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Ashmore

Sitting on a time bomb

By Jan Dehn

The gravitational pull from QE has lifted prices for developed market assets and depressed them in Emerging Markets (EM). With fundamentals still much stronger in EM, investors in developed markets are in effect sitting on a time bomb ahead of monetary tightening. The markets know it, hence the recent volatility. The ECB knows it, hence its preparation last week to further ease policy. Even members of the FOMC know it, hence their inability to clearly signal the direction of travel. The decision whether to hike is not a conventional one – after all, growth is modest and there is no inflation. Instead, this is akin to an investment decision – incurring a small cost upfront in the hope of a higher payoff later. But does the high level of uncertainty and an asymmetric payoff justify a move now?

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.8	–	-3.79%
MSCI EM Small Cap	10.5	–	-3.51%
MSCI Frontier	8.8	–	0.14%
MSCI Asia	10.1	–	-3.43%
Shanghai Composite	11.6	–	7.96%
Hong Kong Hang Seng	6.3	–	-7.04%
MSCI EMEA	8.9	–	-4.37%
MSCI Latam	12.0	–	-4.67%
GBI-EM-GD	7.10%	–	-2.49%
ELMI+	5.31%	–	-1.21%
EM FX spot	–	–	-1.93%
EMBI GD	6.05%	391 bps	-0.03%
EMBI GD IG	4.82%	261 bps	-0.25%
EMBI GD HY	8.09%	610 bps	0.26%
CEMBI BD	5.96%	405 bps	-0.14%
CEMBI BD HG	4.68%	275 bps	-0.10%
CEMBI BD HY	8.40%	652 bps	-0.22%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.6	–	-3.36%
1-3 year UST	0.71%	–	0.09%
3-5 year UST	1.47%	–	0.14%
7-10 year UST	2.13%	–	0.52%
10+ years UST	2.89%	–	0.50%
US HY	7.68%	630 bps	0.30%
European HY	5.04%	503 bps	-0.15%
Barclays Ag	–	226 bps	0.42%
VIX Index*	27.80	–	1.75%
DXY Index*	96.17	–	0.34%
EURUSD	1.1164	–	-0.36%
USDJPY	119.33	–	1.61%
CRY Index*	196.70	–	-0.40%
Brent	49.1	–	-9.42%
Gold spot	1122	–	-1.06%

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

Emerging Markets

EM economies are coping with a raft of external headwinds at the moment, including capital outflows, lower commodity prices and negative risk sentiment which, inevitably, lead investors to view EM with caution. These factors matter at the margin, but they are not enough to create a crisis for the asset class. Nor do we expect this to be the case. As we argued last week, this is a 'non-crisis crisis', a case of asset prices weakening far more than justified by fundamentals within the asset class. It is no wonder why this is happening – the gravitational pull of the QE sponsored developed markets is sucking capital from EM. The bubble valuations in developed markets are therefore a mirror image of the excessively cheap valuations in EM. Asset prices have long ago lost touch with reality and could continue to do so for some time. However, investors must always bear in mind that the key to returns over the full cycle is not how EM is priced relative to developed markets, but how each and every asset is priced relative to the underlying fundamentals of its specific issuer. On that metric, EM offers value, while investors in developed markets are sitting on an overvalued 'time bomb'. We expand the discussion of recent events – and look ahead to the Fed decision on 17 September – in the global section below. Within EM, these are the main developments of the past week:

- **Brazil:** Ratings agency, Moody's, stated last week that Brazil's economy did not justify junk status. This is a minor palliative in what was otherwise a fairly horrendous week for the government. Rumours continue to swirl that finance minister, Joaquim Levy, will leave, though the government went out of its way to give him its backing last week. Levy's departure would be a serious blow to President Dilma Rousseff and would bring her one step closer to impeachment. Moreover, it is unlikely that a stronger finance minister would want the job, so confidence in the recovery would weaken further. That would not go down so well after last week's nasty data surprises. Industrial production shrank 1.5% in July versus -0.1% expected and PMI declined to 45.8 versus 47.2 expected. The central bank wisely left rates unchanged at 14.25% – there is little to gain from kicking a man that is already down. Our view is that Brazil's problem is self-inflicted and cyclical. The pain suffered by the economy right now is not just the result of fiscal profligacy and excessive intervention in the central bank's decisions in the past, but also the consequence of severe fiscal and other rigidities that deepen and prolong the

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Emerging Markets

process of adjustment. On the other hand, we believe Brazil will survive this crisis and that investors should consider building positions at major milestones in the adjustment process, such as in response to ratings downgrades, major cabinet reshuffles and, the big one if it happens, impeachment.

- India: The government has taken steps to eliminate a major uncertainty affecting foreign institutional investors in India by dropping a demand that such investors pay minimum alternative tax (MAT) on investments undertaken prior to 1 April 2015.

