Issued: 6 October 2014

Never says Neves

By Jan Dehn

President Dilma Rousseff wins the first round of the Brazilian presidential election, but Aecio Neves did far better than expected as attention now shifts to the run-off on 26 October. The power struggle is going down to the wire in Indonesia. Malaysia does the right thing on energy subsidies. Russia dismisses concerns about capital controls. Uruguay eases access to its local markets. China forges ahead with developing the muni bond market. Argentina is held in contempt of court and pays another coupon into accounts investors cannot access. Hong Kong's leaders signal willingness to talk. On the global stage, ECB delivers what was expected on credit QE, but nothing more and 'Fed speak' becomes more interesting from here.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,002	–	-0.68%
MSCI EM Small Cap	1,061	–	-0.14%
MSCI FM	697	–	-0.34%
GBI EM GD	6.70%	–	-0.35%
ELMI+	3.51%	–	-0.39%
EMBI GD	5.40%	293 bps	-0.05%
EMBI GD IG	4.51%	200 bps	0.30%
EMBI GD HY	7.41%	510 bps	-0.71%
CEMBI BD	5.24%	300 bps	0.19%
CEMBI BD HG	4.38%	212 bps	0.19%
CEMBI BD HY	7.14%	493 bps	0.20%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1968	-0.47%
VIX Index	14.55	-8.95%
5 year UST	1.72%	-4 bps
10 year UST	2.44%	-4 bps
US HY	6.36%	0.55%
European HY	5.02%	0.11%
EURUSD	1.2544	-1.22%
USDJPY	109.42	0.07%
Brent	91.86	-3.73%
Copper	310.27	-1.12%
Gold	1194.26	-1.97%

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

Emerging Markets

- **Brazil:** Aecio Neves, from the centre-right PSDB party, did far better than expected and will now face President Dilma Rousseff in a run-off for the job of president on 26 October. Neves polled 33.8% versus Dilma's 41.4% (based on 98% of the votes counted). Marina Silva faded to 21.3% (the same she polled in the previous election). The focus will now be on who Marina supports (or does not support) in the run-off. Neves polled significantly better than predicted in the polls, suggesting that he now has strong momentum. He also has funds to finance a strong campaign. The market is likely to be warmly disposed toward Neves, who has already appointed Armenio Fraga, a credible former head of the central bank, as its future finance minister. Brazil faces three major challenges: a credible economic team, the need for fiscal adjustment and reform to reduce the bloated state sector, especially in credit. Compared to Dilma, Aecio would deliver the first two but it is unlikely, in our view, that he would have the votes to significantly change Brazil's current status as 'the France of South America'. Meanwhile, economic weakness continues in Brazil. The August primary balance was the lowest since 1997 as weak economic growth and ineffective subsidies continue to take their toll on the public finances. A primary surplus of less than 1% of GDP now seems likely this year, down from 3.4% of GDP in 2008. Industrial production rose 0.7% mom in August, which was much better than expected (0.1% mom). Aside from the usual cyclical ups and downs, a sustained recovery in Brazil is unlikely until after the election and only if the government changes its economic team and begins to address the economy's cyclical and structural problems.
- **Indonesia:** Outgoing President Susilo Bambang Yudhoyono (SBY) said he would issue an emergency decree to overturn a law passed last week that would replace direct elections of local officials with individuals appointed by parliamentarians. This is good news. If left unchallenged, the bill would significantly increase central control of local politics in an undesirable manner. An SBY decree would have to be passed by Parliament in order to take effect. Hence, the focus in Indonesia is now on the ability of President-elect Joko Widodo (aka Jokowi) to form a majority coalition and how easily he can govern. Here the picture remains ambiguous. On the positive side, numbers suggest that a Jokowi-led majority is possible. Talks are ongoing and likely to intensify leading up to Jokowi and Vice-president Jusuf Kalla's swearing in ceremony on 20 October. On the negative side, allies of opposition-leader Prabowo have secured several key positions in parliament, including the influential role of speaker. The economy is doing well. Indonesian exports rose strongly in August, up 10.6% compared to -6.4% in July. Despite the increase in exports, imports rose marginally faster due to front-running of imports ahead of local cultural festivals. It is worth bearing in mind that exports constituted about 23% of

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Emerging Markets

GDP in Indonesia, while the net export contribution to GDP is close to zero. Hence, the Indonesian economy is mainly a domestic demand story, not a trade story. Inflation in September was 4.5% yoy, up 0.1% from August, while core inflation moderated to 4% yoy from 4.5% yoy in August.

