

EM High Yield tops the 2015 score sheet; Summary of the main events of the past two weeks

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Emerging Markets (EM) High Yield hard currency sovereign and corporate debt indices top bond returns in 2015. IMF reform heralds better representation of EM in global financial matters. Saudi Arabia changes tack on fiscal policy. Venezuela's President Maduro attempts to use his majority in the Supreme Court to try to dismantle the opposition's super-majority in the National Assembly. Ukraine passes a critical fiscal reform bill in order to comply with the IMF Stand-by Agreement. Mexico's steady economic expansion continues. China achieved its target for swapping local government loans into bonds in 2015 and looks set to continue in 2016. Turkey's Central Bank leaves rates unchanged despite inflation remaining far higher than the target. Brazil's current account deficit was a full USD 2bn smaller than FDI inflows in November. In the global backdrop, the collapse in the Chicago PMI and a sharp downwards revision to expected growth in Q4 2015 raises important questions about the health of the US economy going into 2016. In Europe, nationalism continues to infect economic policy as Scandinavian countries re-impose border controls for the first time in 50 years in yet another indication how developed economies continue to favour populist short-term measures over effective meaningful reforms.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)	Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
MSCI EM	9.4	—	-1.11%	S&P500	16.0	—	-0.96%
MSCI EM Small Cap	10.7	—	0.96%	1-3yr UST	1.01%	—	0.05%
MSCI Frontier	8.4	—	1.41%	3-5yr UST	1.70%	—	-0.03%
MSCI Asia	10.6	—	-0.65%	7-10yr UST	2.21%	—	-0.15%
Shanghai Composite	11.3	—	-2.03%	10yr+ UST	2.96%	—	-0.76%
Hong Kong Hang Seng	6.3	—	-2.25%	10yr+ Germany	0.56%	—	0.11%
MSCI EMEA	6.6	—	-2.34%	10yr+ Japan	0.26%	—	0.10%
MSCI Latam	10.4	—	-1.55%	US HY	9.28%	757 bps	0.37%
GBI-EM-GD	7.13%	—	-0.79%	European HY	5.78%	576 bps	-0.57%
ELMI+	5.00%	—	-0.61%	Barclays Ag	—	225 bps	-0.01%
EM FX spot	—	—	-0.79%	VIX Index*	18.21	—	2.64%
EMBI GD	6.39%	409 bps	0.10%	DXI Index*	98.20	—	0.22%
EMBI GD IG	5.08%	271 bps	0.01%	EURUSD	1.0923	—	-0.41%
EMBI GD HY	8.46%	627 bps	0.22%	USDJPY	118.83	—	-1.30%
CEMBI BD	6.42%	428 bps	0.04%	CRY Index*	176.27	—	1.05%
CEMBI BD IG	4.82%	268 bps	-0.02%	Brent	37.9	—	0.05%
CEMBI BD Non-IG	9.27%	713 bps	0.14%	Gold spot	1072	—	0.26%

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

2015 score sheet

So the final weeks of the year made little difference to the year-end picture after all, the final numbers for the EM and global indices are in and we make three general comments: Firstly, within EM, hard currency debt markets proved very resilient, while assets denominated in anything else than US dollars, from local currency bonds to equities, proved a drag on portfolios measured in USD terms; Secondly, the strong performance of High Yield indices relative to High Grade indices illustrates the importance of value and the power of income in asset allocation decisions; Lastly, EM credit products (i.e. hard currency markets) have done better than US credit indices, illustrating again the importance of value and positioning.

First, the contrasting fortunes of hard and local currency denominated assets dominated EM index returns. The most used hard currency sovereign bond index, the JP Morgan EMBI GD, closed the year up +1.18 (for a spread widening of +63bps), while the market's most utilised local currency government bond index, the JP Morgan GBI-EM GD index, was down -14.92% due to positive local returns of +3.28% (local bond yields were up +63bps but the 7% carry made a big difference), and negative spot FX returns of -17.62%. Within local debt markets, four countries managed to post positive returns: Nigeria was up +24.2% but liquidity constraints made this very difficult to monetize and the country was dropped out of the index; Russia was up +8.3% thanks to the sharp drop in local bond yields since December 2014; China GBI was up +2.8% despite -4.5% in negative FX contribution; and India was up +3.3% also despite a -4.6% headwind from Spot FX. At the opposite end of the spectrum, the local bond indices for Turkey, South Africa, Colombia and Brazil all dropped

2015 score sheet

between 21 and 30% owing to negative terms of trade shocks (the latter three countries), or rising political and policy risk (all excluding Colombia). EM equity markets also struggled in US dollar terms, with a net total return of -14.9% for the MSCI EM index, while they posted a more modest -5.8% loss in local currency terms or in EUR terms, for example.

