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WEEKLY INVESTOR RESEARCH

Ashmore

Update on year-end and early 2015 developments in Emerging Markets

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We summarise the main developments over the year-end period. Prime Minister Yatsenyuk said he would be willing to leave the question of Crimea to "future generations". Indonesia's government moves on fuel subsidies in a development that will free up substantial fiscal resources for infrastructure. Lithuania joins the EUR. Brazil's fiscal and monetary authorities take off the kid-gloves. India eases the administrative burdens involved in land transactions. China provides further evidence of the extremely rapid liberalisation of its financial system. Saudi Arabia now looks set to open its USD 500bn stock market by April. In G3, the currency wars continue.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	948	–	-0.47%
MSCI EM Small Cap	994	–	1.04%
MSCI FM	608	–	-0.30%
GBI EM GD	6.51%	–	-0.61%
EM FX spot	–	–	-0.81%
ELMI+	5.84%	–	-0.12%
EMBI GD	5.65%	351 bps	-0.04%
EMBI GD IG	4.44%	227 bps	0.00%
EMBI GD HY	8.25%	622 bps	-0.13%
CEMBI BD	5.55%	357 bps	0.03%
CEMBI BD HG	4.48%	249 bps	0.07%
CEMBI BD HY	7.97%	601 bps	-0.06%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2058	-1.41%
VIX Index	17.79	22.69%
5 year UST	1.62%	-9 bps
7 year UST	1.92%	-10 bps
10 year UST	2.12%	-9 bps
US HY	7.13%	0.06%
European HY	5.26%	0.16%
EURUSD	1.1952	-1.84%
USDJPY	120.36	-0.22%
Brent	54.75	-2.74%
Copper	137.50	0.00%
Gold	1194.50	0.98%

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

Emerging Markets

- **Ukraine:** Ukraine's parliament revoked the country's non-aligned status. While the move could be seen as a precursor for closer ties with NATO, we think Prime Minister Arsenyi Yatsenyuk's statement on Crimea is more telling about the direction of travel in the near-term. Yatsenyuk, one of the most anti-Russian members of the Ukrainian government, extended an important olive branch to Russia by saying that "future generations" may have to resolve the question of Crimea. His statement in effect removes Crimea from the list of issues that need to be resolved in order to achieve a peace agreement with Russia. Our view is that the main protagonists in the conflict now have strong economic incentives to seek a peaceful solution. In another important development, Ukraine's parliament approved the 2015 Budget, which is an important step towards facilitating the completion of the IMF program.
- **Indonesia:** The government has cut fuel subsidies substantially and moved the country onto a fixed subsidy model. Due to inflation, the real value of the subsidy will now decline in the coming years. The subsidy bill looks set to fall below IDR 100trn from the earlier budgeted amount of IDR 276trn, thus freeing up resources for much needed infrastructure spending. There may also be upside risks in terms of ratings agencies, which will deem the change in subsidy policy to be credit enhancing. Indonesia's trade balance went into a small deficit of USD 426m in November, but the latest manufacturing activity for December was weak with the PMI index falling to 47.6 from 48 in November. This suggests that the trade deficit may be temporary. Inflation rose 2.5% in the month of December in response to November's fuel price hike (associated with subsidy cuts), taking core inflation to 6.4% yoy in December. The effect of the fuel price hike on inflation is likely to be temporary.
- **Lithuania:** Lithuania has adopted the EUR as its official currency. All three Baltic States are now members of the Eurozone. While markets have fretted about the collapse of the Eurozone – and may again – the single currency has in fact been expanding. Lithuania's inclusion in the single currency is likely to boost trade and lower hurdle rates for cross-border direct investment into Lithuania from other Eurozone economies.

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Emerging Markets

- **Brazil:** Four important developments took place in Brazil over the year-end period. First, the government published the worst fiscal numbers for nearly two decades. The November fiscal deficit was BRL 7.6bn versus BRL 1.3bn expected. Second, the government announced a significantly more aggressive fiscal adjustment than had been expected. The fiscal savings will be BRL 18bn versus BRL 7bn expected. These savings should put the government on track to meet its 1.2% of GDP primary surplus target for next year. Thirdly, the central bank extended its FX intervention program until the end of March 2015, but halved the daily auction amount from USD 200m to USD 100m. Finally, in its quarterly inflation report the central bank adopted a distinctly more hawkish stance. The combination of sharp fiscal savings, less FX intervention and the prospect of further rate hikes show that Brazil's return to macroeconomic stability will involve adjustment both of the domestic and external accounts. This makes the adjustment credible, in our view. Manufacturing picked up to 50.2 in December from 48.7 in November, but the outlook for manufacturing still looks weak ahead of the likely fiscal correction this year.