- Malaysia: The government surprised the market by raising subsidised fuel prices by 10%. The economy is capable of handling the hike and inflation pressures are modest, so the timing is good. The move will increase the efficiency of the economy and contribute to meeting the government's fiscal deficit target. The government plans to move to a balanced budget by 2020. In 2014, the deficit will be 3.5% of GDP, down from 3.9% of GDP last year.

- Russia: A completely unfounded rumour that Russia would introduce capital controls was vociferously refuted by President Vladimir Putin, Russia's finance ministry and the central bank. The rumour triggered some panic selling in some quarters, thus helping market makers to make money out of nothing at the expense of investors, who crossed the bid-offer spread unnecessarily. Capital controls would amount to an unusually draconian U-turn on macroeconomic policy, which would be incompatible with the central bank's commitment to a free floating RUB (or dirty float at least). The government has also just eased access to its local bond market (OFZ) by making settlement Euroclearable. Finally, a floating exchange rate is extremely effective in insulating the government finances against oil price volatility. Capital controls would likely be a last resort, in our view. Instead, central bank governor Elvira Nabiullina announced a Dollar repo facility to help ease any short-term shortages. Russia has more than USD 460bn of FX reserves and its central bank has not been afraid of raising rates. An intensification of FX intervention is also likely to precede any move towards capital controls, in our view. Russian households have approved of President Putin's actions to protect vital Russian national interests in the Black Sea, notably the key naval base of Sebastopol in Crimea. Hence, there has been little Dollarisation among ordinary Russians, despite the headlines. Russia's domestic economy is sluggish, but not falling off a cliff. The PMI report for September was 50.4, above the expectation of 50. Retail sales also show resilience. Services PMI also improved to 50.5 from 50.3. On the negative side, inflation rose to 8.0% yoy in September from 7.6% in August, mainly due to a rise in food prices (attributable to sanctions).

- Kenya: The Kenyan government has re-based the GDP index and concluded that the economy is 25% larger than hitherto reported (USD 55.3bn). Frontier economies regularly undertake large GDP revisions for very good reasons – unlike mature economies that experience very few structural changes in their economies, frontier economies often evolve rapidly. Entirely new institutions and industries are created and countries progress through development stages much more rapidly than rich countries did in their day. The fact that GDP is rebased only infrequently, of course, means that real GDP growth rates tend to be materially and systematically biased towards under-estimating growth in frontier economies. As for Kenya, the now larger economic base translates into improvements in the country's fiscal and current account deficits as a share of GDP, reducing them from 7.7% to 6.4% and from 6% to 5%, respectively. The public debt ratio also improves from 57% to 47% of GDP. On the other hand, the tax and spending efficiency of the government – meaning the percentage of the economy taken by the government in taxes and subsequently spent on goods, services, debt service and other stuff – is now lower. Fans of small government will welcome this. Fans of big government will bemoan the decline in the role of the state. In reality, of course, nothing has changed at all except that Kenya now measures its economy more accurately. Hence, the debate is somewhat academic, in our view.

- Uruguay: The government has lowered the reserve requirements for foreigners buying local nominal government bonds to zero. The reserve requirement for foreign purchases of central bank issued securities has been cut from 50% to 30%. This removal and reduction eliminates obstacles to accessing local bonds, in our view. It also shows that Uruguay understands that one of the ways to 'win' in a world of tighter liquidity is to increase foreign access to its local markets. Undoubtedly, there is also a desire to support local currency markets in the face of a violent recent surge in the Dollar. The most efficient way to increase the foreign share of the local market is to join one of the main EM local currency bond indices. After all, the majority of the world's investors will invest in just about anything as long as it is part of an index (the meaning of passive investment). In the specific case of Uruguay, we do not expect a sudden rush into the market, however. Uruguay has closely contested elections on 26 October with a possible run-off on 30 November. We think the main contenders are all sensible types, but elections tend to put things on hold. More importantly, Uruguay's local nominal bond curve is very illiquid and lacks clearly defined liquid benchmarks. Finally, the bonds are not in the GBI EM GD index. Investors therefore tend to express their local views via Uruguay's off-shore UYU denominated inflation-linked bonds, which are more liquid.

