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Ashmore

# Brazil's cyclical problem and China's growth outlook

By Jan Dehn

This year the markets ganged up on both Brazil and China, but at this time next year the focus will have shifted elsewhere, because neither Brazil nor China face anywhere near lethal problems. We are far more concerned about how on earth the QE economies are going to get out of the financial bubble they are being sucked into. The stock market reaction to very weak data in the US last week is a case in point. How can a market that only rallies on bad news ever create conditions that facilitate a healthy exit from unconventional monetary policies? We also discuss the Ukraine terms of debt restructuring which contain some innovative features.

| Emerging Markets | PE/Yield | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| MSCI EM | 10.5 | – | 1.92% |
| MSCI EM Small Cap | 11.6 | – | 1.02% |
| MSCI Frontier | 8.5 | – | -1.18% |
| MSCI Asia | 10.9 | – | 1.76% |
| Shanghai Composite | 11.5 | – | -2.02% |
| Hong Kong Hang Seng | 6.9 | – | 1.23% |
| MSCI EMEA | 9.4 | – | 0.51% |
| MSCI Latam | 12.6 | – | 2.69% |
| GBI-EM-GD | 6.97% | – | 1.02% |
| ELMI+ | 4.86% | – | 0.43% |
| EM FX spot | – | – | 0.29% |
| EMBI GD | 6.24% | 423 bps | 0.08% |
| EMBI GD IG | 4.92% | 283 bps | 0.57% |
| EMBI GD HY | 8.42% | 660 bps | -0.58% |
| CEMBI BD | 6.21% | 447 bps | -0.21% |
| CEMBI BD HG | 4.63% | 287 bps | -0.02% |
| CEMBI BD HY | 9.01% | 728 bps | -0.58% |

| Global Backdrop | PE/Yield/Price | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| S&P 500 | 14.9 | – | 1.10% |
| 1-3 year UST | 0.58% | – | 0.31% |
| 3-5 year UST | 1.29% | – | 0.74% |
| 7-10 year UST | 1.99% | – | 1.35% |
| 10+ years UST | 2.84% | – | 2.38% |
| US HY | 8.53% | 723 bps | -1.73% |
| European HY | 5.75% | 580 bps | -0.69% |
| Barclays Ag | – | 226 bps | 0.33% |
| VIX Index* | 20.94 | – | -2.68% |
| DXY Index* | 95.53 | – | -0.50% |
| EURUSD | 1.1268 | – | 0.27% |
| USDJPY | 120.18 | – | 0.32% |
| CRY Index* | 194.11 | – | -1.61% |
| Brent | 48.7 | – | 2.94% |
| Gold spot | 1135 | – | 0.10% |

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

## Emerging Markets

Every single year a small number of Emerging Markets (EM) countries out of a now sizeable collection comprising more than 60 readily investable countries get into some kind of serious trouble, usually self-inflicted, though sometimes they just experience severe external shocks. Inevitably, their predicaments taint the entire asset class, although usually only for a relatively short period of time. The afflicted countries usually take remedial action and the problems are resolved. Consider the line-up of troubled EM countries over the past couple of years. In 2013, the financial world and its media hangers-on got into a real tiff about India's alleged 'Fragile Five' structural malaise. South Africa and Indonesia were similarly labelled as lost causes. By early 2014, it was clear that these countries were not quite lost causes after all and the focus shifted to Turkey before shifting to Russia later that year. This year Brazil and China have been the lightning rods of the EM bears. Each of these episodes follows a remarkably consistent pattern; at first the markets really struggle to make a call on the final outcome, resulting in aggressive selling. Market prices inevitably overshoot to the downside. Meanwhile, the actual crisis turns out to be far less extreme than implied by the worst predictions at the time of the crisis.

This pattern of over-reaction in response to often manageable cyclical or political challenges is so regular that it can comfortably be predicted that both Brazil and China will survive their current challenges and that the world will soon move on to focus on a new set of 'vulnerable' EM credits. It simply becomes difficult to sustain panics, especially when they are founded on alarmist speculation rather than fact. With the exception of a very small number of chronically dysfunctional credits – Argentina and Ukraine are two good examples – almost every time an EM country is caught up in a market panic the peak of the panic turns out, in retrospect, to have been the best possible time to buy. Bearing these 'stylised facts' about EM panics in mind, how will this year's EM punch bags, Brazil and China, fare in the months to come?

