affairs of many EM countries regularly fell hostage to tensions between Superpowers. Superpowers variously sponsored and unseated local despots that were allowed to rule with impunity at the expense of local political accountability. Fortunately, today only a very small number of EM countries are caught up in Cold War dynamics today. Ukraine is one. Syria another. Egypt a third. This small group of unfortunate countries are riskier than other EM countries, especially if they also have sharp internal divisions that can be exploited.

Still, we think Ukraine is likely to end up in a different place than Syria. Ukraine already has a new government and much now depends on the strength of its leadership. Its primary task has to establish economic stability, which in turn will generate greater legitimacy. Strong leadership will also force EU/US and Russia to work to Ukraine's priorities, not the other way around. But clearly final clarity about the longer-term political outlook will only arrive after the elections scheduled for May this year.

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Emerging Markets

While media will focus heavily on Crimea and the potential military angle, the key element from a long term investment perspective is economic stabilisation. The EU/US have signalled a desire to extend strong support for the new government in Kiev. A cabinet of the new technocratic administration has been formed. The government reform program was announced and early indications suggest that the administration is willing to make tough decisions. The IMF is due to visit Ukraine this week.

The IMF now needs to respond quickly to Ukraine's economic stabilisation program with an offer of a full financing package, including measures to stop the on-going run on the banks. Russia's voting share on the IMF board is less than 3%, well below the 15% required for a veto, so politics should not interfere too much on that front.

Ukraine's debt levels are relatively low and the country is solvent, though secession by Crimea would worsen the debt dynamics in the rest of Ukraine. Still, for now, Ukraine's economic problem is essentially a liquidity problem. International insistence on a haircut on privately held debt, such as in Greece, or, say, confiscation of foreign private bank deposits, such as in Cyprus, would therefore be major policy mistakes. They would discourage rather than encourage new private money and hurt business confidence. This would snuff out the rapid recovery, which remains eminently possible in Ukraine due to the country's low sensitivity to higher interest rates (small construction sector, etc). By contrast, a deepening of the economic crisis would quickly backfire on the interim administration and thus threaten the shift of political accountability away from Russia (under Yanukovich) towards the people.

We expect the IMF to assess the interim administration's adjustment proposal. We expect the leading candidates for the election in May to stay relatively quiet during the adjustment phase to avoid being tainted by the bitter medicine.

Both Russia and EU/US have economic skin in the Ukraine game. Ukraine owes Russia money, but Russia can raise gas prices. Russia is already paying a price – this morning Russia's central bank was forced to raise interest rates by 150bps. Moreover, G7 countries are talking about economic measures against Russia, though Europe would be vulnerable to counter-sanctions from Russia on account of Europe's heavy dependence on Russian energy. Net net, this interdependence is a good thing, though no guarantee against further escalation.

The Frugal Five

Last year, 'Fragile Five' became a catchy phrase to denote countries with current account deficits perceived to be in danger of crisis due to Fed tapering.

Today, it may soon be more appropriate to label these countries the 'Frugal Five'. All five countries have raised interest rates, all have adjusted their currencies, some have undertaken major fiscal adjustment too. These include changes to subsidy policies and, in the case of Brazil and Turkey, reversals of some of the more heterodox policies. It is clear that these countries never faced serious crisis risk. Instead, they faced the type of standard macroeconomic adjustment challenges that all countries face in the course of regular business cycles, usually self-inflicted rather than caused by anything the Fed has done. Stocks of reserves were simply too large, debts too low, and the room for policy adjustment too large to trigger crises, despite the very negative external environment.

Let us remind ourselves of the latest developments in the 'Frugal Five':

- India's trade deficit has halved, real growth has begun to rise after bottoming out at a still impressive 4.5% yoy rate in Q2 2013, and inflation has fallen sharply from more than 11% in late 2013 to 8.8% today.
- Brazil's growth rate more than doubled in 2013 compared to 2012, despite sharply rising policy interest rates and spending cuts that also helped to push down inflation. Indeed, last week the government released GDP growth for Q4, which showed that 2013 growth was 2.3% (from 1.0% in 2012) due to a much stronger than expected Q4 print (+0.7% qoq versus +0.3% qoq expected).
- South Africa's real exchange rate – a competitiveness indicator – has improved by more than 15% over the past 12 months against a backdrop of better than expected fiscal performance. Last week the government published a tighter than expected budget against a backdrop of realistic expectations of rising growth and declining inflation.
- Indonesia's trade balance has moved into outright surplus on a 3-month rolling average basis, while 2013 real GDP growth surprised to the upside at 5.8%. Inflation has also stabilised and should decline significantly over the coming months as the effect of recent subsidy reductions pass through the data.
- Turkey reacted much later than the other four and the full improvement in external balances and inflation rates still lies ahead of us. Still, the trade deficit dropped from USD 9.9bn in December to USD 6.8bn in January. We expect the recent decision by the central bank to raise rates to depress imports, while a more competitive currency will benefit exporters. The combination should produce significantly stronger external accounts this year as the inflation pass-through from the exchange rates begins to fade.

