Issued: 4 August 2014

WEEKLY INVESTOR RESEARCH

Ashmore

From Hero to Zero

By Jan Dehn

US stocks have priced in a great amount of growth, but not rising rates and tapering. A correction in developed markets is entirely warranted, in our view. To the extent Emerging Markets (EM) assets are lower in price it is a good time to add as EM fundamentals look solid and improving in a number of important countries. This week, however, we discuss the situation in two of the few challenged credits in EM, namely Argentina and in Russia.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,066	–	-1.14%
MSCI EM Small Cap	1,089	–	-1.23%
MSCI FM	707	–	0.74%
GBI EM GD	6.63%	–	-1.63%
ELMI+	3.58%	–	-0.83%
EMBI GD	5.21%	269 bps	-0.82%
EMBI GD IG	4.46%	189 bps	-0.77%
EMBI GD HY	6.91%	459 bps	-0.90%
CEMBI BD	5.20%	294 bps	-0.48%
CEMBI BD HG	4.39%	211 bps	-0.37%
CEMBI BD HY	6.98%	475 bps	-0.70%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1925	-2.69%
VIX Index	17.03	35.59%
5 year UST	1.66%	-5 bps
10 year UST	2.49%	1 bps
US HY	6.11%	-1.32%
European HY	4.86%	-0.54%
EURUSD	1.3422	-0.15%
USDJPY	102.63	0.77%
Brent	103.55	-2.24%
Copper	330.59	-0.66%
Gold	1294.05	-0.65%

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

Emerging Markets

- Argentina: Argentina defaulted after failing to ensure that holders of 2033 Discount Bonds under New York Law received their coupons on the 30 July following the expiry of the grace period. Argentina had deposited the funds with the payment agent, but a ruling by the US courts barred the payment agent from sending the money to bondholders.

ISDA's Credit Derivatives Determinations Committee has ruled that a credit event has taken place. With CDS thus eligible triggered, bond holders can submit eligible securities to writers of CDS in exchange for a par payment, usually in cash, creating incentives to buy the cheapest to deliver bonds.

This may increase incentive to accelerate and cross-accelerate the bonds. Acceleration requires the support of 25% of bond holders. Argentina has issued a total notional of USD 56bn of potentially affected bonds, including both exchange and New York Law bonds (USD 25bn Discounts, USD 17bn Pars, USD 13bn Quasi-pars and USD 1bn Global bonds). A total of USD 29bn of securities is cross-defaultable, according to HSBC. Acceleration could be reversed within 60 days if holders of at least 50% of the principal value of the accelerated bonds vote in favour.

Ratings agencies have downgraded bonds to selective default. This does not have direct implications for whether a default occurs under the bond indenture or in CDS, but some investors may have restrictions that prevent them from holding securities rated to be in default by rating agencies.

It is likely that Argentina's bonds will continue to be included in the main EM benchmark fixed income indices. The main principle of inclusion is not whether a bond is in default or not, but rather whether it is possible for investors to replicate indices. Thus, as long as bonds are traded by market makers they are likely to remain included in the indices.

Continued overleaf

Emerging Markets

The outlook for the bonds and for Argentina remains uncertain and is likely to stay that way for some time. There are many possible scenarios of which the most relevant are:

With respect to the holdout investors:

Argentina might still choose to pay holdout investors, but doing so on terms other than those originally offered to exchange bond holders would trigger the so-called RUFO clause. This clause requires Argentina to offer all bond holders improved terms if better terms are extended to holdout investors. This would exceed the resources of the Republic and contradict the Republic's publicly stated policy not to pay so-called 'vulture funds'. We therefore think this outcome is unlikely.

Private sector bank syndicates – allegedly independent of the Republic of Argentina – could still buy up NML's claim (NML is the plaintiff), say, on the belief that they can obtain a better eventual settlement than the price they pay for the claim. In principle, this could cause NML to drop the case. But the respite might be temporary: The so-called 'me toos' – other holdout investors with similar claims – could quickly make similar demands and thus make the problem come back. The combined claims of the plaintiff plus the 'me toos' is about USD 15bn, which is more than half of Argentina's FX reserves.