Second, in a difficult year for EM and a broad disaffection with the asset class, High Yield managed to outperform Investment Grade indices. In the sovereign debt space, the High Yield sub-index returned +4.3%, with spreads up a mere 8bps to 638bps. The top performing markets were the 'storied' countries such as Russia, Ukraine and Venezuela, which recovered from negative price action in the previous year. In the corporate debt space, the JP Morgan CEMBI Broad index returned 1.17%, in line with the sovereign index, but the High Yield sub-index returned 3.4%, outperforming the IG sub-index by 350bps with both indices widening by the same magnitude of 70bps. Again the top-performing markets included Russia and Ukraine, but also China and Kazakhstan for instance. That said, the composition of the HY index has changed over the year owing to the impact of fallen angels from Russia and now from Brazil as well.

Third, and maybe most surprisingly in a year when many commented on the drop in growth differential between developed markets (DM) and EM, in 2015 EM credit indices out-performed DM credit indices, which were flat to down on the year. In the US market the investment grade corporate credit indices were flat while high yield corporates dropped 5%, nearly 10% behind the corresponding EM index. The EUR high yield market did a little bit better but was still down 1% according to BaML. In the equities space, it is hard to argue that DM did well either: the Dow Jones was flat, and although European equities did better in local term (e.g. Eurostoxx50 +6.4%), spurred by a considerable increase in monetary stimulus, they were still down 4.5% in USD terms. So for US dollar based investors the EM High Yield sovereign and corporate credit markets ended up being the best performing asset of 2015.

Emerging Markets

- **IMF reform:** At long last, and very positively in our view, US approval of the IMF reform plan, which had been stalled in Congress since 2010, is expected to double the financial firepower of the international lender and to redress the blatant under-representation of large emerging economies. In particular, China's voting share is expected to jump from 3.8% to 6%. The US would see its voting share shaved down from 16.7% to 16.5% but would keep their veto, while European countries would stand to lose more control over the organisation.
- **Saudi Arabia:** The Saudi Arabian fiscal deficit came in lower than expected in 2015 (15% of GDP versus 20% of GDP anticipated). This meant that the Kingdom's debt to GDP rose to a still very low 5.8% of GDP last year, according to new budget numbers released by the government as part of the 2016 Budget. The main elements of the 2016 Budget are a reduced deficit (expected to come down to about 12% of GDP in 2016), greater military and security spending and reduced spending on healthcare and education. Roughly half of the deficit will be financed locally and half will be financed by external issuance and draw down from reserves. Importantly, the government will scrap subsidies and introduce VAT within two years. This will be painful for the Saudi economy and have secondary impacts on the wider GCC, but adjustment is necessary given that the country's main income from the sale of oil (petroleum revenues are 73% of total revenue) are down due to lower global oil prices. The end of mispricing of resources and free money is also economically beneficial. The 2016 Budget is a major reversal of the recent policies that aimed at sustaining domestic demand at levels that had been consistent with higher oil prices.
- **Venezuela:** The Maduro government is fighting back after losing its majority in the National Assembly. The main threat to Maduro is that the opposition's two-thirds majority can be used to unseat him. In response, the Maduro-controlled Supreme Court has accepted challenges against the election of several opposition deputies. If the challenges are accepted, the opposition will lose its two-thirds majority and thus its effectiveness in holding Maduro to account. The obvious response of the opposition should be to use its majority to appoint new Supreme Court judges – as many as it takes – to overturn the Maduro majority in the Court, but Maduro's pre-emptive use of the Supreme Court may make this difficult. Hence, at the start of 2016 the political outlook for Venezuela looks anything other than settled. FX reserves jumped by USD 1.8bn in December to USD 16.6bn; this is a regular pattern which is often caused by tax payments in US dollars by PDVSA, the national oil company.
- **Ukraine:** despite much uncertainty and division within the ruling coalition, on Christmas Day the Rada finally bowed to pressure from international lenders and passed a fiscal reform bill believed to secure continued IMF financing. The 2016 Budget was also passed with a deficit target of 3.7% of GDP, in line with the IMF requirements. The IMF will now review the approved measures. The government also declared its intentions to ease capital controls once IMF financing is resumed.
- **Mexico:** Mexico's steady economic expansion continues, according to the most recent consumer credit numbers. Credit to the private sector in November was 10.6% higher versus the same month last year. This represents a pick up from 6.9% yoy in June and 3.6% yoy last November. October's GDP proxy pointed to 2.28% yoy growth versus 2.04% yoy expected.

