Move over please!

By Jan Dehn

Much attention was paid to the expectation that China will overtake the US as the world's largest economy this year, but the bigger story in our view is that Emerging Markets (EM) actually overtook developed economies as the largest share of global GDP already last year. This is clear from new IMF data released in April. Clearly, both investor perceptions about and allocations to EM continue to lag far behind EM's rapid fundamental advances. This is true in both equities and fixed income, but especially in fixed income, where allocations by many investors lag weighting implied by simple GDP weighting by as much as ten times. This suggests that EM's long-term technicals remain extremely strong.

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Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,001	–	0.20%
MSCI EM Small Cap	1,050	–	0.64%
MSCI FM	668	–	1.57%
GBI EM GD	6.82%	–	0.65%
ELMI+	3.55%	–	0.29%
EMBI GD	5.42%	279 bps	0.48%
EMBI GD IG	4.60%	192 bps	0.68%
EMBI GD HY	7.43%	505 bps	0.09%
CEMBI BD	5.35%	305 bps	0.33%
CEMBI BD HG	4.43%	213 bps	0.39%
CEMBI BD HY	7.19%	488 bps	0.21%

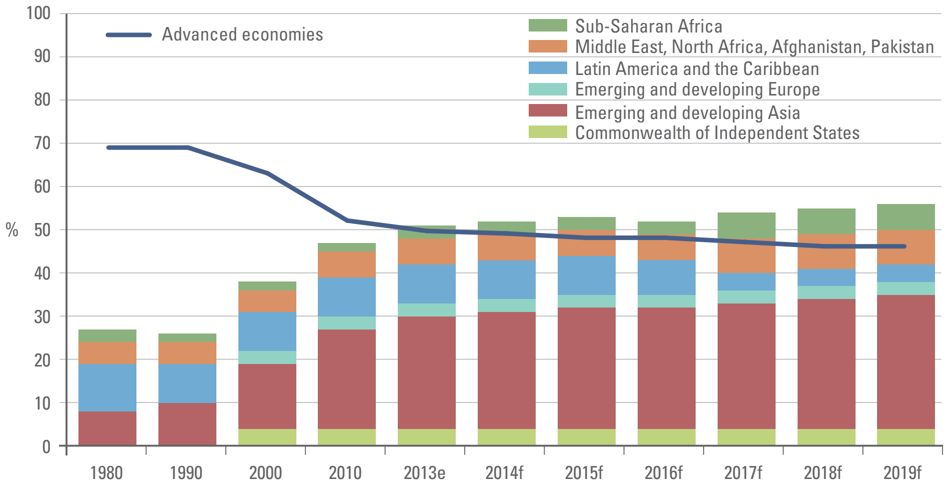
Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1885	0.36%
VIX Index	13.29	-3.06%
5 year UST	1.69%	-4 bps
10 year UST	2.62%	-7 bps
US HY	5.31%	0.20%
European HY	4.40%	0.23%
EURUSD	1.3929	0.85%
USDJPY	101.95	-0.63%
Brent	107.93	-1.35%
Copper	311.75	-1.02%
Gold	1307.23	0.79%

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

Emerging Markets

Much has been written about China overtaking the United States as the largest economy in the world this year. However, we think the less publicised fact that EM now constitute – for the first time ever – more than 50% of global GDP is at least as relevant for investors. According to the IMF's April 2014 World Economic Outlook, EM's share of global GDP (PPP adjusted) reached 50.4% in 2013, up from 31% in 1980. This means that EM has increased its share of global GDP by an average of 0.6% per year over the past 33 years. Interestingly, the IMF expects EM share of global GDP to increase at an ever faster pace going forward. According to its forecasts, EM's share of global GDP will grow by an average of 0.7% per year from now until 2019 to reach 54.5%. Allocations to EM by most central banks, sovereign wealth funds, public and private pension funds, endowments, foundations, and retail investors remain massively below what would be implied by simple GDP weighting.

Fig 1: **EM's share of global GDP now exceeds that of developed economies**



Source: IMF World Economic Outlook April 2014, Ashmore.