Alternatively, the government could refrain from taking any action whatsoever with respect to the holdouts until after the expiry of the RUFO clause in January 2015. At that point, Argentina would be able to enter into negotiation with all holdout investors instead of just the plaintiff, thus potentially increasing its relative bargaining power. After the expiry of the RUFO clause, holders of restructured debt would not have the right to ask for the same terms as holdout investors.

The government could also opt not to fix the problem with holdout investors at all, giving up on the idea of fixing outstanding issues with the New York Law bonds altogether. In this case, the holdouts would be potentially paid the same 30c to the dollar offered on the 2005 and 2010 restructurings or even never be paid, at least by the current government.

With respect holders of exchange bonds:

The government has repeatedly stated that it will 'pay' exchange bond holders. It has not been able to deliver on this promise. Even so, the government says it will continue to send money to the payment agent as a signal of its willingness to pay. This signal of willingness to pay will help, but not necessarily prevent acceleration of the bonds, which could potentially increase the number of holdout investors sharply.

It would be possible for the government to resume normal service of the exchange bonds if a deal is stuck in the courts. This could happen in a number of ways, including:

NML asks Judge Griesa (and Griesa agrees) to re-instate a suspension of his ruling that currently bars the payment of coupons. This could happen, for example, if the government and plaintiffs make progress towards a deal, or if private banks took over the claim from NML.

Bond holders could also come together to waive the RUFO clause. This would require 75% of bond holders. Once the RUFO clause is gone there is nothing (other than Argentina's domestic constraints) that prevents Argentina from settling with holdouts and such a move would allow for the payment agent to release the funds to pay coupons on exchange bonds.

The government could attempt to swap NY law bonds to local law bonds by offering holders of discount bonds to swap their bonds into identical securities issued under local law, which would be serviced, including the past due coupon. The government has stated on a number occasions that it might undertake such a swap. But the operation is not straight-forward. Not all holders of New York Law bonds might be allowed to hold local law bonds; so they could become new holdout investors. Also, the US court has stated that a swap to local law would constitute an attempt to bypass US law, making it difficult if not impossible for international banks to facilitate such a swap and paying agents to settle the transactions. Of course, that would not prevent an Argentine banking institution from offering to sell local law bonds and buy identical New York Law bonds, as in a normal trading operation. Once an exchange has taken place the local law bonds are then paid along the lines currently used for local law bonds.

The government could also opt to stop servicing the newly defaulted exchange bonds altogether with a view to restructuring the entire debt stock at some unspecified point in the future. This would save Argentina about USD 0.5bn this year (or USD 3.3bn if accelerated), all else even, but raise concerns about the longer-term outlook as Argentina is increasingly isolated. The risk of acceleration would rise. As noted above, acceleration can be remedied, but only within a narrow 60 day window.

Continued overleaf

Emerging Markets

What does the default mean for the future of New York Law as a jurisdiction for issuers in EM? The willingness to push Argentina into default to ensure compliance with New York Law certainly increases the credibility of New York Law. On the other hand, this outcome benefits only a very a small number of holdout investors at the expense of the far larger group of holders of performing debt. Bond holders might conclude that a legal framework that places the interests of a minority of holdout investors so far above the interests of the majority of bond holders – the precedent set in this particular situation – is too risky. Holders of Argentina's New York Law bonds have certainly not been 'safer' than holders of local law bonds. Holdout investors have not been paid for more than a decade, while holders of exchange bonds have now been pushed into default. By contrast, holders of the local law Dollar bonds issued since Argentina's last default have so far been paid in full and are unlikely to be materially affected by Judge Griesa's ruling.

Issuers might also have second thoughts about issuing under New York Law. After all, many EM countries get hit by occasional weather shocks or outbreaks of political instability, which can inadvertently push them into temporary non-payment (for example, this happened to Ivory Coast not so long ago). When countries are prone to shocks, it is not in their interest to issue under a legal framework that affords so much power to small groups of holdout investors; because it can complicate the process of restructuring (a settlement is easily derailed).

Therefore, the Argentina situation only reinforces existing strong trends towards local law issuance in EM in our view. Most EM countries today rely on local law bonds for the bulk of their financing. In fact, 86% of all EM bonds are in local currency of which the vast majority are in local law. Issuing under another country's laws is a legacy of a past long gone; today's reality and the future in EM belongs firmly to local law.

What effect does Argentina's case have for other countries?

