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WEEKLY INVESTOR RESEARCH

Debt, denial and many moving parts in Emerging Markets

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Ahead of US rate hikes we remind everyone that per capita debts have risen by USD 50,000 in developed countries and fallen by USD 3,500 per person in Emerging Markets (EM) since 2000. We also cover the latest developments in China's financial liberalisation, changes in the Indian banking sector, Tabare Vazquez's victory in Uruguay, elections in Moldova, pipeline developments and inflation in Russia, the change in policy direction in Brazil, Mexico's manufacturing up-turn, cabinet appointments in Ukraine, Argentina's local law debt swap, bond market developments in Indonesia, rising political noise in Venezuela, falling political noise in Colombia and Ethiopia's entry to the global capital markets. We also discuss the Fed, payrolls, US manufacturing, ECB and Japan's upcoming election.

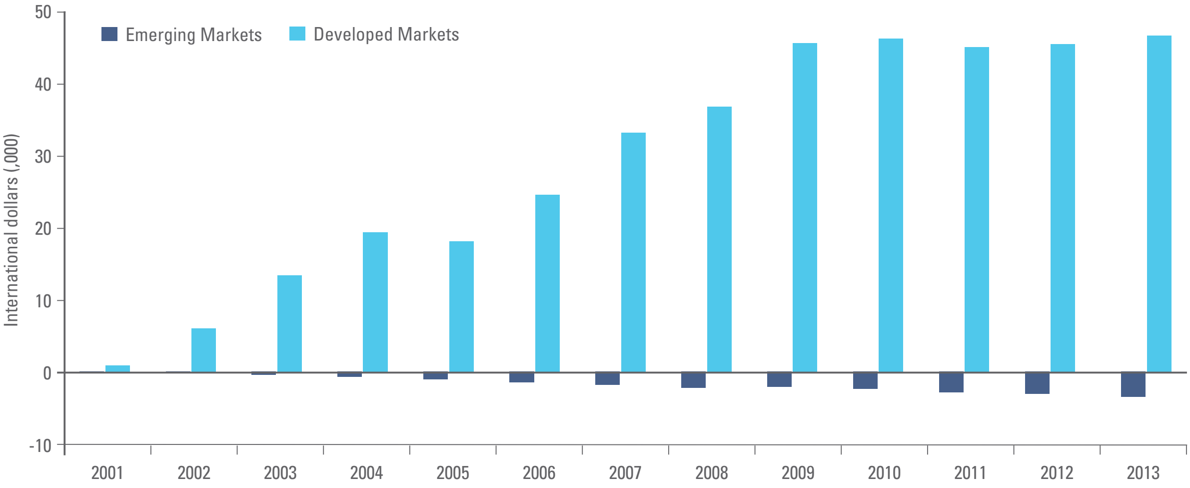
Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	982	–	-0.29%
MSCI EM Small Cap	1,010	–	-0.20%
MSCI FM	623	–	-0.77%
GBI EM GD	6.38%	–	-2.26%
EM FX spot	–	–	-1.45%
ELMI+	4.04%	–	-0.87%
EMBI GD	5.41%	308 bps	-0.33%
EMBI GD IG	4.35%	198 bps	-0.43%
EMBI GD HY	7.68%	549 bps	-0.16%
CEMBI BD	5.38%	325 bps	-0.68%
CEMBI BD HG	4.38%	223 bps	-0.42%
CEMBI BD HY	7.57%	546 bps	-1.22%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2075	1.12%
VIX Index	11.82	-17.28%
5 year UST	1.71%	17 bps
7 year UST	2.08%	12 bps
10 year UST	2.32%	8 bps
US HY	6.78%	-0.34%
European HY	4.96%	0.27%
EURUSD	1.2253	-1.97%
USDJPY	121.16	2.41%
Brent	67.16	-7.01%
Copper	301.30	-0.29%
Gold	1195.55	-1.67%

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

Emerging Markets

Fig 1: **Accumulated debt per person, net of income gains between 2000 and 2013 (PPP adjusted international current dollars)**



Source: BAML, IMF, Ashmore.