- **Brazil:** Brazilian assets had already been the subject of widespread selling long before the recent S&P downgrade of the sovereign debt from investment grade (IG) to junk. For most investors Brazil's problems have been known and understood for some time. In our view, they are 100% self-inflicted – the result of severe economic mismanagement on the part of the government. The good news is that the damage never got so severe as not to be reversible. Indeed, the damage is already slowly being reversed through tighter fiscal and

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monetary policies, though a complete cure is still some time off, because the government's acute loss of political capital has made it difficult to pass effective corrective measures in parliament.

In fact, there are still easily identifiable downside risks on the horizon, including more economic weakness, further ratings downgrades and possible impeachment of the president and other members of the broader political establishment on account of a wide-ranging scandal over funding of political parties.

Consider the economy. Recall that Brazil overheated due to inept macroeconomic management, particularly under former Finance Minister Guido Mantega, who is now widely recognised as one of the worst finance ministers the country has ever had, although Presidents Dilma and Lula bear the ultimate responsibility for hiring him. Mantega's incompetent economic management literally took Brazil from a star performer to one of the worst performing economies in the world in record time. The cure is to cut spending, to raise interest rates and to devalue the currency. It would of course also be good to see some deeper reforms, which could help the economy recover more quickly, but this looks unlikely and it is ultimately not essential. Reforms are difficult due to the so-called 'car wash' corruption scandal, which has engulfed the Dilma administration and destroyed its political capital. The recovery will therefore be slow and painful and the trend growth rate, even post-recovery, is likely to be tepid.

Brazil's growth rate is still declining – witness weak Industrial Production and consumer and business confidence prints last week – however, there are important silver-linings. Fortunately, the problem is ultimately a cyclical one, not a structural one. Parts of Brazil's economy are showing signs of healing. The erosion in the public finances is already slowing. For example, August's fiscal outturn was better than expected (the primary deficit narrowed by 0.1% of GDP to a still weak -0.8% of GDP). The external balances are improving sharply – for example the September trade surplus rose to USD 2.9bn versus USD 2.5bn expected. Petrobras was allowed to raise gasoline prices last week, helping the company's balance sheet. In our view, Brazil will not default, it will not have a balance of payments crisis and it will not even need the help of outside institutions such as the IMF or the World Bank. Debt levels remain sustainable and FX reserves are adequate. The solutions are known, the new economic team is competent and Brazil's institutions will continue to function. Brazil will re-emerge from its current troubles, so investors should ultimately view the current weakness as an opportunity. They may need to be patient to harvest returns, but they will come.

It is particularly important to understand the inflation dynamics. The current combination of falling growth and rising inflation is obviously unpleasant, but inflation is high in part due to changes in administrated prices, which is a base effect that goes away in the next 6 months or so. Brazil's economy has already shed one million jobs over the past twelve months. Unemployment is now putting serious downwards pressure on wages, particularly in the informal sector, where rapid wage adjustment is the norm. The remaining driver of inflation is the currency, whose weakness has had a far greater impact on inflation than in other EM countries, because the central bank's credibility was so badly eroded over the last few years. However, central bank credibility is slowly being restored on the back of high real rates and as inflation peaks and then begins to fall – as it will – it is likely to fall considerably. The currency has already sustained a significant depreciation, falling from 1.6 to the USD to more than 4.0, so when inflation declines investors will flock back into the local bonds in great numbers. That time is not so far away.

What is the probability of another sovereign downgrade? The short answer: high, especially from Fitch. Moody's is still holding on to the idea that Brazil is an investment grade credit, but it too may be forced to downgrade the country at some point. It could be an academic decision. Just one further downgrade is sufficient to force passive IG-only mandates to liquidate their Brazilian assets. Investors lucky enough not to have surrendered their decisions whether to buy or sell bonds to a ratings-based index rule should buy on whatever weakness that may result from selling by passive IG funds. Most active investors that exercise a minimum amount of diligence will have known for a long time that the country is in deep trouble and may already be underweight. Many will also know that Brazil will ultimately recover. In short, this is a good place from which to begin to build positions in Brazil.

In general, it is worth remembering that a ratings agency is just another analyst, whose verdict just happens to have been vested with some institutional importance. Historically, ratings agencies have been so slow to respond to changes in credit fundamentals that their verdicts have almost ensured losses for investors following them; investors have been forced to sell at precisely the wrong time, that is, near the very bottom, in response to downgrades, when bonds have already taken all the losses, when bonds are close to the point of maximum potential upside.