Emerging Markets

- **China:** China's local government bond swap program reached CNY 3.18trn in 2015, in line with the target. The new bonds have benefitted from declining government yields, taking the average funding cost down to 3.5% from 10% previously and therefore saving local governments considerable amounts in debt service costs. Refinancing of the CNY 2.8trn of local government debt falling due in 2016 will likely also be achieved using loan for bond swaps. With another CNY 2trn in central government bond issuance the stock of tradable local and central government bonds in China will likely reach about CNY 20trn in 2016. China's GDP at the end of 2014 was approximately CNY 64trn. China's economy is likely to grow about 6.5% in 2016, aided by more expansive fiscal policy as the government continues to dramatically adjust the economy to enable the expansion to continue. We expect reforms to continue to focus on financial sector liberalisation, consumption-supporting measures and a greater role for prices in the allocation of resources, including at state owned enterprises. The official PMI for December rose marginally to 49.7 from 49.6 in November. Industrial profits rose 0.9% mom in November after contracting 0.9% mom in October.
- **Turkey:** The Central Bank dispensed a surprise on 22 December by failing to hike interest rates. Inflation is running above 8% versus a target of 5% and the Central Bank policy rate at 7.5%. President Erdogan has been leaning on the Central Bank on numerous occasions in a bid to sustain easy monetary policies. Erdogan wishes Turkey to follow an Asian-style investment-led growth model, but this approach is undermined by a low domestic savings rate and insufficiently technocratic institutions, including excessive political pressure on the Central Bank.
- **Brazil:** The current account deficit declined to just USD 2.9bn in November versus USD -3.9bn expected. In the same month, the inflow of FDI was USD 4.9bn. FDI inflows have now exceeded the current account deficit for seven months and the trade surplus is now close to USD 12bn. While much attention is directed at Brazil's economic contraction as well as the bad political situation the economy is, at root, undertaking a cyclical adjustment, which is already quite advanced. The improvement in the external balances due to BRL weakness and very soft demand for imports is important to follow, because herein lies the key to Brazil's recovery.

Snippets:

- **Argentina:** Special Master Daniel Pollack confirmed that substantive talks with holdout investors will begin in the second week of January. Luis Caputo, debt negotiator for the newly elected Macri administration, has had two meetings with Pollack in December.
- **Colombia:** Minutes of the monetary policy committee point to the likelihood of another interest rate increase in January. Colombia has not adjusted as much to lower oil prices as some other countries, which is why the current account deficit remains wide (6.6% of GDP year to date as of the end of Q3 2015).
- **India:** The current account deficit was marginally wider than expected in Q3 at USD 8.2bn (consensus expectation was USD 7.8bn).
- **Indonesia:** inflation fell to 3.35% yoy in December, owing notably to base effects from last year's cuts in fuel subsidy.
- **Malaysia:** November inflation was 2.6% yoy versus 2.3% yoy expected. The higher than expected inflation rate was mainly due to a hike in excise taxes on tobacco. The Markit Manufacturing PMI number for December edged up one point but remained low at 48.0.
- **South Korea:** Inflation rose to 1.3% yoy in December versus 1.1% yoy expected. Core inflation was unchanged at 2.4% yoy. Exports weakened -13.8% yoy in December, but the trade balance posted a healthy USD 7.2bn surplus.
- **Thailand:** Exports shrank at a 7.4% yoy pace in November, weaker than expected (-5.0% yoy).
- **Azerbaijan:** the third biggest oil producer in the former Soviet Union, devalued the Manat another 32%, in a welcome, but somewhat belated move, after spending a significant amount of reserves defending the currency at unrealistic levels.