- Argentina: There was further confirmation this week that the next administration will seek a speedy resolution to the holdout issue, when an advisor to Daniel Scioli – who leads the presidential election race – said Scioli was willing to talk to holdouts. The change in tack for Scioli was made possible some weeks ago, when serving Economy Minister, Alex Kicillof, in effect said the same thing. In related news, local news sources reported that the government has put a proposal to a US court that both holdouts and the government present their demands in order to begin the process of finding an agreement. Our view is that the next government will want a speedy resolution to the holdout issue in order to be able to undertake a relatively gentle macroeconomic adjustment supported by renewed external borrowing.

Snippets:

- Czech Republic: Wages rose 2.7% yoy versus 2.0% yoy expected. The central bank interest rate is 5bps.
- Kazakhstan: After letting the currency float last month the Kazakhstan central bank set interest rates at 12%, which the bank deemed to be suitable for achieving the 6-8% inflation target. Oil countries often struggle with exchange rates. During oil price booms flexible exchange rates tend to appreciate too much leading to exchange rate intervention and even adoption of fixed rates. Then, when oil prices fall, oil economies often end up struggling to defend their currencies and, in some cases, adopt floating rates.
- Mexico: Gross fixed investment surprised to the upside in August. Equipment and machinery investment rose 22.1% yoy resulting in an 8.6% yoy rise in overall investment (versus 6.5% yoy expected).
- Poland: The central bank left the policy rate unchanged at 1.5%.
- Russia: Russia's Gazprom, the world's largest energy company, announced that it has signed an agreement to build a third pipeline to China to supply gas. This is part of Russia's long-term strategy to divert gas exports away from Western Europe. The Russian government also announced plans to issue an inaugural bond in Chinese RMB. On the macroeconomic front, inflation in August rose marginally to 15.8% yoy. This was a disappointing print relative to expectations (15.6% yoy), but the 'miss' was entirely due to higher tourism prices (0.3% yoy), that is, Russian spending on tourism services abroad. In turn, this is due to the recent RUB depreciation. Foreign prices are obviously not under control of the Russian central bank, so this data point will probably be discounted somewhat by the bank, in our view. Net of tourism prices, the inflation rate declined marginally to 15.5% yoy.
- Sri Lanka: The Sri Lankan government announced that it would let the currency float. The Rupee immediately weakened to 138 from 134 versus the USD.
- Turkey: Inflation in August was higher than expected at 0.4% mom. This lifted the yoy inflation rate from 6.8% in July to 7.1%.
- Venezuela: President Nicholas Maduro announced that Venezuela will receive another USD 5bn for investment in the oil sector from China. The funds will boost Venezuela's foreign exchange reserves. After declining sharply from more than USD 24bn in early 2015 Venezuela's foreign exchange reserves have now stabilised in the USD 15-17bn range.

Global backdrop

Financial markets are sitting on a time bomb. Since 2008/2009, a massive rally in developed market assets has been predicated almost entirely on a large 'doubling down' of monetary policy, including zero interest rate policies and quantitative easing. This enormous easing effort in effect extended an already 30 year period of monetary easing that had seen 10 year US Treasury yields fall from 16% in the early 1980s and which culminated in the 2008/2009 debt crisis. The decision to respond to the debt crisis in 2008/2009 with further monetary easing – rather than monetary tightening as had been the case during the Great Depression – looked intelligent at the time, but this strategy was always based on an assumption that governments would take their implicit obligations to deleverage the economy and implement reforms seriously. Neither has taken place. Central banks have therefore had to do more monetary easing than anyone imagined just a few years ago. While this has been great for asset prices, money printing has not done much for the underlying real economies of the QE economies. The result has been a growing gulf between asset price valuations – which reflect future expected returns from the underlying economy – and what the economy is actually able to deliver. There is another word for this phenomenon: a bubble. Central banks have now painted themselves into a corner.

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Global backdrop

Asset prices are now so high that it is close to impossible to withdraw the cheap money. The European Central Bank (ECB) became the latest manifestation of this truth last week, when, contrary to market expectations, ECB President Mario Draghi increased the share of any eligible outstanding security that the ECB can buy in its asset purchase program. Draghi also cut the real GDP growth forecast for the Eurozone and re-stated that he will use any means to achieve the inflation target. Clearly, there is no immediate growth crisis in Europe. The ECB's actions are pre-emptive, aimed at being able to effectively oppose any potential damage to asset prices arising from possible tightening of financial conditions in the US.

The real conundrum faced by the QE central banks, including the Fed, is that efforts to tighten could have enormous negative wealth effects if asset markets lose faith in the money illusion embedded in the valuation of developed markets' stocks and bonds after years and trillions of Dollars of money printing. Moreover, if such a disaster happened, the central banks would have no tools at their disposal. Clearly Draghi understands this point completely – hence, his preparation for yet more QE.