Likely to be very small, mainly due to the slowdown of volumes with trading partners like Brazil. Argentina's case is unique; no other country in EM is in a similar situation. We think, therefore, that contagion risk from Argentina's default is extremely small. That is not to say that financial markets will trade Argentina's misfortune rationally; after all we continue to see periodic outbreaks of irrational EM credit and equities trading, for example when investors dump the entire asset class at signs of uncertainty in developed economies. But it is important to distinguish between price volatility and risk. Not since 1998 has the volatility of EM asset prices had the capacity to derail the economic fundamentals across large numbers of EM countries. In other words, we have not seen an episode of economic contagion for more than one decade. The reason for EM's fundamental resilience is mainly that EM now principally finances domestically, while EM's fiscal balances, stocks of reserves and central bank policies have improved dramatically. EM's price volatility is largely due to investor behaviour, not EM fundamentals. Thus, to the extent that Argentina's default leads to broader EM asset price weakness this should be viewed as a buying opportunity, in our view.

As for Argentina today, it is a very different situation from 2001. One important difference is that there will be no "break of peg" through a forced conversion of savings from USD to Pesos with an implied 75% devaluation. In 2001, this caused a 25% collapse of the economy alongside a banking crisis. Today, ARS is a dirty floating currency, which has depreciated steadily. The central bank has been accumulating reserves over the recent months and holds USD 29bn in its coffers. The stock market is trading at all-time highs, which is a sign locals are far from panicking. The government has the ability to pay its USD denominated obligations: the total public sector refinancing requirement for the rest of this year is just USD 3.3bn (of which USD 1.9bn are interest payments). Obligations are mainly two payments of USD 200m each on the Bonar 17s and Boden 15s due in October plus some USD 800m of interest payments on the Discount and Par bonds in December (which the government has so far pledged to continue to send to the payment agent). The economic impact is therefore likely to be much more limited than in 2001. Fundamentally, given a net public sector debt stock of just 21% of GDP this default is clearly not due to unwillingness or inability to pay in the conventional sense.

Having said that, all credits are risky and Argentina is a significantly higher risk credit than most in EM. The country has a long history of balance of payments crises, episodes of hyper-inflation and default. The economy is currently in a weak state and the quality of macroeconomic policy is woeful. Argentina has enormous potential in energy, mining, tourism, agriculture and many other industries, but under the current government these strengths are unlikely to be realised. The situation could change next year: Argentina is scheduled to hold elections in October 2015 and President Cristina Kirchner is unable to run for re-election. The current front runners for president include Buenos Aires governor Daniel Scioli and former cabinet chief Sergio Massa. Both are Peronists, but from a different school of Peronism and widely expected to pursue policies that are considerably more market-friendly than the current administration. Whether this is enough to alter Argentina's longer-term trend of under-performance relative to its potential is far less clear.

Continued overleaf

Emerging Markets

- **Ukraine/Russia conflict:** The newly announced European and US sanctions on Russian private and corporate persons triggered a modest rally in Russian assets after the announcement, which suggests that the market had marginally overstated their importance. Later prices declined in line with US stock markets (see global section). We think none of the recent sanctions pose serious challenges to Russia in the short term, but the threat of further sanctions has not gone away, including the possibility of further restrictions on Russian banks' access to international financial markets.

The leaders of Brazil, Russia, India, China and South Africa recently announced the establishment of the New Development Bank (NDB), a multilateral development bank intended as an alternative to the World Bank and the IMF. The five countries between them control USD 5.1trn of FX reserves plus large quantities of sovereign wealth fund assets. Facing sanctions from Western governments, this would be an excellent opportunity for Russia to test the lending preferences of the NDB.

Ukraine, of course, remains at the heart of the current conflict between Russia and the West. This is a classic Cold War stand-off for control over a strategically placed country. A solution could involve an agreement between Germany's Angela Merkel and Putin, because we think a sustainable solution is one that involves a neutral Ukraine, with peacekeepers on the ground in Eastern Ukraine and greater autonomy to Eastern Ukraine under a new Ukrainian constitution. President Poroshenko of Ukraine will have to agree to such a plan and Europe can ensure that he does so due to its leverage over Ukraine via trade, financing, investment and other means.