Between 2000 and the end of 2013, developed economies increased the volume of outstanding government and corporate debt by an astonishing USD 66,027,859,420,489.[1] Over the same period, their GDP only increased by USD 16,679,400,000,000 (in current PPP adjusted international USD terms). Debt rose by the equivalent of USD 60,942 for every man, woman and child. After netting out the per capita income gains over the same period the debt burden rose by USD 46,967 per person. In EM, outstanding EM government and corporate bond debt increased by USD 12,047,005,781,161, while GDP increased three times more (USD 36,683,352,000,000), equivalent to each man, woman and child in EM getting USD 3,513 less indebted

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[1] Based on Bank of America Merrill Lynch data.

Emerging Markets

over the period. This is shown in the chart above. If the x-axis looks like it is sloping downwards don't worry. It is just an optical illusion caused by the largeness of the cumulative increase in per capita debt in developed economies over the period. Developed economies have wallowed for years in the pleasant fiction that the debt does not cost anything. We suggest this dream ends when the Fed begins to raise rates.

- Argentina: The government announced a major liability management operation involving local law debt securities. The government is offering to buy back up to USD 6.7bn of Boden 15s (maturing October 2015) and also to offer to swap Boden 15s into a new longer dated Boden 2024 bond of which the government intends to issue USD 3bn. Boden 15s constitute a major part of the government's 2015 amortisation burden, so depending on participation for the buyback this could significantly reduce default risk in Argentina in the final months of the Kirchner administration. Either way, the operation is a strong sign that Argentina intends to honour its obligations in local law bonds. Capacity to pay has recently improved due to new bilateral financing from France and China as well as proceeds from the auction of 4G mobile phone licences. Argentinian bonds issued under New York law are not receiving coupons due to a ruling by a New York judge that prevents the banks entrusted to process payments from releasing the funds until Argentina has paid in full to holdout investors from the 2001 default. Argentina has consistently refused to do so. From a peak in January of 1073bps at the end of January 2014 the blended spread of Argentina's sovereign curve has declined to 697bps despite the default. By contrast, the blended sovereign spread for the Russian sovereign, one of the safest credits from the perspective of ability and willingness to pay has widened by 265bps to 474bps.

- India: The Reserve Bank of India signalled rate cuts early in 2015, but kept the policy repo rate unchanged at 8%. Other policy rates were also left unchanged. Inflation is on a declining trend in India and will receive further momentum from lower oil prices. Equally important, greater fiscal discipline is allowing rates to be reduced, which should be beneficial for investment spending and therefore increase economic growth. India is experiencing a cyclical upswing evident in stronger PMI numbers, higher auto sales, a pick-up in corporate investor sentiment and aided further by the expectations of rate cuts next year. Coal mining licences are due to be auctioned in March 2015, which should be supportive for power plants. In the financial sector some 85 million people are about to be given bank accounts as the government seeks to convert in-kind subsidies into cash payments. This is good economic policy, but the benefits to the banking sector and India are broader and the boost from including so many more people into the financial sector should not be underestimated. Efforts are also underway to improve the efficiency of India's banks, which should help to bring down borrowing costs for businesses and households over the longer term. More efficient banks are also important for the efficiency of the bond market as a pre-cursor for a possible opening of the domestic bond market to foreign investors. One of the measures under consideration is a change to rules governing conversion of debt into equity, which could help public banks in capturing some upside from restructuring loan books. The government has proposed a new bankruptcy law, which should also help lenders. Finally, Parliament passed two labour reform bills that cut red tape for hiring new workers and promotes training and apprenticeships.