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Emerging Markets

The turnaround in the 'Frugal Five' illustrates two important points about EM economies: Firstly, EM policy makers may occasionally be late in adjusting (usually for fear of causing instability), but when they move they tend to do so decisively, with political backing. Secondly, EM countries have sound deeper fundamentals, so once their policy adjustments have begun their economies tend to respond quickly. It also helps that they tend to have highly flexible markets.

That is not to say everything is rosy in the 'Frugal Five'. It never will be, by the way. The legacy of having dabbled in discredited heterodox macroeconomic policies will make it difficult for Turkey and Brazil to generate a strong private sector investment response in this recovery. Turkey is also in the midst of an explosion of domestic political scandals (but we think the economic risks are much smaller). All five countries go to elections this year, so some short-term reticence among investors can be expected both at home and abroad. In Indonesia, India, and Turkey the elections have the potential to bring genuine renewal, but in Brazil and South Africa we do not expect major changes in the government.

Countries do not have to be perfect to warrant investment: they just have to be better than what is priced in and what is available elsewhere. The sooner investors get their heads around the fact that as a whole the 65-strong EM countries are generally healthy – including the 'Frugal Five' – the sooner they will see that EM is precisely that, better than what is priced in and better than what is available elsewhere.

China FX volatility

China continued to foster volatility in its two currency markets (CNY and CNH) via fixing moves and intervention via agents acting on behalf of the central bank. The purpose is to prevent speculation, to promote two-way trading as China slowly moves towards more FX flexibility, and to give the currency an attractive entry point for potential private investors prior to anticipated lower dollar sales (as exports revenues normalize from extra-ordinarily high levels in January).

Moderately better economic policies but worse politics in Venezuela

Political tensions are rising in Venezuela but at the same time the government is slowly beginning to address some of the worst macroeconomic imbalances. Against this somewhat contradictory backdrop, we think ability and willingness to pay remains strong. The erosion of political conditions creates noise, but without impacting the risk of default significantly, in our view. Venezuela can service debt and meet amortizations payments (USD 5bn this year) from dollar revenues at current oil prices and given the USD 20bn of reserves. There are also strong vested interests in the system of bond trading in Venezuela, including in the official sector. The recent introduction of multiple (three) exchange rates is a de facto devaluation, which is extremely positive for the public accounts. We do not expect major spread compression due to continuing supply of dollar bonds, but we think a sovereign spread of 1280bps over US treasuries offers value at this time. As for the political tensions, they are due to shortages, inflation, and the arrest of an opposition leader (Leopoldo Lopez). The opposition in Venezuela refused to attend a government sponsored summit to ease tensions. There has been violence.

Global backdrop

In Europe, the ECB's monetary survey suggested that the Eurozone economy is growing slowly but steadily. M1 expanded 6.2% yoy in January, consistent with real GDP growth of 2.0%, but loan growth continued to be negative. The reason is that European banks are insolvent and this is also why Europe's recovery will lag that of the US recovery. But in the end this means that US will also get inflation earlier than Europe, supporting the EUR versus the Dollar over the medium term. Lastly, in Italy Prime Minister Renzi won a confidence vote and can now get on with governing.

Japanese Industrial Production rose 4.0% in January, significantly higher than expected (2.8%), but most likely due to a temporary surge in consumer demand prior to a VAT hike scheduled for April. This does not bode well for economic activity in Q2 and could prompt further stimulus, in our view. Headline CPI inflation declined from 1.6% in December to 1.4% in January (core was unchanged at 1.3% versus the BOJ's target of 2%).