- **India:** The government announced new administrative changes intended to reduce the onerousness of buying and selling land. The measures should help to speed up infrastructure investments in India. Manufacturing activity rose to 54.5 in December from 53.3 in November, taking India's PMI to the highest level for two years.

- **China:** SAFE, China's State Administration of Foreign Exchange, has changed the rules for how banks calculate net open positions on foreign exchange loans. The measure could enable Chinese banks to unwind USD 95bn of FX positions. We expect more and more measures to liberalise the Chinese capital account this year as the government aims to achieve global reserve currency status for the CNY. Indeed, in the last week of 2014 China extended bilateral CNY swaps with three more countries (New Zealand, Malaysia and Russia). In other policy developments, PBOC, the Chinese central bank, announced that deposits placed by financial institutions with financial institutions will now be included in the formal definition of deposits. Since inter-financial sector deposits are not subject to reserve requirements, the effect will be to ease the loan to deposit limits in China. In economic developments, manufacturing activity was marginally stronger in December than the market had expected as the official PMI number reached 50.1 versus 50 expected, although manufacturing slowed from November (50.3). HSBC's PMI number also declined to 49.6 in December from 50 in November; HSBC's PMI number has greater representation from small and medium sized enterprises than the official PMI.

- **Saudi Arabia:** Following a preliminary announcement in July 2014 that it plans to open its large domestic stock market to foreign investors, unnamed Saudi Arabian officials said that the market could be opened as early as April 2015. The Saudi Arabian stock market is more than USD 500bn in size. The other notable development in Saudi Arabia was that the 2015 Saudi Arabian budget was published. The Budget does not involve major retrenchment in overall spending as the government intends to use fiscal levers to smooth the effect of the lower oil prices on the economy. Saudi Arabia's public finances are very strong.

Snippets:

- **Russia:** Russia's PMI fell sharply to 48.9 in December from 51.7 in November. The slowdown in economic activity comes at a time when inflation is rising due to recent RUB depreciation – in December yoy inflation rose to 11.4% compared to 6.5% a year ago. We expect further economic weakness in Russia, but the inflationary effects will prove temporary, not least due to the recent decision by the central bank to raise policy rates to 17%. Russia has the means to manage the transition to weaker oil prices.

- **Mexico:** Manufacturing activity surged to the highest level since December 2012 according to the Mexican PMI, which rose to 55.3 in December. This was 1.1 points higher than in November. Output, employment, new orders and new export orders all rose above 50. Real GDP was also stronger than expected in October, rising 2.5% vs 2.4% expected.

- **South Korea:** Exports increased at a rate of 3.7% yoy in December versus 0.1% yoy expected. In contrast to the previous month, exports to China, Europe and other Asian economies picked up in addition to exports to the US. As a result of a decline in imports due to sluggish domestic demand the trade surplus rose to USD 5.8bn. Korea's current account surplus was also strong, rising to USD 11.4bn in November from USD 8.8bn in October. Domestic activity remains quite soft. November industrial production was down 3.4% yoy. Due partly to weak domestic demand and falling oil prices inflation also declined to a rate of 0.8% yoy in December. This is the lowest rate of inflation since 1999.

- **Turkey:** The trade deficit widened to USD 8.3bn in November. This was a great deal wider than the USD 7.0bn trade deficit expected by the market. The November print pushed the 12 months rolling trade deficit up by USD 1.1bn to USD 85.9bn. The culprit was gold imports, which rose by USD 2bn in November.

- **Argentina:** Real GDP contracted by 0.8% in Q3, which was marginally weaker than expected (-0.6% yoy). Argentina defaulted in Q3 and the parallel exchange rate weakened sharply during that period, but the economy and the currency have since stabilised. October's monthly economic activity indicator was up marginally.

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Emerging Markets

- South Africa: The November trade deficit collapsed to just ZAR 5.7bn after a record high deficit of ZAR 21.6bn in October. The drag on the trade balance from oil dropped sharply in the course of the month. The 12 month rolling trade balance is still larger than at the same time last year.
- Turkey: The central bank raised reserve requirements for FX denominated bank and finance company liabilities for up to 1 year maturity from 13% to 18%, while it cut reserve requirements for 2-3 year liabilities to 8% from 11%. It also raised the reserve requirements to 7% from 6% for 3-5yr liabilities and left them unchanged at 6% for FX liabilities with longer maturities. Net-net, the average reserve requirement rises by about 1% to 12.8% across the maturity structure. The effect will be to boost central bank reserves by about USD 3bn, while banks and finance companies will be discouraged from short-term speculative borrowing in Dollars.
- Vietnam: The economy grew at an impressive rate of 8.4% in Q4 2014. This means that the economy as a whole increased by 6.0% in 2014 as a whole, according to new government statistics. The market had expected full year growth of 5.7% in 2014. Both exports and domestic demand are growing strongly.
- Colombia: Being a major oil producer with a strong economic team, the government of Colombia lost no time in adjusting its fiscal program to the new reality of lower oil prices. The new revised 2015 financing plan fully accounts for lower oil prices and envisages only modest increases in domestic and external borrowing. The government expects growth of 4.2% in 2015 with a fiscal deficit of 2.8% of GDP.