- China: China is actively engaging government and private sector institutions around the world in a bid to internationalise the Renminbi and turning it into a global reserve currency. The Sri Lankan government is the latest government to consider issuing bonds in Renminbi, according to Sri Lankan central bank sources. China's drive will be successful, in our view. China is also opening its domestic market to foreign investors in both equities and fixed income. We think China will diversify its foreign exchange holdings, particularly when inflation re-emerges in the US. These three drivers will provide strong structural support for the Renminbi, which, in our view, will be among the strongest currencies in the world over the next decade. As China's currency appreciates it will have to rely more on domestic demand-led growth. In turn, this requires new macroeconomic tools, notably bond markets. China's financial liberalisation is now embracing securitisation. A senior official in China's Banking Regulatory Commission this week said that credit securitisation will be elevated to priority status. This is very positive both for banks and the emerging mutual fund industry. Chinese savings rates are about 50% of income and savers have few ways to invest their money outside stocks, property and low paying deposit accounts (trust products are also available, but they are mainly used by wealthier investors China's services PMI rose to 53 in November slightly up from 52.9 in October, while the trade surplus for November was much larger than expected. At USD 54.47bn, the trade surplus was the largest ever. To place the number in context, the latest US trade deficit was USD 43.4bn. China's trade surplus is rising in large part due to weaker imports, but the larger trade surplus will be a positive contributor to GDP growth.

- Russia: Gazprom's CEO Alexey Miller announced that the South Stream gas pipeline – that was due to transport gas to parts of Europe – will no longer be built. South Stream, which was intended to transport 63bn cubic metres of gas per year, was intended to bypass Ukraine. Southern Europe's gas needs will have to be met via Ukrainian pipelines. This has two implications: First, it is good for Ukraine, because gas is now more likely to flow via the Ukrainian pipeline system. Second, as the Ukrainian conflict is unresolved Europe would now be more at risk than if gas intended for Europe would have flowed via an ex-Ukrainian pipeline. This lingering Russian leverage could be intended to aid Russia in meeting its objectives in Ukraine, including discouraging Ukraine from joining NATO. Russia has signed new long-term supply agreements with China this year for 68bn cubic metres of gas. In other news, headline inflation in Russia accelerated to 9.1% yoy in November from 8.3% in October. Food import bans and a much weaker RUB are the likely culprits, but core inflation also rose

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Emerging Markets

from 8.4% in October to 8.9% in November. The central bank has raised rates to attempt to keep inflation expectations under control, but more rate hikes will likely be required given the magnitude of the RUB move. We think the central bank will do what it takes to keep inflation expectations in check. The proof of success will only become apparent in the future, however, when the temporary effects of the exchange rate move and the food import ban begin to fade.

- Ukraine: The Poroshenko government appointed a new cabinet, including technocratic finance and economy ministers. This is positive for the prospects of fresh IMF and EU financing. The EU is due to meet to discuss additional financing for Ukraine this week. IMF and EU financing is key to avoiding a sovereign default during the period of adjustment from an economic crisis caused by what appeared to be eye-watering corruption under the Yanukovich administration. The IMF now intends to return to Ukraine this week rather than in the middle of January. This leaves a bigger window of time to review the program before major liabilities fall due in Q1 2015. FX reserves have now fallen below USD 10bn as Ukraine paid Russia for past and new gas flows. Ukraine has so far delivered on all major targets under the IMF program, but the lingering conflict in the east has meant a worse economic situation than envisaged. We think Ukraine remains strategically important to both the EU and the US, wherefore IMF/EU support is likely to be renewed. Hopes for a new ceasefire in Eastern Ukraine are rising ahead of talks between Russian and Ukrainian senior officials in Minsk this week.

- Moldova: The result of the parliamentary election was that pro-EU parties secured 44% of the seats, while pro-Russian parties won 40%. This means that it will be tough to form a stable parliament. Moldova's situation has certain parallels with the situation in Eastern Ukraine. The government banned a pro-Russian party from participating in the election on allegations that it received financing from Russia (external election financing is banned in Moldova). Russia occupies an enclave in Moldova called Transnistria – a frozen conflict zone similar to the Donbass region in Eastern Ukraine.