What about the impeachment risk, then? Dilma may indeed be impeached, but it is not certain. The president's approval rating has now stabilised, albeit at low levels. A new cabinet was appointed last week, which gives seven new ministerial posts to the PMDB party, while Dilma's own PT loses three ministers. This should impact some near-term stability, but even so if Dilma gets impeached it would not be a great surprise and it could ultimately help to speed up the recovery. Why? For one, Brazil would not be saddled with a lame-duck government until 2018. Secondly, impeachment would almost certainly be viewed as a national trauma that will remind everyone of the dark days of Collor. As such, impeachment will likely change the national mood. Everyone from the lowest worker to the highest politician will recognise the need for change. This would lead to acceptance of the need to deeper reform, which in turn would be good for investors, for the

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economy and ultimately for the Brazilian people. Amidst all the gloom, it is also noting that too little attention is being paid to the integrity of Brazil's institutions. The car wash scandal is being orchestrated by an independent judiciary wielding legitimate powers of legal accountability over members of the executive and the legislature. Whatever happens in the political arena the solution is likely to follow the path set out in the country's constitution. There is no reason to fear for the democracy.

Brazil's central bank, of course, was never granted formal independence and its reputation has been severely tarnished, resulting in a very patchy record of late. But ultimately the central bank in Brazil remains super powerful. The large stock of reserves means that Central Bank governor Alexandre Tombini and his colleagues have the tools to prevent the worst of the volatility in the currency. They are using these powers and the Central Bank's reputation is slowly improving.

The biggest risk for investors right now is that Brazilian assets rally. Most investors are very underweight and sentiment is very bad. The QE programs that have driven developed markets are no longer working. Market sentiment will turn at some point and when it does many will be surprised.

- China: the overwhelming concern is of course about growth. Almost every year in the past decade the market has been fretting over the risk of a hard landing in China and this year is no exception. In fact, the simplistic and emotional focus on a hard landing belies the far more nuanced growth outlook for China. China growth trajectory rather than being binary is shaped more or less like an asymmetric shallow bowl. Growth has been and will continue to gently slow in the next few years, but it will then bottom out and gently rise to a level that is nevertheless lower than the average growth rate of the past decade. Even so, China's growth will still be high by most international standards. Why is China's growth likely to follow this particular path?

On the most basic level, China is changing from a high savings/high investment/high growth economy to a low saving/low investment/high consumption economy. This means meaningfully lower growth rates, though this is not something to be afraid of. The transition to consumption-led growth is necessary and healthy and ensures that the country's expansion is sustainable. And China has a bright future as a consumption-led economy. With a savings rate of 49% China has a lot of room to increase consumption and therefore growth.

China has also invested a lot in the future and continues to do so. Unlike many other countries, China has invested heavily in infrastructure, so its economic expansion is not likely to run into serious supply-side constraints on that front. This relative advantage will turn out to be particularly important when the global economic cycle picks up again. The future is also bright for China's manufacturing sector. China is investing very heavily in technology and innovation. The country is building intellectual property rights courts, which means that rewards to innovation will be captured better by innovators going forward. Indeed, China is – under the radar – well underway to emerging as one of the leading tech giants of the world. Innovation will ensure that China is capable of making the transition from factor input growth to total factor productivity growth.

Above all, China is also currently undertaking more forward-looking economic reforms than all other countries in the world put together. Curiously, the market has a very hard time recognising a good reform story when it sees one. Perhaps it is the fact that so few foreign investors are in China; that so few pay attention to what is going on inside the country and that reforms create noise. Sure, reforms create temporary uncertainty that leads investors and consumers to hold back on spending during the transition. You have to crack eggs if you want to make an omelette. The way to think about China's slowdown is that it is an investment; the reforms will bear fruit in growth terms in the future.

Investors are particularly focused on three areas of alleged vulnerability. The first one is FX mismatches on corporate balance sheets. But following the capital outflows this year China's corporates have now largely closed their FX mismatches (at a very small cost to the currency and hence corporate balance sheets). This risks arising from greater currency volatility from here are therefore no longer of major fundamental importance. Granted, there is still speculation, because it is cheap to short the RMB, but China's authorities are likely to take action to discourage excessive speculation.

The second area of concern is interest rates liberalisation and impact on default rates. Interest rate liberalisation will force corporates and local governments to finance at market determined interest rates. This will surely increase defaults and result in slower investment for a period, but ultimately interest rate liberalisation will result in better resource allocation and therefore more efficient markets. This will prove good for growth. China's public finances are strong enough to prevent major systemic problems, in our view. Only last week China eased mortgage rules, an important step forward towards stimulating consumption.