What is far more concerning is that the US Fed is in serious danger of hubris. Investors, media commentators, analysts and other pundits have been falling over themselves praising the Fed and the US economy for the last few years. Many FOMC members actually appear to believe this hype, despite years of lacklustre growth under what can only be described as more stimulatory conditions than anyone could even imagine five years ago. Basing a recovery solely on asset price inflation – such as most QE economies have done – requires a disciplined approach. Tightening monetary policies before the underlying economy has regenerated its capacity for high rates of real GDP growth under normal monetary conditions not only risks collapsing asset prices, but will also spill over to the real economy and seriously damage confidence in policy makers.

The question before the Fed – whether to tighten monetary policy at the FOMC meeting on 17 September – is therefore a serious one. A 25bps hike will not, in itself, harm anyone. The Fed's view, clearly, is that it could be an important positive signal of confidence in what will be a long and drawn-out return to normality. But here is the problem. A financial market inebriated by cheap and abundant money may well go on to price a completely inappropriate path for the return to a normal monetary stance. This would risk a collapse in stock prices, given the real economy's low trend productivity growth rate, high levels of debt and massive medium term fiscal challenges.

Payrolls dropped sharply this month from 245K to 173K and the labour market participation rate dropped by 0.1%, which was why the unemployment rate fell. ISM and factory orders were weaker and the trade numbers continue to soften (in large part due to a strong USD). Draghi's decision to change the rules for his asset purchase program clearly shows that he has concerns about the Fed's ability to control market expectations for future hikes if it moves in September. The market's volatility of the last few weeks shows that many investors harbour the very same concerns. The Fed's reluctance signals a clear path either way may also suggest that many FOMC members themselves are worried. So, it is prudent to move given that there is no inflation risk?

Look at it this way. The Fed's decision is not really a conventional monetary policy decision. After all, growth is modest and there is no major near-term risk of inflation. Instead, the Fed wants to show progress towards normality. As such, this decision has all the hallmarks of an investment decision: Pay a little upfront by raising rates 25bps, but hope to reap gains longer-term by instilling confidence in the recovery of the underlying economy. But all investment decisions are taken under conditions of uncertainty. And when the uncertainty is particularly large and has asymmetric pay offs, such as now, theory would suggest that it is appropriate to apply a particularly high hurdle rate. In other words, wait.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-3.62%	-15.83%	-26.35%	-3.30%	-2.00%
MSCI EM Small Cap	-2.92%	-12.30%	-21.73%	0.01%	-1.21%
MSCI Frontier	-0.01%	-11.66%	-22.39%	8.40%	3.73%
MSCI Asia	-3.24%	-13.69%	-19.39%	1.94%	1.97%
China A shares	-1.43%	-0.88%	41.81%	18.66%	6.13%
China H shares	-5.87%	-21.32%	-16.90%	3.79%	-1.40%
MSCI EMEA	-4.49%	-12.05%	-28.13%	-7.50%	-3.70%
MSCI Latam	-3.57%	-25.85%	-44.33%	-14.74%	-10.90%
GBI EM GD	-2.06%	-14.11%	-23.02%	-7.71%	-2.56%
ELMI+	-0.78%	-7.62%	-15.09%	-4.57%	-2.26%
EM FX Spot	-1.58%	-15.42%	-25.10%	-11.74%	-8.47%
EMBI GD	-0.08%	1.16%	-1.18%	2.35%	5.24%
EMBI GD IG	-0.20%	-0.73%	-0.99%	1.14%	4.38%
EMBI GD HY	0.09%	3.72%	-2.42%	4.19%	6.51%
CEMBI BD	-0.06%	1.99%	-0.17%	3.42%	4.90%
CEMBI BD HG	-0.01%	1.69%	1.20%	3.42%	5.08%
CEMBI BD HY	-0.16%	2.52%	-3.04%	3.64%	4.71%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-2.55%	-5.36%	-1.84%	13.37%	14.07%
1-3 year UST	0.12%	0.65%	0.74%	0.45%	0.69%
3-5 year UST	0.29%	1.96%	2.96%	1.29%	1.87%
7-10 year UST	0.75%	2.50%	5.44%	1.51%	4.38%
10+ years UST	1.41%	-0.56%	8.60%	1.63%	6.92%
US HY	0.22%	0.25%	-3.17%	4.93%	7.64%
European HY	-0.05%	2.46%	2.10%	9.72%	10.35%
Barclays Ag	0.46%	-0.09%	1.29%	3.31%	4.48%
VIX Index*	-2.22%	44.79%	129.94%	93.32%	16.81%
DXY Index*	0.36%	6.53%	14.84%	19.83%	16.11%
CRY Index*	-2.67%	-14.46%	-31.71%	-36.89%	-28.16%
EURUSD	-0.36%	-7.74%	-13.68%	-12.89%	-12.32%
USDJPY	1.61%	0.43%	-11.27%	-34.43%	-29.83%
Brent	-9.42%	-14.44%	-51.35%	-57.07%	-36.91%
Gold spot	-1.06%	-5.58%	-10.45%	-35.38%	-10.74%

*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.

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