- Turkey: Turkey's trade deficit widened to USD 8bn in August, a material deterioration from the USD 6.5bn deficit in July. On the other hand, inflation significantly undershot expectations. CPI inflation was 8.86% yoy versus 9.36% yoy feared and 9.54% yoy last. TRY has been one of the weakest currencies in EM during the recent Dollar surge, so the low inflation print suggests that pass-through has been relatively weak. Even so, Turkey's economic policies are entirely hostage to President Erdogan's political ambitions, particularly his desire to win a landslide in the parliamentary election scheduled for next August and subsequently changing the constitution with a view to giving himself far greater powers. We believe that the central bank is influenced by Erdogan's objectives and likely

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Emerging Markets

to err on the dovish side. Hence, inflation is likely to face mainly up-side risks. Recent utility price adjustments could elevate prices in the next few months. The official core inflation target in Turkey is 5% – a target that has never been met. Given this broad macroeconomic stance, the economy's vulnerability to higher US rates could quickly become a focus, especially during bouts of Treasury market volatility. It was therefore a positive development when Finance Minister Mehmet Simsek said on Thursday that the government will undertake a comprehensive set of economic reforms, including some measures before next year's election. However, he also noted that the bulk of reforms would be done after the election, consistent with Erdogan's near-term political agenda.

- China: When the Chinese budget law was amended a few months ago to provide a legal basis for bond issuance by local governments a framework of regulations governing such bond issuance was still pending. Last week, the State Council produced this important directive. The directive is a very positive development, because it marks the beginning on a brand new phase in the muni bond market in China. Specifically, the directives specify quotas, formats and legitimate purposes for local government borrowing, ban public borrowing via outside entities (so-called local government financing vehicles, or LGFVs) and allow borrowing using bonds. The measures are consistent with the view that China's bond market is going to gain far greater importance going forward. This serves three purposes: one, to discipline local governments; two, to improve the transmission mechanism for monetary policy; and three, to encourage higher consumption by adding bonds to savings instruments available to ordinary people. To encourage the bond market China is liberalising interest rates. This will expose credit weakness in some areas, but China's economy is strong enough to handle this, while authorities will continue to provide targeted relief to particularly vulnerable sectors. Thus, it is not inconsistent with the overall direction of travel that the government last week eased access to mortgages for non-first time buyers. Banks will also be encouraged to issue MBS and issue longer-term bonds in order to be able to issue more mortgages. There will also be incentives to encourage property developers, including pilot REITs. Lending to social housing and shanty town developments will also be given priority. These changes are consistent with China's move towards consumption led domestic demand-led growth. China's services PMI maintained a 54 handle.

- Argentina: The government paid USD 161m in coupon payments on US and UK law par bonds to Nacion Fideicomisos, the new payment agent that has replaced Bank of New York. It is unclear how the funds will reach investors without co-operation from international payment agents, who are currently barred by a US court from passing payments to bond holders. In the past week, Judge Griesa ruled Argentina to be in contempt of court for attempting to pay bond holders via local payment agents. This is largely meaningless, in our view, as Argentina has already opted to head down the road less travelled. A poll suggests that Mauricio Macri, mayor of Buenos Aires, has opened a 9% point lead in the race for the presidency next year. Macri would be warmly welcomed by markets, but we warn that political fortunes in Argentina oscillate so violently that the 'signal to noise ratio' in this poll – with respect the actual election outcome next year – is close to zero. Central bank president Juan Carlos Fabrega resigned to be replaced by capital markets regulator Alejandro Vanoli. This changes nothing in Argentina, which will continue on its likely unsustainable path of populist policies until the term of President Cristina Kirchner expires next year. Controls are likely to tighten, buying more time, but ultimately making the required adjustment larger. Parliament has begun processing a law proposal that would allow some debts denominated in FX to be settled in pesos at the official exchange rate. Despite echoes of Argentina's traumatic experience of 'pesofication' during the 2001 default this law would not take effect until 2016. By then Argentina will have a different government that may well opt to reverse the law, if passed.

- Hong Kong: Hong Kong leader Leung Chun-ying says he will talk with protesters, but not meet their demands to step down. This marks the start of a negotiation process which is likely ultimately to defuse the tensions, though we think the protests surprised the authorities and found them ill-prepared to deal with events. This is now likely to change, in our view. We think tensions between pro-democracy activists and the authorities in Hong Kong are likely to find a negotiated and peaceful resolution. Both sides have a lot to lose and therefore incentives not to let things get out of control. In particular, China has great vested interests in making a success of Hong Kong, which is one of the main off-shore centres for RMB trading, a business showcase for China and an economic powerhouse in its own right. Similarly, Hong Kong dwellers have higher levels of opportunity, greater wealth, and more freedom than Chinese from mainland China.