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Emerging Markets

- **Russia and Ukraine:** The latest round of EU and US sanctions were far milder than had been expected in the market and Russia's President Putin responded to the gesture by pulling back some troops and toning down the aggressive rhetoric.

The détente in international diplomacy was however offset by an increase in the level of tension on the ground in Ukraine, including outbreaks of violence in Odessa. Kiev this week announced conscription to deal with the Russian threat and there were further clashes, marking a further escalation in tensions on the ground.

Still, we note that a broad-based popular uprising in Eastern Ukraine in favour of Russia's annexation of the region has so far failed to materialise, which reduces the odds of Russian annexation, in our view.

The détente at an international level may yet prove to be an important turning point in the crisis, but the situation on the ground can quickly unleash another round of international recriminations. In any case, we expect the situation to remain fragile at least through the upcoming election cycle in Ukraine. The US and Europe have now linked further sanctions to the 25 May election in Ukraine if elections are disrupted by Russia.

We believe that Russia's long-term objectives remain the inclusion of Ukraine into the Eurasian Economic Union and gaining control over Ukraine's underground gas storage facilities. The best way for Russia to further these aims are to keep Ukraine weak and not part of the Eurozone and especially not part of NATO. To achieve this Russia will therefore want to undermine the legitimacy of any future pro-Western administration in Kiev. This means continuing support for pro-Russian separatists in Eastern Ukraine, especially in the run-up to the election.

Looking beyond the election on 25 May, Ukraine will need to change the constitution and then likely have fresh elections later this year; plenty of important milestones to follow and plenty of opportunities for Russia and the West to stir up proxy-confrontations in Ukraine.

Away from the diplomatic theatre we believe both Europe and Russia have strong mutual interests and therefore incentives to find a diplomatic solution to the tension in Ukraine. We think Germany together with Russia will lead this process, though often behind the scenes. We note as an example of this work the release of OSCE observers last week.

Meanwhile, it was announced on 30 April that the IMF will disburse USD 3.2bn of a USD 17bn standby agreement for Ukraine. As with all IMF programs, the program is fully funded, so Ukraine will be able to service all debts coming due over the next two years, provided it complies with the program and that the country is not split up as a result of Russian annexation (in which case the program has to be renegotiated, possibly with private sector involvement). In another positive development for Ukraine, Slovakia and Kiev announced a gas supply agreement. This helps as although Ukraine has so far been able to secure some 13 bcm of gas from non-Russian sources, its annual gas imports are closer to 22 bcm.

- **China:** Manufacturing is stabilising. Official manufacturing PMI in April was 50.4, up from 50.3 in March. HSBC's Markit PMI also rose marginally from last month at 48.1 (versus 48 in March). We do not expect a sharp pick up in manufacturing or growth, because China is busy transforming its economy from export to domestic demand led. Transitions of this kind place a near-term tax on growth, but will ensure the sustainability of growth for the country once inflation returns in the world's QE economies and EM currencies strengthen by virtue of the strong external balances. No country in the world will be more impacted by this change than China. China this week announced credit insurance measures and VAT rebates to aid exporters in their transition to a more volatile currency environment as part of the process of interest and capital account liberalisation.

- **India:** Officials from the Finance Ministry in India said that the government will take steps to make the capital market more investor friendly after the ongoing election. This will include the establishment of an independent debt management office and allowing Euroclear settlement of Indian debt, as well as deepening the FX derivatives market. When viewed in conjunction with ongoing reforms of the Indian banking system our reading of the tea leaves suggests an opening of the Indian domestic bond market to foreign investors in the not-too-distant future. The Indian domestic bond market is USD 760bn and we calculate that India would instantly become 10% of JP Morgan's GBI-EM-GD index if capital account restrictions were removed.

- **South Korea:** Following recent stronger than expected growth data Korea unveiled better than expected trade numbers. April's exports rose 9% yoy versus 5.5% expected and 5.1% yoy in March. Imports were also stronger than expected, albeit by a smaller margin, so the trade balance improved more than expected (surplus of USD 4.46bn versus USD 4.3bn expected, and USD 4.2bn last).