Global backdrop

In Europe, the retreat into nationalism continued as Sweden imposed border controls with Denmark and the latter responded by proposing border controls with Germany. The primary motivation for the imposition of intra-European border controls is to stop the flow of Syrian and other refugees. In turn, this reflects failures of individual member states to agree on policies to govern the external borders of the Union itself and how to distribute refugees within the Union. The re-imposition of border controls will undermine the common market, reduce investment and slow the rate of economic growth. Political uncertainty rose in Spain after an indecisive election and the probability of an in-out referendum on EU membership in the UK in 2016 remains very high.

In the US, Chicago PMI, a much followed indicator of manufacturing activity, crashed from an already weak 48.7 in November to a recession-like 42.9 in December. A number below 50 is generally consistent with economic contraction. Initial claims for unemployment benefit also shot up by 20k to 287k, which was well

Global backdrop above expectations. Pending home sales dropped 0.9% mom versus an expected increase of 0.7% mom. Core durable goods spending was weaker than expected. Consumer confidence and home prices beat expectations, but existing home sales were soft. Q3 2015 GDP was a modest 2.0% qoq annualised, held back by the external accounts that are suffering under a very strong US dollar. This does not look set to change in Q4; so far the Atlanta Fed's estimate for Q4 GDP growth is just 1.3% qoq annualised (revised lower on 23 December from its earlier estimate from 16 December of 1.9% qoq annualised. The savings rate in the US rose to 5.5% in December from 5.0% at mid-year.

In Japan, retail sales were much weaker than expected in November. On a yoy basis, retail sales contracted by 1% versus -0.1% expected. Industrial production also disappointed (-1.0% mom in November versus -0.5% mom expected).

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.37%	-14.83%	-14.83%	-6.55%	-4.55%
MSCI EM Small Cap	-0.04%	-6.81%	-6.81%	-1.48%	-3.03%
MSCI Frontier	-0.29%	-14.66%	-14.66%	4.65%	0.28%
MSCI Asia	-0.66%	-9.17%	-9.17%	-0.50%	0.05%
Shanghai Composite	2.73%	11.15%	11.15%	19.06%	7.33%
Hong Kong Hang Seng	-1.32%	-16.91%	-16.91%	-1.83%	-1.86%
MSCI EMEA	-7.13%	-19.65%	-19.65%	-13.17%	-8.53%
MSCI Latam	-4.23%	-30.87%	-30.87%	-19.17%	-14.18%
GBI EM GD	0.00%	0.00%	-14.92%	-9.95%	-3.48%
ELMI+	-1.12%	-7.61%	-7.61%	-5.59%	-3.03%
EM FX Spot	0.00%	0.00%	-17.62%	-13.14%	-9.41%
EMBI GD	-1.39%	1.18%	1.18%	0.99%	5.36%
EMBI GD IG	-1.31%	-1.13%	-1.13%	0.07%	4.67%
EMBI GD HY	-1.51%	4.34%	4.34%	2.28%	6.41%
CEMBI BD	-1.23%	1.30%	1.30%	1.86%	4.46%
CEMBI BD IG	-0.56%	1.35%	1.35%	2.28%	4.95%
CEMBI BD Non-IG	-2.39%	1.11%	1.11%	1.03%	3.61%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P500	-1.59%	1.37%	1.37%	15.12%	12.55%
1-3yr UST	0.00%	0.00%	0.38%	0.33%	0.60%
3-5yr UST	0.01%	0.01%	1.55%	1.14%	1.90%
7-10yr UST	0.01%	0.01%	2.07%	1.49%	4.87%
10yr+ UST	0.01%	0.01%	-1.09%	2.75%	8.48%
10yr+ Germany	0.01%	0.01%	0.39%	6.10%	9.09%
10yr+ Japan	0.00%	0.00%	2.55%	5.90%	4.98%
US HY	-2.97%	-4.99%	-4.99%	1.66%	5.33%
European HY	-2.17%	1.39%	1.39%	6.36%	9.35%
Barclays Ag	-0.69%	-0.24%	-0.24%	2.42%	4.54%
VIX Index*	0.00%	0.00%	-5.16%	1.05%	2.59%
DXY Index*	-0.43%	-0.43%	7.82%	21.99%	23.61%
CRY Index*	0.00%	0.00%	-23.35%	-40.25%	-47.03%
EURUSD	0.56%	0.56%	-8.46%	-16.42%	-17.92%
USDJPY	-1.16%	-1.16%	-0.68%	34.80%	44.84%
Brent	1.69%	1.69%	-32.81%	-65.94%	-59.47%
Gold spot	1.01%	1.01%	-11.04%	-35.28%	-22.36%

*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.

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