- EM PMIs: PMIs rose in all three CE-3 economies (Czech Republic, Hungary and Poland) in September, despite an outright decline in Eurozone PMI (50.3 from 50.5), a fall in UK PMI (51.6 from 52.2) and an outright negative PMI print for Germany (49.9 vs 50.3 expected). Czech Republic PMI rose to 55.6 from 54.3, Hungarian PMI rose to 52.6 from 51, and Polish PMI also rose, albeit by only 0.5 to a still modest 49.5. South Africa's PMI rose to 50.7 in September from 49 in August. Turkey's PMI also rose to 50.4 in September from 50.3 in August. China's September PMI was stronger than expected at 51.1, unchanged from August. PMIs are patently not the same as growth. PMIs measure manufacturing sector activity and tend to be heavily influenced by the inventory cycle. PMI cycles have become more coordinated across the world due to globalisation, but still retain an element of country-specific dynamics, especially in more closed economies, or economies that trade a smaller percentage of the output with the rest of the world.

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Global backdrop

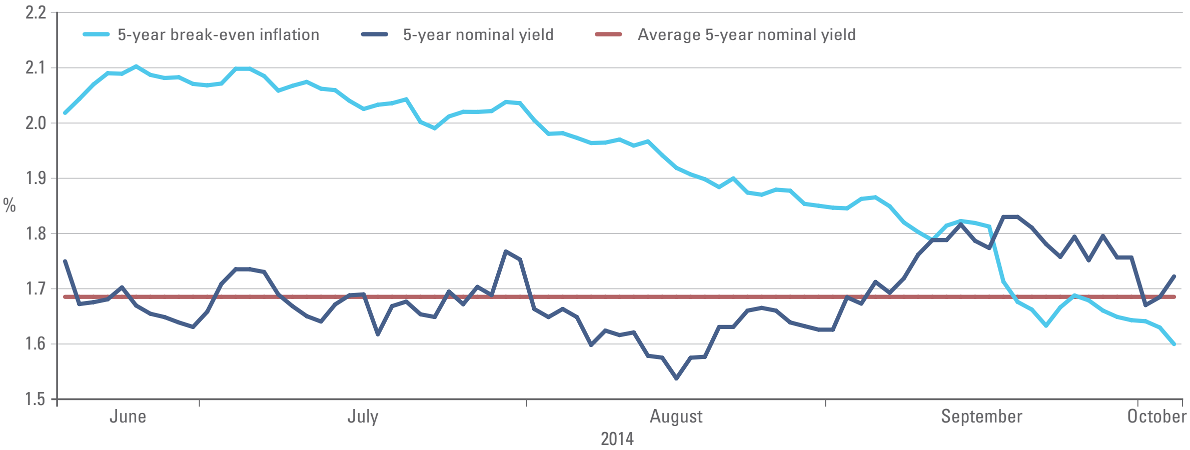
Snippets:

- **Thailand:** Inflation in September was well below expectations at 1.75% yoy (market expected 2.0%). The vast majority of EM countries have very low inflation due to strong political demands from lower income populations with few if any means of hedging inflation. Countries that allow their inflation rates to drift higher tend to pay a severe political price.
- **South Korea:** Exports rose 6.8% yoy in September with particularly strong gains in exports to the United States and China, while exports to both Japan and Europe declined. But the strongest demand for Korean exports came from the Middle East and Latin America, where exports rose 35% yoy and 16% yoy, respectively. On the other hand, South Korean PMI softened to 48.8 in September from 50.3 in August.
- **Uganda:** Uganda is considering a USD 1bn benchmark Eurobond to fund infrastructure investments. Uganda would become the latest EM country to augment the ranks of the EMBI index, which has grown from 26 countries 10 years ago to more than 60 countries today.
- **Venezuela:** The freely traded (illegal) parallel exchange rate in Venezuela last week breached VEF 100 per US dollar for the first time. There are three official exchange rates ranging from about VEF 6 per Dollar to about VEF 50 per Dollar.
- **Mexico:** The improvement in Mexico's cyclical indicators continued as PMI rose 0.5 points to 52.6 in September. This is the highest level achieved this year. Mexico's recovery has been sluggish due to drags from a moribund homebuilding industry, slow execution of government projects, investments delayed pending passage of regulations and on account of volatility in the US economy. Mexico's impressive reform effort, however, has bought room for Mexico to grow faster before encountering inflation, in our view.
- **South Africa:** Lesetja Kganyago has been named as Governor of South Africa's Reserve Bank (SARB). Kganyago was formerly deputy governor of the SARB, but he made his name while at the National Treasury. He brings extensive experience and skills in both economics and finance to the job of SARB governor and we strongly welcome his appointment.