- Brazil: Brazil may have just returned to positive GDP growth in Q3, but ahead lie both fiscal and monetary adjustment, which could well push Brazil back into negative growth at some point in 2015. Last week the central bank underlined this fact by raising rates by 50bps to 11.75%. Brazilian firms appear to be anticipating pain, because Industrial Production (IP) was flat in October. This means that IP has fallen 3.0% this year so far. Business confidence is also low due to bad governance over the past few years. IPCA inflation declined slightly in November to 6.56% from 6.59% in October. In many ways, Brazil today resembles India towards the end of the Congress administration. Back then, India had been too generous on fiscal policy front, which then forced the central bank into raising interest rates and thereby causing growth to stall (by crowding out investment). As India has shown, it is not quite as difficult as it appears to turn this kind of situation around. After all, the problems facing Brazil are not the kind of massive balance sheet challenges facing, say, most developed economies. The core ingredient in Brazil's adjustment has to be fiscal, but restoring credibility in policy-making is also extremely important. Brazil has embarked on both, though Brazil has not been blessed with a vigorous new government, so the recovery in Brazil is going to be more muted than in India. We see grounds for being more optimistic about Brazil as an investment destination in 2015.

- Mexico: Manufacturing picked up strongly in November as the PMI index rose to 54.3 from 53.3 in October. This is good news for President Enrique Peña Nieto, whose approval rating has been falling of late, partly due to the political fallout from an episode involving the suspected death of 43 student teachers, who allegedly were handed over to a drug gang by members of the police. Peña Nieto has vowed to change the constitution to disband corrupt municipal police units. One of the main differences between the previous PAN administration and the current PRI administration is the approach to organised crime in Mexico. The PRI is less confrontational, but this policy could easily backfire. Organised crime in Mexico ultimately challenges the power of the state. When they are granted concessions they are appeased only temporarily before they resurface and demand further concessions against the threat of even more vicious violence. President Peña Nieto's handling of the case of the 43 student teachers is therefore an important test not just of his leadership, but also of the state, in our view.

- Indonesia: The government has proposed changes to bank regulations that would allow bonds issued by banks to count as deposits for purposes of meeting loan to deposit regulatory limits. This means that banks would be able to increase loans if they issue more bonds, thus leveraging up the banking system and increasing financial intermediation. Such developments create opportunities, but they also increase risks. In Indonesia's case, however, financial penetration remains very low with just 20% of Indonesians in possession of bank accounts, while private credit to GDP is astonishingly low at just 38%.

- Venezuela: The government has charged Maria Corina Machado, a prominent opposition politician with participation in a plot to assassinate President Nicholas Maduro. The government also alleges US involvement in the conspiracy. Numerous opposition politicians, including Leopoldo Lopez have been imprisoned on charges of a similar ilk. There are moves afoot in the US legislature to impose sanctions on Venezuela on the grounds of human rights abuses. The charges against Machado will only encourage US legislators further.

- Colombia: Peace talks with the FARC rebel group look set to resume after the organisation released several hostages, including a senior officer from the Colombian army. President Juan Manuel Santos won a second term in a closely contested election where the central question was whether or not to pursue peace talks with