In the US, US Fed Chairwoman Janet Yellen said in a testimony last week that the pace of tapering depends on how much of the recent slowdown in the US data is due to weather. This is a slight shift in a dovish direction from the Fed, in our view. As for the data itself, it is slowly getting better, especially compared to the first six weeks of 2014 when the data was unambiguously weak. Manufacturing activity was still generally week, but there were exceptions. The Chicago Fed National Activity Index for January came at -0.39 versus -0.20 expected and both the Dallas and Richmond Fed manufacturing surveys were significantly weaker than expected. Kansas Fed manufacturing declined versus previous month and Milwaukee ISM declined, both versus last month and versus expectations. On the other hand, Chicago PMI broke the pattern by coming marginally stronger in

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Global backdrop

February than in January (59.8 vs 59.6). Two releases of US consumer confidence data also produced contradictory signals. Bank of America's survey of credit card spending (covering the period up to 21 February) suggested no pickup in spending in February despite better weather. On the other hand, Housing was also mixed. Weekly mortgage applications dropped to just 349, close to the lowest level recorded since 2001 (and less than half the level reached in 2012). But the NAHB and the Case Shiller 20-city house price indices were stronger than expected. Pending home sales weakened, but new home sales beat expectations, although not by enough to suggest a break-out from recent sluggish ranges. The new home sales data showed that sales were strongest in the US northeast and southern regions, both regions that were caught up in bad weather. Hence, this data too points to an inventory adjustment rather than weather related weakness. Durable goods improved in January but this was in part offset by weaker December revisions. Labour market indicators weakened with the number of people claiming unemployment rising to a new high for the year. Finally, US Q4 GDP was revised down from 3.2% to 2.4% qoq annualized.

What does the US economic picture mean for EM? Not much for fundamentals, but quite a lot for EM asset prices. We think the recent respite in EM fixed income markets has mainly been due to weaker US data rather than a wholesale revision about EM's vulnerability to tapering. We think many investors still (wrongly) believe that EM is more vulnerable to tapering than developed economies, despite plenty of fundamental evidence to the contrary. Basically, the market is still trading according to the 'rule of thumb' rather than rationally assessing risks in EM, in our view.

'Rule of thumb' tends to happen whenever the market faces something new and unknown and scary, such as tapering. Then the 'right' trade is always to sell EM (and buy some US stuff, usually Dollars and or US treasuries). 'Rule of thumb' trading creates EM price volatility, usually far in excess of what is justified by fundamentals. 'Rule of thumb' trading always eventually gives way to more rational value trading once the new risk phenomenon is better understood, discounted, or has gone away altogether.

The US treasury market has been more well-behaved during 'Tapering II' than during the Fed's first attempt to taper (when the Fed abandoned as the policy after bond markets pushed real yields higher by 100bps). But the stability of US treasury yields this time around is largely due to weak US data, in our view. Soft data has temporarily increased demand for US treasuries and allowed the Fed to reduce its purchases without blowing up the market.

The milder reaction of the US treasury markets to Tapering II is undoubtedly one of the reasons for the recent stronger performance in EM fixed income markets. How long will the relief from weaker US data last? Since the US slowdown is an inventory correction with some bad weather thrown in for good measure we would expect the US economy to pick up again later this year as the weather effects go away and the inventory adjustment nears completion. At that point, it is quite likely that so-called 'Bond Vigilantes' will once again take on the Fed by pushing up US treasury yields in a bid to test the Fed's commitment to maintaining the pace of the taper.

How will EM react when treasury volatility returns? EM never gets the benefit of any doubt, so we would expect the resumption of US treasury volatility to cause a new bout of EM asset price volatility. But, importantly, as we already see, successive iterations of US treasury volatility have progressively less impact. This is because there are other factors at play. First, EM local bond yields have repriced, so investors are compensated for the volatility. EM local bonds now pay 6.9% compared to 5.1% in April last year (note that EM local bond yields declined from 7.2% at the end of January). Second, technicals are obviously far stronger, so there are fewer sellers and those that are underweight already turn buyers when markets rally, or risk underperforming. Third, EM fundamentals have remained solid despite the heavy anti-EM sentiment, and this is slowly getting through to investors as they begin to look behind the headlines. Fourth, EM credits with perceived vulnerabilities, such as the 'Fragile Five' are adjusting. Finally, the US and European periphery bull trades are beginning to look tired.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.3%	-3.5%	-5.7%	-1.7%	17.3%
MSCI EM Small Cap	-0.4%	1.3%	-1.0%	-0.3%	22.8%
MSCI FM	-0.9%	4.0%	21.9%	7.5%	15.6%
GBI-EM-GD	–	-0.89%	-10.14%	1.18%	10.39%
ELMI+	–	-0.80%	-2.99%	-0.75%	4.77%
EMBI GD	–	2.33%	-1.42%	7.03%	12.18%
EMBI GD IG	–	2.91%	-2.69%	5.75%	9.64%
EMBI GD HY	–	1.22%	0.92%	9.16%	15.68%
CEMBI BD	–	2.01%	0.11%	5.81%	12.73%
CEMBI BD HG	–	2.46%	0.63%	6.24%	10.75%
CEMBI BD HY	–	1.34%	0.60%	5.45%	19.96%

Source: All data Ashmore.

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