Global backdrop

The global backdrop has not changed markedly over the year-end holidays. G3 currencies are locked in a currency war, which has seen both the EUR and JPY weaken versus the Dollar. Energy prices have been volatile with a clear downward bias, reflecting in part the rise in the Dollar. In terms of the data, after an upwards-revised Q3 growth number the US macroeconomic data on balance weakened going into the last few weeks of last year. Consumer confidence rose to 92.6, which was below the 93.9 expected. December's Chicago PMI number fell to 58.3 from 60.8 in November and 60 expected. The number of people who claimed unemployment benefit for the first time during the last week of the year rose to 298,000 from 281,000 during the previous week. US durable goods orders fell in November by 0.7% in contrast to an expected rise of 3.0% according to Bloomberg. New home sales also declined by 1.6% in November with negative revisions for previous months, while existing home sales fell 6.1% in November (-1.1% expected). There were two major exceptions to the weaker data: Pending home sales rose 0.8% in November versus 0.5% expected, and University of Michigan consumer confidence print was 93.6 versus 93.5 expected.

In Japan, the government coalition announced further fiscal stimulus in late December. Corporate taxes will be cut but while there will be some offsetting revenue-generating measures elsewhere the net tax cut will be JPY 350bn. On 27 December, the government also announced a JPY 3.5trn stimulus package. We expect the government to continue to push on the levers of monetary and fiscal stimulus, but to fall short on expectations of structural reforms. Core inflation in Japan slowed to 2.7% in November from 2.9% in October, while industrial production declined 0.6% in November, contrary to market expectations of a rise of 1.1%. Household spending declined and retail sales were significantly weaker than expected (0.4% yoy vs +1.2% yoy expected). Nominal wages declined for the first time in nine months in November, while real wages fell at a staggering rate of 4.3% yoy.

In the Eurozone, Greece's parliament failed to appoint a new president. This means that Greece will have fresh elections on 25 January. It is possible that the anti-austerity Syriza party will get into government, which raises the possibility that ECB's safety net under Greek bonds will be withdrawn to potentially trigger another Eurozone debt crisis. The Greek situation illustrates perfectly the dirty secret of many developed economies that their credit worthiness is weak and hinges more on central bank support and regulatory biases than fundamentals. Meanwhile, credit growth in the Eurozone improved in Q3. M3, a broad measure of money, increases 3.1% yoy in November compared to 2.6% yoy expected. Even so, ECB officials continued to talk about sovereign QE, keeping this story red hot going into 2015 and helping to push down the EUR. QE seems to be Europe's only defence against higher US rates given the inability of Europe's politicians to solve Europe's deeper economic problems.

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Global backdrop

Emerging Markets	Month to date*	Year to date*	1 year	3 years	5 years
MSCI EM	–	–	-1.2%	4.2%	2.0%
MSCI EM Small Cap	–	–	1.4%	8.0%	3.2%
MSCI FM	–	–	5.9%	13.4%	7.7%
S&P 500	–	–	14.66%	20.32%	15.41%
GBI EM GD	–	–	-5.46%	-0.14%	2.51%
ELMI+	–	–	-7.08%	-0.85%	-0.47%
EM spot FX	–	–	-12.66%	NA	NA
EMBI GD	–	–	7.46%	6.10%	7.56%
EMBI GD IG	–	–	9.84%	5.15%	6.81%
EMBI GD HY	–	–	3.32%	7.60%	8.65%
5 year UST	–	–	2.86%	0.98%	3.49%
7 year UST	–	–	6.20%	1.85%	5.30%
10 year UST	–	–	11.32%	3.15%	6.90%
CEMBI BD	–	–	4.98%	6.25%	6.78%
CEMBI BD HG	–	–	7.11%	6.05%	6.81%
CEMBI BD HY	–	–	0.61%	7.06%	7.01%
US HY	–	–	2.07%	8.43%	9.37%
European HY	–	–	5.44%	14.98%	12.11%
Barclays Agg	–	–	0.69%	0.68%	2.62%

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

*MTD and YTD data will be available from next week.

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