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Emerging Markets

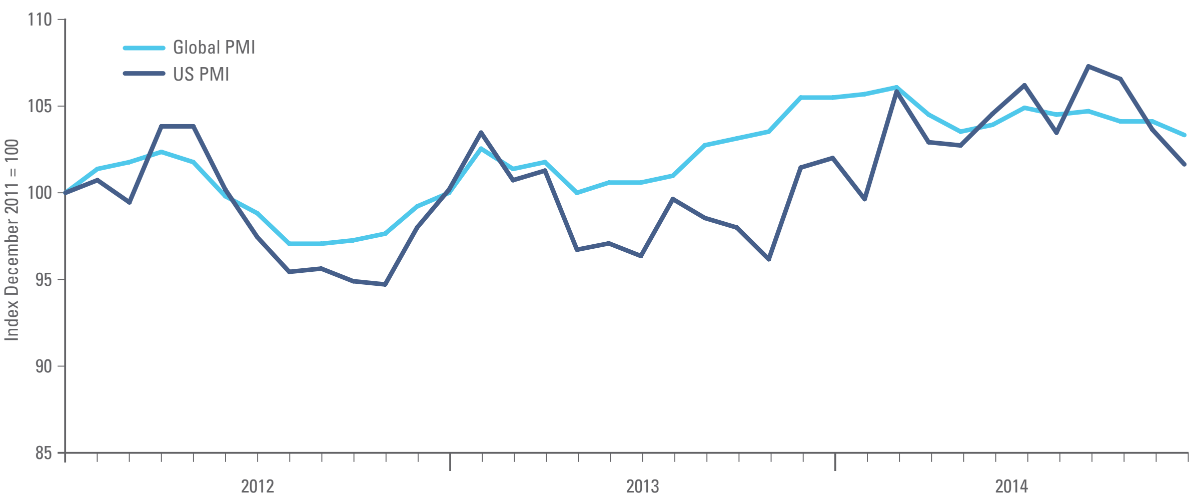
the FARC. As such, this development is very positive for Santos and for Colombia. One of the main challenges faced by the government in resolving this conflict is that it has ceased to be an ideological conflict a long time ago; the FARC is a commercial organisation that finances its operations and lines the pockets of its leaders by meeting the voracious demand for cocaine in developed economies. In other words, dismantling the organisation will ultimately involve a major loss of income for its senior members. The government's challenge is how to offer lifestyles with the same or better appeal.

- **Ethiopia:** Ethiopia is set soon to become the 62nd member of the JP Morgan Global Diversified Emerging Markets Bond Index (EMBI GD). The government issued USD 1bn of an inaugural index-eligible 10-year dollar denominated sovereign bonds at a yield of 6.625%. Sub-Saharan Africa is the fastest region for external debt markets in EM. Africa is also the fastest growing continent in the world. The end of the Cold War and access to global capital markets instead of dependence on aid has been critical to raising Africa's growth rates. African countries are useful diversifiers in global fixed income portfolios; the sovereign risk profiles of African countries are not only diverse, but also distinct from those of other regions of EM.
- **Uruguay:** Tabaré Vazquez of the ruling left-leaning Broad Front coalition has been elected president for the second time after beating Luis Lacalle Pou 54-41. Vazquez will take over as president from José Mujica on 1 March. The Broad Front holds a majority in parliament. Infrastructure investment is expected to play an important part in the program of Vazquez administration. We expect overall economic policy to remain sensible.
- **Lower oil prices:** Taiwanese inflation dropped by 0.2% to 0.9% yoy in November. The Philippines saw consumer prices decline by 0.1% to 3.7% yoy (versus 4.0% expected). By contrast, in Malaysia, one of Asia's main oil producers, exports declined by a larger than expected 3.1% yoy, though Malaysia was still able to sustain an overall trade surplus of MYR 1.2bn (MYR 62.8bn year to date). These are the immediate effects of the decline in global oil prices. Of course, governments are not just going to sit and idly watch as external shocks come and go. Many oil importers in Asia have already exploited the opportunity presented by lower oil prices to slash energy subsidies. Exporters too will adjust, partly via currencies, partly via fiscal measures.