Global backdrop

Last week's strong payroll number and lower unemployment rate keeps the Fed on its path towards hiking in H1 2015. This is supportive for the Dollar but the bond market does not share the optimism. In fact, it has begun to price in a much weaker trajectory for US inflation. Real US 5-year yields have risen to positive territory for the first time since 2011, but (as the chart below illustrates) inflation break-evens have collapsed while nominal 5-year yields have been flat. Or to put it differently, the bond market is saying that the Fed is on track to significantly undershoot its inflation target due to early hikes, reflecting a growing expectation of slower US growth going into 2015. The rise in the Dollar threatens growth (estimates suggest that a 10% rise in the Dollar wipes between 50-100bps off US growth rates). The stronger Dollar also tightens with the result that stocks weaken (down quarter to date) and US high yield has sold off. While a strong Dollar is a popular call, and herd mechanics could prevail for some time, we think past episodes of Dollar strength are a poor model for the current situation. Firstly, the US economy is very heavily indebted. Secondly, the model of recovery hinges on maintaining easy conditions while the economy deleverages. Slower growth, wider credit spreads and re-emerging risks of deflation – of the Fed's own making – could easily undermine confidence in the present rally. Yes, the Fed wants to get its first hike off the books, but this will likely be accompanied by 'Fed speak' to calm markets at least until inflation arrives to provide some relief from higher real rates.

Fig 1: **Rising real yields due to falling break-evens**



Source: Ashmore, Bloomberg.

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Global backdrop

France now expects to meet the EU-determined 3% of GDP fiscal deficit target by 2017, which is two whole years later than originally planned. Italy has also delayed meeting its 3% deficit target by a year. Europe had weaker than expected PMIs and softer than expected inflation this month. Catalonia says it will go ahead with an independence vote on 9 November. Services PMIs were also softer, but less so as one would expect (inventory cycles are far less pronounced in services industries than in manufacturing industries). Retail sales, on the other hand, bounced back to record a 1.9% yoy increase versus 0.7% yoy expected. ECB responded to broadly negative sentiment by confirming purchases of up to EUR 1trn of covered bonds and asset backed securities, but ECB President Mario Draghi failed to validate expectations for outright sovereign QE at this ECB meeting. ECB's credit easing is essentially a band aid for deeper weaknesses caused by failures to reform, failures to deleverage and failures to fix the insolvency of banks in Europe. We do not believe QE policies will generate inflation or return Europe to a higher trend growth rate. Hence, the (very) gradual rise in US rates over the next few years will likely result in higher real rates in Europe, which Europe, of course, needs like a hole in the head. The result will be slower demand, greater current account surpluses, and ultimately a stronger EUR, for all the wrong reasons.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.3%	1.7%	2.0%	8.4%	4.9%
MSCI EM Small Cap	-0.2%	7.2%	7.4%	10.9%	7.2%
MSCI FM	-0.5%	21.2%	28.6%	18.0%	8.3%
S&P 500	-0.20%	8.12%	19.65%	24.06%	16.33%
GBI EM GD	-4.30%	0.84%	-1.34%	2.69%	4.58%
ELMI+	-2.51%	-1.20%	-1.59%	0.83%	0.99%
EM spot FX	-0.64%	-6.17%	-8.68%	NA	NA
EMBI GD	0.10%	8.14%	9.54%	8.03%	8.06%
EMBI GD IG	0.35%	8.38%	8.46%	6.30%	6.78%
EMBI GD HY	-0.35%	7.74%	11.95%	10.92%	10.04%
5 year UST	0.24%	2.27%	1.04%	0.75%	3.24%
7 year UST	0.41%	4.90%	2.53%	1.16%	4.59%
10 year UST	0.61%	8.71%	5.69%	1.73%	5.46%
CEMBI BD	0.23%	6.49%	8.39%	8.43%	7.42%
CEMBI BD HG	0.25%	7.06%	8.43%	7.15%	6.97%
CEMBI BD HY	0.20%	5.26%	8.32%	11.73%	8.83%
US HY	0.18%	3.93%	7.59%	11.37%	11.26%
European HY	0.08%	4.98%	9.29%	16.88%	13.27%
Barclays Agg	-0.23%	1.41%	0.50%	1.06%	2.59%

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

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