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WEEKLY INVESTOR RESEARCH

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The global economic rebalance continues

By Gustavo Medeiros

The global economic rebalancing act extended over the past week, with both the Brazilian and Indonesian trade balances bouncing back into surplus. In China, the government announced a small economic stimulus package designed to reverse the marked slowdown experienced in the first quarter. Conversely, in developed markets, overly optimistic expectations are being rebalanced towards a more sober reality: growth forecasts for the US are being revised downwards following the publication of disappointing trade numbers, and the ECB finally recognised that inflation is undershooting their expectations and that they may have to do something unconventional about it. Investors piled into European fixed income assets, singing the old Elvis tune which calls for "a little less conversation, a little more action".

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1002	–	0.91%
MSCI EM Small Cap	1056	–	1.67%
MSCI FM	640	–	2.20%
GBI EM GD	6.90%	–	0.34%
ELMI+	3.71%	–	0.05%
EMBI GD	5.50%	275 bps	0.55%
EMBI GD IG	4.72%	191 bps	0.35%
EMBI GD HY	7.41%	492 bps	0.94%
CEMBI BD	5.41%	303 bps	0.27%
CEMBI BD HG	4.53%	214 bps	0.18%
CEMBI BD HY	7.24%	485 bps	0.46%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1865	-0.36%
VIX Index	13.96	0.58%
5 year UST	1.70%	-2 bps
10 year UST	2.73%	1 bps
US HY	5.31%	0.27%
European HY	4.36%	0.34%
EURUSD	1.3717	-0.38%
USDJPY	103.26	0.03%
Brent	105.23	-1.64%
Copper	310.50	0.60%
Gold	1299.19	1.17%

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

Emerging Markets

The rebound in Emerging Markets (EM) assets continued to gain momentum, supported by benign global macro data and positive news in local markets. At the macro level, mild economic data in the US has contributed to the lowering volatility in US interest rates. In Europe, Draghi revealed that the ECB Monetary Policy Committee agreed to use unconventional tools such as Quantitative Easing (QE) if inflation does not converge towards the ECB scenario. The German newspaper, FAZ, reported on alleged ECB studies modelling the impact of a EUR 1 trillion in Euro-QE – more than enough to replace the US Fed's reduction in money-printing. Both events led to a rebound in investor appetite for high yielding assets. Inexpensive Emerging Markets equities, currencies and local bonds were on the top of the list, together with European peripheral debt.

South Korean exports gained further ground owing to strong demand from the US, Europe and ASEAN economies, lifting the trade balance to USD 4.19bn versus USD 3.85bn expected.

The Brazilian trade balance bounced into surplus in March, helped notably by a reduction in the oil account deficit. The number is a sign that the process of rebalancing is under way, helped by BRL weakness and tight monetary policy. The Central Bank hiked the benchmark Selic interest rate for the 9th consecutive month to 11% in line with expectations. Domestic markets reacted positively to the statement, which indicated it might be the last hike of this cycle, provided inflation did not surprise on the upside. The statement's previous commitment to "continue[ing] the process of interest rates adjustment", typically associated with mid-cycle decisions, was removed, and replaced with a simple promise to "monitor the evolution of macroeconomic scenario until its next meeting, in order to define the next steps of its monetary policy strategy."

Indonesia also experienced a bounce in its trade data which returned to a surplus in February due to a sharp decline in raw material imports. Another sign of economic stabilisation in Indonesia was the decline in consumer prices during March to a 9-month low at 7.3% yoy while core inflation had a small uptick to 4.6%.

Turkey also posted a slightly better trade balance in February, with a small reduction in the trade deficit to USD 5.1bn from USD 6.8bn. However, March headline inflation jumped to 8.4% yoy nsa, vs. 8.1% expected, and the core inflation index also jumped to 9.3% yoy owing to the lagged effects of the currency devaluation.

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Emerging Markets

Notwithstanding the global macro backdrop and favourable technicals in EM assets, it looks as if the market is starting to respond to incremental evidence that economic re-balancing is at play with external vulnerabilities subsiding: EM equities rose by 1.4% during the week while EM fixed income indexes rose between 0.4% and 1.2%. Even flows from institutional investors returned to the market as EFPR showed inflows of USD 2.5bn to EM Equities and USD 1.0bn to EM debt.