Global backdrop

Fed officials issued bullish statements about the outlook for the US economy and signalled that new guidance would be provided for the market once "considerable period" is removed from the statement ahead of the first Fed hike. The next FOMC meeting is on 19 December. We think the Fed will be very careful not to tighten policies too quickly. Inflation and inflation expectations do not warrant major hikes and fast-paced tightening could deflate the bubble in asset prices that sustains confidence in the US (with potentially very negative consequences not only for the economy, but also for faith in policy makers). Payrolls were strong (321K vs 230K expected) but the market reaction was somewhat muted. One reason might be that November is dominated by the 'Black Friday' sales effect, i.e. a rise in temporary employment (not just couriers). The household survey count of jobs created also disappointed (+4K vs 320K expected) so the unemployment rate was unchanged at 5.8%. Hourly earnings were significantly higher at 0.4% vs 0.2% expected, but that too may reflect temporary 'Black Friday' labour demand. For these reasons, some discounting of the payroll number itself may have taken place. Even so, as 2014 comes to a close sentiment about the US remains very strong, especially versus Japan and Europe, although compared to the rest of the world the US is not particularly impressive. For example, as illustrated below, US manufacturing has underperformed global PMI since 2011 (when the Markit PMI series began).

Fig 2: **Global and US PMIs**



Source: Bloomberg, Markit, Ashmore.

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Global backdrop

The ECB disappointed some speculators by not announcing QE in its December meeting. In fact, the ECB did not even give a firm indication that QE would be coming in Q1 2015, only that it would 'assess' the need for further easing measures in the coming meeting. Behind the scenes technical staff are preparing for QE. We think the decision to not launch sovereign QE this month was the right decision for two reasons. First, the real problem is financial intermediation. If the financial transmission mechanism is defective broad-based sovereign QE will not be very effective in terms of stimulating demand. Second, the ECB would be wise to keep sovereign QE in reserve. Europe will almost certainly face higher interest rates when the US raises rates, so it will need sovereign QE to keep periphery bond yields low to avoid a second European debt crisis. Sovereign QE would also be a useful recourse if one or more the periphery countries in European electorates vote into power some really crazy people.

Prime Minister Shinzo Abe looks set to expand his majority in the lower house at the 14 December election. Abe and his coalition partners already control two-thirds of the votes in parliament. An election victory for Abe is already fuelling a further rally in USDJPY on the grounds that 'Abenomics' – a set of policies intended to inflate and devalue Japan out of its problems – will be given a further boost. The big question, however, is whether Abe will use his super-majority in parliament to structurally reform Japan. So far, there have been few signs of that. Without deeper structural reforms, we do not think that monetary and fiscal stimuli will save Japan. Q3 2014 GDP was revised down from -1.6% to -1.9% qoq annualised, which contrasted sharply with an expectation in a market keen to see the Japanese equity market rally and JPY decline continue. Capital spending was revised down sharply and inventories were revised higher. This does not bode well for the growth momentum in Japan.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.2%	0.8%	1.5%	3.6%	2.9%
MSCI EM Small Cap	-1.6%	3.3%	3.5%	7.2%	4.4%
MSCI FM	-2.3%	10.0%	12.7%	13.7%	8.7%
S&P 500	0.43%	14.45%	18.66%	20.73%	15.80%
GBI EM GD	-2.87%	-2.65%	-2.62%	0.16%	2.95%
ELMI+	-1.40%	-5.81%	-5.89%	-1.03%	-0.49%
EM spot FX	-2.06%	-10.36%	-10.92%	NA	NA
EMBI GD	-0.83%	9.06%	10.39%	6.76%	7.95%
EMBI GD IG	-0.53%	10.28%	11.13%	5.48%	6.76%
EMBI GD HY	-1.35%	6.97%	9.28%	8.88%	9.72%
5 year UST	-0.42%	3.54%	2.23%	1.15%	3.38%
7 year UST	-0.50%	6.72%	5.32%	1.97%	4.99%
10 year UST	-0.54%	11.30%	10.06%	3.28%	6.30%
CEMBI BD	-0.94%	6.01%	6.48%	6.73%	7.07%
CEMBI BD HG	-0.42%	7.73%	8.00%	6.46%	6.87%
CEMBI BD HY	-2.01%	2.49%	3.35%	7.65%	7.89%
US HY	-1.16%	2.72%	3.37%	9.26%	10.01%
European HY	0.26%	6.09%	7.12%	15.56%	12.54%
Barclays Agg	-1.17%	0.10%	-0.09%	0.59%	2.06%

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

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