- **Mexico:** President Peña Nieto this week forwarded secondary energy sector legislation to the Senate. This follows crucial constitutional changes approved last year that introduced private sector involvement in Mexico's energy sector. We expect the legislation to pass between now and mid-summer. Once the legislation has been approved we expect to begin to see investment in the sector with material upside accruing to Mexico through the medium and long term.

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Emerging Markets

- **Brazil:** Responding to poll ratings that continue to slide ahead of elections in October, President Dilma Rousseff this week hit the panic button by announcing a 10% increase in Bolsa Familia, a popular income support scheme for low income workers. Dilma's approval rating declined to 37% from 44%, according to pollster, MDA. Brazil's public finances are deteriorating, but from a very strong base. The main challenge for the Dilma adminstration, in addition to winning the election, will be how to restore growth. This requires stronger business confidence and investment, but a clear lurch towards more heterodox policies under the leadership of Finance Minister Guido Mantega will make this difficult to achieve. Mantega's policies have destroyed trust in the government's handling of the economy and thus undone most of the enormous gains in credibility achieved under the previous administration. In a positive development, the trade balance was stronger than expected in April. At USD 506m, the surplus was more than twice as large as expected and year to date the trade balance has improved about 10% relative to last year at this time.

- **Indonesia:** Indonesia clocked a growth rate of 5.2% yoy in Q1, down from 5.7% in Q4 2013. Exports softened, but domestic demand picked up. Investment increased from 4.4% yoy to 5.2% yoy.

- **South Africa:** South Africa's trade balance worsened sharply in March. The deficit was ZAR 11.4bn compared to ZAR 1.5bn expected. Still, the monthly data is extremely volatile. Despite the worse than expected data, we do not worry about South Africa's trade deficit. The South African Reserve Bank is highly credible and likely to tighten policy to keep inflation in check and ZAR has strengthened despite the print. South Africa's corporates do not have material FX mismatches. In other economic news, both manufacturing and employment remained sluggish according to data released last week. While sluggishness is hardly surprising ahead of this week's election, we think South Africa also struggles to overcome deeper structural growth impediments that are unlikely to be addressed in the near future.

- **Panama:** The Panamenista Party, led by vice president Juan Carlos Varela, has won the parliamentary election in Panama, and now faces the prospect of fixing a growing fiscal problem without a majority in parliament against a backdrop of a slowing economy. The growth phase of the expansion of the Panama Canal is now ending.

- **Venezuela:** Rafael Ramirez, veteran official and current vice-president in charge of the economy, this week announced a number of important positive economic policy changes. We think implementation will be patchy, particularly since the government has strong vested interests in maintaining the existing rent seeking system. Besides, President Maduro's approval rating dropped to 37% in April from 55.2% at the same time last year, according to a new poll by Datanalisis, a credible pollster. Even so, we regard the announcements by Ramirez as unambiguously positive. Among the most important measures we highlight Ramirez's recognition that the current macroeconomic imbalances, including shortages of goods, are cyclical in nature, and that some adjustment is necessary in aggregate demand.

- **Turkey:** Inflation rose faster than expected in April. Over the month, inflation rose 1.3% compared to a consensus expectation of 0.9%. The high prints are mainly due to inflation pass-through from a weaker exchange rate. Turkey's central bank has been very late in correcting its macroeconomic imbalances, probably due to a busy election schedule. This triggered a bout of currency weakness earlier this year, which is now feeding into inflation and could continue to do so for another month or two. Still, we expect the pass-through to moderate over the course of the rest of the year.