Press reports last week suggested that Merkel and Putin are working on a peace plan that involves securing Ukrainian borders, acceptance of the Russian annexation of Crimea, a neutral Ukraine outside of NATO. Ukraine would be allowed to approach the EU, however, Russia would get secure transit for gas shipments to Europe in exchange for fresh financing for Ukraine. There has been no official confirmation of these reports of a peace plan, but we think they will gain in credibility once conditions elsewhere become more conducive for a deal.

In particular, following the latest round of sanctions the situation on the ground in Eastern Ukraine is gaining in importance, in our view. The balance of power between Ukrainian forces and the pro-Russian separatists has recently shifted in favour of the Ukraine military. This will not have gone unnoticed in Moscow: Putin knows that the key to his influence in Ukraine is that pro-Russian separatists retain a solid foothold in Eastern Ukraine. If they are defeated militarily, then the risk is that Ukraine turns all pro-Western, which in turn means that Putin could end up with a very anti-Russian country on its borders. Putin does not want this. Thus, the closer we get to a military defeat for the separatists the stronger the incentive becomes for Putin to engage in a negotiated settlement that would lead to a neutral Ukraine.

The analogy here is Syria, in reverse. In Syria, the rebels fighting the Bashar al-Assad regime were militarily defeated and as a result the West lost influence in Syria completely (Russia was on the side of al-Assad and 'won' this conflict).

As Ukrainian forces push for final victory in the East, this can result in significant escalation in the military conflict in the short term, but if the Ukrainian military continues to prevail then we may in fact be drawing closer to the first real opportunity in this conflict for a negotiated settlement.

In a very positive development that should ensure the payment of the next tranche of IMF money, Ukraine's Parliament voted in favour of budget, tax code amendments and the bill on the gas transit system. Parliament also voted to reject the resignation of Prime Minister Yatsenyuk. Ukraine also raised taxes on oil, gas and iron ore.

Global backdrop

After months of low US equity volatility aided by easy monetary policy by the Fed and the ECB, financial markets were ruthlessly ripped from their summer slumber by a decent Q2 GDP growth number, stronger Chicago PMI and a higher than expected US employment cost index print, which led to fears that the Fed might be behind the curve. US High Yield also saw the fourth consecutive week of outflows, while company earnings failed to impress. Geopolitics added to fears. The bear steepening of the US yield curve also unsettled investors positioned for bear flattening. And in conditions of generally low summer volatility, this led to a re-pricing of financial assets the world over. VIX, an index of US equity volatility, spiked to 17 from near its all-time low level, while US bond yields moved from 2.44% to 2.57%. While these are relatively modest moves in the greater scheme of things, the outsized reaction in the US stock market was perhaps most telling. Here, stocks dropped sharply, which suggests that US equity markets have priced in an inordinate amount of good US growth this year, but very little of the associated financial tightening. Indeed, valuations in both US bond and equity markets look very rich both near-term and especially long-term. Spreads for US high yield corporate bonds are still incredibly tight (US HY spreads are half of those for identically rated EM corporate bonds, for example). Elsewhere in developed economies, German bond yields hit new lows amidst still very tight periphery

Continued overleaf

Global backdrop

sovereign European credit spreads. Thus, faced with general unattractiveness of financial assets everywhere in the developed world, but also beset with fear, the markets predictably opted to go into cash instead of buying value in EM, temporarily pushing up the Dollar. This provided respite for the Dollar, but the Dollar move is clearly predicated on the outbreak of risk aversion rather than fundamental drivers, wherefore the move is temporary, in our view. A more rational assessment of comparative value will follow, which will point to vastly better relative value in Emerging Markets following the irrational sell-off last year. EM has already beaten developed markets year to date: EM stocks, EM small cap stocks and EM frontier stocks are up 8.3%, 9.8% and 22.1% year to date, respectively, compared to just 5.7% for the US S&P 550 index. In fixed income, EM external debt is up 9.1% versus a return of 6.9% for US 10 year bonds, while EM local bonds have returned nearly three times as much as similar duration US 5 year bonds. The re-pricing of financial assets last week has created a good opportunity to top up on EM allocations as valuations improve again.