Finally, the market is concerned about potential fall-out from liberalisation of the capital account. Capital account liberalisation is difficult; this reform inevitably creates volatility, because some types of investors – hedge funds, cross-over, banks, retail – always seek to front-run slower real money/institutional investors. China will learn the lessons of the volatility of this year. The primary lesson is that China must deepen the institutional basis for its markets, both domestically and among the foreign investor base. Outflows could dominate inflows in the short run, but China can control the speed of outflows via regulation, e.g. QDII. Investors need to look beyond the short-term noise. The opening of China's capital markets will ultimately be very growth enhancing for China. China's domestic markets are destined to become the biggest bond and equity markets in the world

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## Emerging Markets

and China's currency will eventually become the world's dominant global reserve currency, in our view. All investors should already now have a China strategy, just as most investors have a US strategy. September's PMI rose marginally to 49.8 from 49.7 last month.

- Ukraine: Further details have emerged regarding the sovereign debt restructuring. In particular, it includes several innovative features that enhance the value of the bonds and incentivise bondholders to take part in the exchange. The Exchange Offer Memorandum was released on September 22 and invites holders of c. USD 18bn of Ukraine sovereign Eurobonds to vote before October 12. The restructuring gives the government some needed cash flow relief via a 4-year extension and 20% principal haircut, but also gives bondholders a coupon increase and a sweetener in the form of GDP-linked securities attached to the bonds pre-restructuring – a technique already used by Argentina over a decade ago. What is new is that the Ukrainian GDP-linked securities include a 'Put' option that allows holders of the securities to claim 'par' (or 20% of the notional of the old notes) if certain covenants are breached before the end of the IMF's EFF program in May 2019. The exchange offer has been very well received by investors since it was announced last month. The structural enhancement of the GDP-linked securities has further increased the interest in the securities as investors re-evaluate the value of these contingent securities and expect that they will be tightly held and difficult to find after the exchange settles at the end of October.

Snippets:

- Chile: Unemployment dropped 0.1% to 6.5% in August.
- India: Manufacturing PMI declined to 51.2 in September from 52.3 in August. The RBI cut rates by 50bps, putting the central bank ahead of the curve.
- Indonesia: Inflation in September moderated to 6.8% yoy from 7.2% yoy in August. Inflation was expected to be 6.9% yoy by the market.
- Mexico: Credit to the private sector accelerated to 8.8% yoy in August from 7.7% yoy in July and 3.3% in the same month last year.
- Peru: Inflation moderated sharply to just 0.03% mom in September from 0.38% mom in August.
- Romania: National Bank of Romania left rates unchanged at 1.75%.
- Russia: Manufacturing PMI rose to 49.1 in September from 47.9 in August. This was the highest level since February and well ahead of expectations.
- South Korea: The current account surplus in September was USD 8.5bn, which was well above expectations. CPI inflation in September moderated to +0.6% yoy versus 0.8% yoy expected. Core inflation was unchanged at 2.1% yoy.
- Turkey: The trade deficit was just USD 3.7bn in September, down nearly 50% in 12 months.

## Global backdrop

US payrolls surprised to the downside and the market rallied strongly, presumably on the expectation that the Fed will not only have to delay the rate hikes that it has been signalling for later this year, but perhaps even engage in another round of Quantitative Easing (QE). It is only a fortnight ago Fed Chairwoman Janet Yellen indicated that the FOMC will hike this year. Let us see. The Atlanta Fed's GDP tracking estimate for Q3 is now just 0.9% qoq annualised (meaning that you need to divide this number by four to get the actual growth number in the quarter). Most investment banks have also halved their growth forecasts by now following a slew of weak data. The trade balance in particular was poor, which is the result of an overvalued exchange rate and an unproductive economy (this is what EM bears used to say about EM economies just a couple of years ago). Treasury Secretary Jack Lew said last week that the US government may encounter the debt ceiling as early as 5 November.