Monetary policy changes:

- Israel left policy rates unchanged at 0.75%

Global backdrop

Looking back at Q1 it would appear that the excessively bearish sentiment about EM was only exceeded by the degree of irrational exuberance about the US economy. The US real GDP growth rate for Q1 was just 0.1%, according to the first estimate released this week. A pick-up in consumption appears to be strongly related to increased income transfers under Obamacare, while the investment component was particularly weak. The latter does not bode well for a very strong rebound, which in any event is not part of our expectation, because we still think household deleveraging remains a drag and investment in particular remains extremely sluggish in the US. Deleveraging is nevertheless happening slowly as evidenced by the Fed's Senior Loan Officer Survey, which showed further thawing of credit markets. This allowed the Federal Reserve to announce a further USD 10bn of tapering, taking its monthly bond purchases from USD 55bn to USD 45bn. The lack of reaction in the bond market shows that tapering is fully priced in and that the Fed has prepared the markets better this time around, especially in the event of a rebound in the data, which seems likely. So far, however, the data is distinctly mixed. Consider the labour market data. The headline was that payrolls strongly outperformed expectations and unemployment dropped by 0.3% to 6.3%, but participation rates dropped by 0.4%, so unemployment would actually have risen if so many people had not given up looking for work. The strong payroll print was at least in part payback from weaker than expected prints during the cold spell over the last few months. But if this strong print was the

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Global backdrop

'bounce back' then what lies ahead? The outlook beyond labour markets is also somewhat mixed. The week produced stronger than expected ADP payroll, strong Dallas Manufacturing and Chicago PMI, better services PMI, and stronger pending home sales, but also weaker Case Schiller home price appreciation, lower consumer confidence, higher claims for unemployment, and softer New York ISM and Milwaukee ISM prints, while vehicle sales also disappointed. We also note that weekly mortgage applications dropped to their lowest level since 2000 at just 333 weekly applications, down from more than 1000 before tapering began.

Meanwhile, inflation in the Eurozone drifted marginally higher in April. Core inflation rose to 1% yoy from 0.7% in March. The ECB has signalled that QE is not likely in the near-term. Both these factors helped to steer EURUSD higher over the course of the week. Portugal exited its EU/IMF sponsored bailout program as bond yields dropped to 3.6% from 6% at the end of 2013. Portugal's debt to GDP ratio is 130% compared to an average net debt to GDP ratio across all 165 Emerging economies of 34%. It is clear that Portugal, Greece, and other periphery economies are not trading at these levels due to fundamental strength, but by virtue of the implicit ECB backstop.

In Japan, retail sales rose 6.3% mom, a strong print, but likely one that is heavily influenced by imminent sales tax hikes. Industrial production was soft relative to expectations and forward expectations also weakened. Of greater concern was news that basic wages declined by 0.4% yoy in March.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.7%	0.4%	-1.2%	-2.1%	10.2%
MSCI EM Small Cap	0.9%	4.8%	-0.3%	-1.5%	14.6%
MSCI FM	1.3%	14.9%	28.6%	9.3%	13.0%
S&P 500	0.05%	2.61%	19.20%	14.62%	18.30%
GBI EM GD	0.38%	3.20%	-9.19%	0.45%	7.87%
ELMI+	0.29%	1.05%	-2.40%	-1.51%	3.22%
EMBI GD	0.31%	5.35%	-1.23%	6.97%	10.51%
EMBI GD IG	0.45%	5.46%	-3.09%	5.73%	8.41%
EMBI GD HY	0.03%	5.13%	2.28%	9.19%	13.51%
5 year UST	0.00%	1.39%	-1.95%	2.57%	3.22%
7 year UST	0.03%	3.02%	-3.43%	3.89%	4.42%
10 year UST	0.15%	5.61%	-3.66%	5.95%	5.04%
CEMBI BD	0.23%	3.84%	0.87%	5.57%	10.81%
CEMBI BD HG	0.29%	4.21%	0.79%	6.04%	9.44%
CEMBI BD HY	0.11%	3.05%	1.08%	4.95%	15.46%
US HY	0.09%	4.05%	6.59%	9.48%	16.26%
European HY	0.12%	4.56%	11.56%	13.06%	19.53%
Barclays Ag	0.18%	3.75%	2.29%	2.28%	5.12%

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