Foreign investor inflows into EM equities have been particularly helpful in a country like India, where FX reserves increased USD 5bn to USD 304bn on the last week of March as the Reserve Bank of India has been buying US dollars to re-build FX reserves. Demand for Indian assets has been boosted by recent electoral polls showing that the nationalist-reformist, Narendra Modi, may win the elections with a strong enough mandate to implement meaningful economic reforms. The six week long election in India, the largest democratic exercise in the world, is starting this week and will run until May 12, but we believe investors will not wait until the final vote to start building positions, especially in the current, favourable market conditions.

China's State Council announced a series of measures to support domestic demand and stabilise growth. The key initiatives include:

- Deepening railway investment with a projected new line length in 2014 of c. 6,600 km (20% larger than 2013) focused on the mid-Western region
- Affordable housing, reallocation and upgrade of shanty towns
- Raising tax-exemption thresholds for SMEs and extending the scheme expiration to the end of 2016.

The announcements reveal a government committed to the process of reforming the economy without allowing for a major economic slowdown in order to prevent any major systemic risks.

Global backdrop

In developed markets, another kind of rebalancing is taking place, namely the adjustment of expectations to a less bullish reality. The main events last week were the ECB meeting on Thursday and the Non-farm payroll (NFP) publication on Friday. Both culminated in an adjustment of expectations from key players in the global financial markets.

On the face of it, the US economy is showing signs of resilience. Non-farm payroll levels of the last two months are close to the average between 1994 and 1999 when the US economy was growing at around 4% per year. ISM data was also bit softer than expected but solidly above the 50 mark. Lastly, strong factory orders contrasted with a worse trade balance number due to lower exports and higher imports.

However, in spite of the resilient data, the strong sell-off in the S&P 500 after the release of the slightly-below consensus NFP, offers evidence that growth expectations built-in to investors' models and minds will need to be adjusted to incorporate a milder economic recovery than has been previously priced-in. Ultra-bullish outlook scenarios from most economists at the beginning of the year have been frustrated by a nasty winter and an inventory cycle correction.

An adjustment to reality is simultaneously happening on the other side of the pond, where the ECB monetary policy committee has admitted its inflation expectations are too optimistic compared to the weak inflation data published over the last few months in Europe (latest CPI print at 0.5%), which threatens a deflationary spiral in a number of economies.

The fact that Jens Weidmann, the hawkish President of the Bundesbank, admitted that QE is on the cards in the same week that Germany's retail sales surprised on the upside – rising 2.0% yoy in February, when markets expected +0.8% – offers strong evidence of the ECB's intention to adopt unconventional policies.

It's fair to say that lower inflation in Europe has been mainly concentrated in energy and food prices, a global phenomenon that is far from negative, as it increases workers' battered purchasing power. However, whatever the reason behind the low inflation numbers, bringing expectations higher in the current background will probably demand a little more action.

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.9%	0.3%	1.4%	-2.9%	13.2%
MSCI EM Small Cap	1.7%	5.1%	3.5%	-1.2%	18.7%
MSCI FM	2.2%	9.5%	26.2%	8.3%	14.3%
S&P 500	-0.36%	1.44%	22.09%	14.29%	19.72%
GBI EM GD	0.34%	2.24%	-7.04%	0.93%	8.94%
ELMI+	0.05%	0.58%	-1.50%	-1.09%	3.67%
EMBI GD	0.55%	4.30%	0.04%	7.11%	11.38%
EMBI GD IG	0.35%	4.02%	-2.47%	5.81%	8.89%
EMBI GD HY	0.94%	4.88%	4.74%	9.51%	14.95%
5 year UST	0.46%	1.29%	-1.94%	3.17%	3.08%
7 year UST	0.39%	2.45%	-3.90%	4.56%	4.08%
10 year UST	0.36%	4.70%	-4.04%	6.63%	4.38%
CEMBI BD	0.27%	3.07%	1.18%	5.81%	11.98%
CEMBI BD HG	0.18%	3.21%	1.00%	6.23%	10.27%
CEMBI BD HY	0.46%	2.75%	1.59%	5.29%	17.87%
US HY	0.27%	3.52%	8.44%	9.79%	18.58%
European HY	0.34%	3.74%	13.16%	13.49%	22.21%
Barclays Ag	-0.13%	2.27%	1.59%	2.74%	5.08%

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

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