Rate hike or no rate hike, the real lesson the market needs to take away from Friday's market response is just how sick financial markets in developed economies have become. The failure of developed economies to fix any of their underlying problems since 2008/2009, while central banks have eased monetary policies in every conceivable way possible has continued to push asset prices higher and higher, far higher than justified by fundamentals. Perversely, the worse the underlying economy the higher asset prices go as the price action on Friday showed. The contrast with EM markets could not be greater. EM has been trading on the back foot for some time due to the massive technical bid by the Fed, the ECB, BOJ and the BOE for developed market assets. EM has experienced sharp discrimination in the market place since the onset of QE – indeed, not a single QE program in the world has bought even a single EM asset. Not a single EM country has engaged in QE. EM has survived despite QE, not because of it. While this has been tough it has also meant that EM asset prices have never attained bubble levels by being inflated artificially by money printing. To the contrary, EM markets have had to contend with negative press and countries have been forced to defend themselves against waves of outflows and speculation. Unsponsored, unloved, trading at spreads that are more than twice as wide as before the 2008/2009 crisis, EM is now the healthiest part of the global financial markets. They also happen to be cheap, though value has never been the driving force behind flows to EM. Some investors will recognise that now is great time to shift from the QE trades to the non-QE opportunity set, but if you are part of those lucky few spare a thought for the many that will only reach the station after the train has already left.

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## Benchmark performance

| Emerging Markets | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| MSCI EM | 1.52% | -13.98% | -16.70% | -4.60% | -3.15% |
| MSCI EM Small Cap | 1.39% | -8.40% | -13.48% | -0.45% | -2.05% |
| MSCI Frontier | -0.07% | -13.67% | -24.26% | 5.90% | 2.03% |
| MSCI Asia | 1.55% | -11.00% | -10.04% | 0.70% | 0.81% |
| Shanghai Composite | -4.69% | -4.16% | 31.16% | 16.51% | 5.37% |
| Hong Kong Hang Seng | 2.99% | -16.69% | -3.13% | 3.33% | -1.35% |
| MSCI EMEA | 0.64% | -11.96% | -19.37% | -8.97% | -5.11% |
| MSCI Latam | 2.62% | -27.14% | -35.61% | -16.81% | -12.48% |
| GBI EM GD | 1.07% | -14.00% | -19.32% | -8.46% | -3.46% |
| ELMI+ | 0.18% | -7.32% | -12.42% | -5.20% | -3.00% |
| EM FX Spot | 0.41% | -15.98% | -22.59% | -12.50% | -9.19% |
| EMBI GD | 0.60% | 0.53% | -0.23% | 1.58% | 4.82% |
| EMBI GD IG | 0.90% | -1.21% | 0.01% | 0.61% | 4.02% |
| EMBI GD HY | 0.19% | 2.87% | -1.48% | 3.02% | 6.01% |
| CEMBI BD | 0.23% | 1.08% | -0.37% | 2.67% | 4.39% |
| CEMBI BD HG | 0.21% | 1.37% | 1.42% | 2.93% | 4.74% |
| CEMBI BD HY | 0.27% | 0.51% | -3.94% | 2.37% | 3.85% |

| Global Backdrop | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| S&P 500 | 1.65% | -3.72% | 2.36% | 12.87% | 13.59% |
| 1-3 year UST | 0.14% | 1.08% | 1.07% | 0.59% | 0.75% |
| 3-5 year UST | 0.26% | 2.97% | 3.69% | 1.60% | 1.84% |
| 7-10 year UST | 0.37% | 3.93% | 6.46% | 1.99% | 4.29% |
| 10+ years UST | 0.63% | 1.09% | 8.86% | 2.97% | 6.99% |
| US HY | -0.56% | -2.81% | -4.46% | 3.35% | 6.45% |
| European HY | 0.28% | 0.44% | 1.02% | 8.19% | 9.56% |
| Barclays Ag | 0.30% | 0.00% | 1.39% | 3.01% | 4.28% |
| VIX Index* | -14.53% | 9.06% | 43.92% | 46.13% | -3.77% |
| DXY Index* | -0.85% | 5.83% | 10.19% | 20.41% | 22.87% |
| CRY Index* | 0.18% | -15.59% | -29.76% | -36.90% | -32.70% |
| EURUSD | 0.77% | -6.88% | -10.54% | -13.62% | -18.52% |
| USDJPY | 0.43% | 0.28% | 10.35% | 52.76% | 44.36% |
| Brent | 0.74% | -15.00% | -47.21% | -56.50% | -42.56% |
| Gold spot | 1.82% | -4.44% | -5.99% | -36.25% | -15.29% |

*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.


## 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

**Riyadh**
T: +966 11 483 9100

**Singapore**
T: +65 6580 8288

**Tokyo**
T: +81 03 6860 3777

**Washington**
T: +1 703 243 8800

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