The 4% qoq annualised US Q2 GDP print and a decent upwards revision that raised the Q1 growth number to -2.1% qoq annualised put the US economy back onto a 2% growth path for the year. One rather large fly in the ointment, however, was that inventories again contributed a lot to the GDP number. To give a sense of the magnitude of the inventories accumulation, consider that US nominal GDP rose USD 250bn from USD 17.044trn in Q1 to USD 17.294trn in Q2, while the increase in private inventories alone accounted for 44% of this increment (USD 109.9bn). This is almost an exact replica of Q3 and Q4 last year prior to the very weak Q1 print this year. Rising inventories do not necessarily bode badly for future demand – companies could be accumulating stock in anticipation of future increases in consumer spending. But rising inventories could also indicate that final demand is poorer than current production, which would then imply a period of destocking ahead, resulting in lower growth. Ultimately, we think consumer demand is still held back by household deleveraging, so we think the US economy will continue on a 2% path for another couple of years.

The FOMC did not fundamentally change path. Volumes of QE were once again reduced by USD 10bn per month. The statement noted slack in the labour markets and the recent pick-up in inflation, which brings prices closer to target. We note that the FOMC opted to link policy to broad conditions in the labour market, not just unemployment. This is a marginal move in a dovish direction.

Labour market data largely vindicated Janet Yellen's dovish stance at the Fed. Unemployment was stable correcting for participation rates. The payroll number was softer than expected, but not a disaster. PCE inflation declined from 1.7% yoy to 1.6% yoy. The US desperately needs inflation to reduce the real debt stock, lower real interest rates and increase the competitiveness of the Dollar to help restore US export competitiveness. A period of inflation is not cost-free, but the cost is mainly lower investment. In an economy that does not invest much anyway, this is a price worth paying to get rid of the country's debt overhang. But it also means that sometime in the future the Fed will have to raise rates much further in order to stamp out inflation. And for that reason long yields will have to be much higher than the market is currently pricing.

Early last week saw further relief for the Europeans when the ECB bank lending survey pointed to an easing of corporate lending conditions, the first return to easier financial conditions since Q2 2007. The improvement follows the adoption of targeted LTROs by the ECB earlier this year. Given that there is no requirement that banks use their ECB money for lending to the corporate sector this is very good news (but probably also partly explained by the fact that there is no value left in European periphery government debt). Improving credit markets offer some hope that Europe can generate inflation, something Europe desperately needs as US treasury yields gradually rise (otherwise Europe would have to cope with rising real yields and associated EUR strength). But later in the weak the faint hope of better credit conditions in Europe faded after European inflation prints came in lower than expected and bank in Portugal reported disastrous results. Suddenly the prospect of European deflation and a return to higher real yields returned and the EUR stabilised around the 1.3380 level.

Ashmore

Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.1%	7.7%	14.3%	0.3%	7.6%
MSCI EM Small Cap	0.0%	9.3%	13.7%	0.2%	9.3%
MSCI FM	0.4%	22.0%	30.6%	13.8%	10.3%
S&P 500	-0.29%	5.36%	15.14%	16.87%	16.69%
GBI EM GD	0.09%	4.96%	3.42%	0.29%	6.24%
ELMI+	-0.05%	1.30%	1.59%	-1.23%	1.96%
EMBI GD	-0.49%	8.56%	10.40%	6.53%	9.60%
EMBI GD IG	-0.38%	7.92%	8.79%	5.08%	7.94%
EMBI GD HY	-0.71%	9.83%	13.74%	9.18%	12.19%
5 year UST	0.44%	2.13%	2.00%	1.58%	3.67%
7 year UST	0.55%	4.36%	3.76%	2.87%	5.09%
10 year UST	0.65%	7.58%	6.31%	4.94%	5.85%
CEMBI BD	-0.25%	6.05%	8.50%	5.65%	8.77%
CEMBI BD HG	-0.16%	6.20%	8.24%	5.68%	7.99%
CEMBI BD HY	-0.44%	5.70%	9.05%	5.88%	11.20%
US HY	-0.50%	3.88%	8.26%	9.02%	12.81%
European HY	-0.35%	5.26%	11.82%	13.31%	15.41%
Barclays Agg	0.27%	4.27%	5.90%	1.69%	4.01%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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

Sao Paulo
T: +55 11 3556 8900

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

Other locations

Shanghai

Bloomberg page
Ashmore <GO>

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

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2014.

Important information: This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised and regulated by the Financial Conduct Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. Past performance is not a reliable indicator of future results. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment.