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Ashmore

Happy 60th!

Last week saw two more countries enter the JP Morgan EMBI GD index, the main Emerging Markets bond index, which now covers 60 countries. The investable universe is far larger. Yet, despite this enormous and diverse universe, the market typically tends to focus on just one or two countries and extrapolate to the entire asset class. This is simplistic, irrational, and inefficient. It is therefore encouraging that sentiment about Emerging Markets slowly improved last week despite rising US treasury yields. Countries such as India and Brazil, which only weeks ago were labelled as crisis countries have successfully stabilised their currencies. Others such as Turkey and Indonesia still have work to do, and investors should continue to manage exposures actively, because there are naturally always differences in credit quality across such a vast investment universe (now USD 14trn). Emerging Markets are not in crisis. Not even close. They are not more vulnerable to Fed tapering than developed economies and their fundamentals are not seriously deteriorating. In fact, Emerging Markets fundamentals are improving in most countries, aided in part by the pickup in global manufacturing. The summer sell-off has predominantly been technical in nature. Last Friday's US payrolls reminded us that the real economic challenges are still in the HIDCs (Heavily Indebted Developed Countries).

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	964		2.97%
MSCI FM	530		-2.04%
GBI-GD	6.93%		-0.14%
ELMI+	4.84%		0.22%
EMBI GD	6.21%	326 bps	-0.25%
EMBI GD IG	5.27%	234 bps	-0.34%
EMBI GD HY	9.60%	683 bps	-0.04%
CEMBI BD	6.08%	355 bps	-0.55%
CEMBI BD HG	5.22%	267 bps	-0.69%
CEMBI BD HY	8.04%	555 bps	-0.50%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,655	1.41%
VIX Index	15.85	-6.82%
5 year UST	1.73%	9 bps
10 year UST	2.92%	13 bps
10 year Bund	1.97%	6 bps
EURUSD	1.3181	-0.08%
USDJPY	99.50	0.16%
Brent	$116	1.15%
Copper	$333	-0.07%
Gold	$1387	-0.29%

Emerging Markets

The investment universe in Emerging Markets continues to increase. While the investable universe far exceeds the narrower confines of the market's preferred benchmark indices, it is nevertheless important that indices continue to grow in line with the actual market.

It was therefore encouraging that last week the external debt universe reached another important milestone, when the JP Morgan EMBI GD index welcomed its member states numbers 59 and 60. The latest two entrants were Slovakia and Trinidad & Tobago, who joined the existing members shown here.

Angola, Argentina, Azerbaijan, Belarus, Belize, Bolivia, Brazil, Bulgaria, Chile, China, Colombia, Costa Rica, Cote D'Ivoire, Croatia, Dominican Republic, Ecuador, Egypt, El Salvador, Gabon, Georgia, Ghana, Guatemala, Honduras, Hungary, India, Indonesia, Iraq, Jamaica, Jordan, Kazakhstan, Latvia, Lebanon, Lithuania, Malaysia, Mexico, Mongolia, Morocco, Namibia, Nigeria, Pakistan, Panama, Paraguay, Peru, Philippines, Poland, Romania, Russia, Senegal, Serbia, South Africa, Sri Lanka, United Republic of Tanzania, Turkey, Ukraine, Uruguay, Venezuela, Vietnam, and Zambia.

Raghuram Rajan, former IMF Chief Economist, last week took over as governor of the Reserve Bank of India. His first actions included liberalisation of the banking sector and opening Dollar funding facilities. Fuel subsidies also look likely to be cut back further, which will help both the fiscal balance and the trade account. On Friday, Japan and India also announced that their joint swap line of USD 15bn will be increased to USD 50bn.

The announcements, which were accompanied by a strong commitment to managing inflation, triggered a sharp turnaround in INR, which rallied from 68.60 to 65.25 against the US Dollar. In our view, India does not have a crisis. Rather India is in need of macroeconomic adjustment to restore external and internal equilibria, which require currency adjustment and domestic demand discipline. India is undertaking both. Under Rajan this will be done more effectively, in our view. However, we believe that realising India's true growth potential will also require deeper supply-side reforms. India's real economy is growing at a speed of 4.4%.

Banco Central do Brasil, the other large Emerging Markets central bank to flex its FX muscles, saw strong positive returns to intervention, when BRL rallied from a low of 2.45 against the US Dollar to 2.29 by the end of last week. Like India, Brazil does not have anything even approximating a crisis and also has very strong structural foundations.

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Emerging Markets

In contrast with India and Brazil, sentiment continues to be negative about Turkey and Indonesia. Their central banks have yet to take sufficiently forceful measures to reassure currency markets. This is not altogether surprising. Turkey's approach to monetary policy has become increasingly heterodox over the past few years. Indonesia has historically been reluctant to implement decisive policy moves until pushed to do so by the market. We think it is unlikely that Turkey and especially Indonesia will experience outright crises, because both have plenty of means to stabilise their markets. However both countries require some macroeconomic adjustment and the longer they delay the bigger the eventual adjustment required.

Our view is that Turkey and Indonesia's challenges are of their own making. Their challenges do not extend to the wider Emerging Markets universe. Indeed, we see few signs of stress in most other countries in the Emerging Markets universe.

Mexico responded to its cyclical slowdown by cutting policy rates 25bps to 3.75%, underlining the country's considerable scope to manage its cycle using regular policy instruments. We expect the government to push ahead with key reforms in the oil and electricity sectors as well as fiscal reform later this year.

In China, the State Council pushed ahead with further institutional changes aimed at speeding up the country's ambitious reform agenda. In August PBOC was awarded a mandate to coordinate financial regulations and this week NDRC was saddled with coordination of reforms to improve central government efficiency, cutting red tape, etc.

Finally, the Polish government announced a long-awaited pension reform, which will see the government pension fund take over all private sector pensions' holdings of government securities. These government bonds will be annulled, thus producing a sharp decline in the government debt to GDP ratio from about 55% of GDP to about 48% of GDP. We do not expect Poland's 10% capped weighting in the JP Morgan GBI-EM GD index to be materially affected.

Global backdrop

The global market place remains extremely focused on the FOMC meeting on 18 September and a possible announcement later this month about succession at the Fed. The sell-off in the US treasury market continued most of last week due to expectations that the labour market continues to improve; that tapering starts in September; and on the back of increasing odds that Lawrence Summers will take over the Chairmanship of the Fed when Ben Bernanke retires.

We think the sell-off in treasuries moved into distended territory by Thursday last week, when both 2-year and 5-year US treasury yields broke out of long-standing ranges to the upside. In our view, the market is being too aggressive in terms of rate hike expectations and ultimately too complacent about long-term term inflation risks.

On the data front, initial claims for unemployment benefit in the US improved and both manufacturing and services ISM indices printed better than expectations last week. This was the main reason for the bearish sentiment surrounding treasuries. Still, sentiment changed sharply at the end of the week, when US payrolls disappointed. At 169K new jobs created in August, the headline job growth number was well below both Bloomberg expectations (180K) and the market consensus, which we believe had moved closer to 200K over the course of the week. Revisions were also negative (104K from 162K originally). While unemployment declined by 0.1% to 7.3%, this was due to a falling participation rate rather than job growth. The participation rate actually dropped 0.2%, which means that unemployment would have risen had participation rates not dropped.

The juxtaposition of, on the one hand stronger services and manufacturing activity, and, on the other softer labour market data, naturally gave rise to volatility in a market bent on seeing everything in black or white. With a slightly longer perspective however, we note that ISM numbers have been excellent indicators of the manufacturing cycle, but lousy predictors of so-called 'exit velocity' in developed economies over the past five years. We do not think this particular upturn in manufacturing is going to be any different. The US economy is currently tracking a growth rate of just 1.7% qoq (seasonally adjusted annualised rate) in Q3 2013.

Panning out to the global manufacturing picture, global PMIs improved significantly according to the latest slew of fresh PMI data releases. As we noted in our discussion of last month's round of PMI data releases the improvements in US and European PMIs observed in July boded well for Emerging Markets PMIs.[1] Sure enough, in August global PMIs rose to the highest level since June 2011 with broad advances not just in developed, but also in Emerging Markets. China's PMI rose to a 16 month high. PMIs also rose elsewhere in Asia, with a few notable exceptions such as India. In Latin America Mexican and Brazilian PMIs rose, while Eastern Europe's PMI indices also saw a broad-based pick up. The pick-up in Emerging Markets manufacturing is of course not consistent with the market's very negative view of Emerging Markets growth prospects. We think the market is wrong.

[1] See *'Mexico heads for an historic constitution reform'*, Weekly Investor Research, 5 August 2013.

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