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Ashmore

Fed up – almost out of excuses not to hike

By Jan Dehn

The Fed has now almost run out of excuses not to hike in December and we think the prospect of more conventional monetary policies in the US will be good for Emerging Markets (EM), not least because it ends the uncertainty surrounding the timing of the start of the rate hike cycle. Meanwhile, in EM itself, the election in the state of Bihar hewed away some of Modi's political capital in India, China's FX reserves rise again, the trade balance in Brazil improves sharply and Saudi Arabia begins to cut subsidies.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	0.56%
MSCI EM Small Cap	12.0	–	0.37%
MSCI Frontier	9.1	–	-0.34%
MSCI Asia	11.5	–	0.86%
Shanghai Composite	14.0	–	6.14%
Hong Kong Hang Seng	7.5	–	1.53%
MSCI EMEA	9.7	–	-1.56%
MSCI Latam	13.0	–	0.84%
GBI-EM-GD	6.85%	–	-1.26%
ELMI+	4.48%	–	-0.89%
EM FX spot	–	–	-1.21%
EMBI GD	6.04%	369 bps	0.04%
EMBI GD IG	4.79%	237 bps	-0.06%
EMBI GD HY	8.11%	590 bps	0.16%
CEMBI BD	5.94%	379 bps	0.15%
CEMBI BD HG	4.54%	238 bps	-0.12%
CEMBI BD HY	8.37%	621 bps	0.59%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	1.02%
1-3 year UST	0.90%	–	-0.44%
3-5 year UST	1.75%	–	-0.87%
7-10 year UST	2.34%	–	-1.36%
10+ years UST	3.10%	–	-2.81%
US HY	7.92%	634 bps	-0.25%
European HY	4.86%	491 bps	0.52%
Barclays Ag	–	225 bps	-0.68%
VIX Index*	14.33	–	-0.74%
DXY Index*	98.96	–	2.03%
EURUSD	1.0783	–	-2.16%
USDJPY	123.43	–	2.24%
CRY Index*	191.03	–	-4.57%
Brent	47.8	–	-2.13%
Gold spot	1095	–	-3.56%

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

Emerging Markets

- **India:** Prime Minister Modi's BJP party and its allies suffered defeat in the Bihar state election. There are no direct immediate consequences for Modi at the central government level, but the defeat indicates that Modi's political capital is now on the wane. The defeat should be discounted to some extent, however, because it is common in midterm elections of this kind for incumbents to suffer setbacks. Even so, the result lowers the odds that Modi will secure a majority in the Upper House of India's Parliament by 2017 and therefore reduces the odds of further reforms. Modi's National Democratic Alliance took only about a third of the seats in Bihar.

- **China:** Taiwan and China took a significant stride to mend relations when presidents of both countries met under amicable terms in Singapore at the weekend. China is undergoing one of the most profound openings in recent history, including economically, financially and politically. The opening of China will inevitably bring tensions as China will be unable to encroach on areas that are perceived by other powers to be their spheres of influence. China's trade balance increased to USD 61.6bn in October from USD 60.3bn in September. The increase in the trade balance was the result of lower than expected imports and exports, pointing to decelerating levels of economic activity in China's tradable sector as well as among her trading partners. At the same time, the larger than expected trade surplus will add to China's GDP growth rate, which increasingly will be dominated by domestic demand (China's savings rate is 49%, so China has enormous potential to grow through higher consumption). China's FX reserves increased marginally to USD 3.514trn at the end of September. This is consistent with our view that most of the FX mismatches on corporate balance sheets in China have been neutralised. Indeed, Chinese corporate bonds performed strongly in October. Meanwhile, the continuing large trade surpluses should be supportive for the level of reserves going forward. Finally, we note that the Shanghai Composite, a major stock market index, regained bull market status last week, after surging 20% from the lows earlier this year. China will report monetary data today and inflation and industrial production later in the week.

- **Brazil:** Inflation was broadly in line with expectations in October. The monthly inflation print was 0.82% versus 0.80% mom expected. The biggest contributor to inflation in October was a hike in fuel prices. Fuel prices are being adjusted as the government removes implicit subsidies. This has a negative effect on inflation on a one-off basis, but ultimately helps the finances of Petrobras, the national oil company. Industrial

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Emerging Markets

production declined 1.3% yoy in September, which was slightly better than expected (1.5% yoy). While the domestic economy is really hurting in Brazil, the economy as a whole is rapidly regaining competitiveness versus the rest of the world on account of falling real wages and a much weaker currency. For example, Brazil's trade balance surplus rose to USD 2.0bn in October compared to USD 1.2 bn expected. The 12-month running trade surplus is now USD 10.1bn, up sharply from the 12-month running trade surplus of USD 6.9bn in September. When inflation eventually starts to tumble Brazil's exporters will be highly competitive. The improvement in the external balances and very healthy levels of FX reserves are among the reasons why Brazil's severe, self-inflicted problems do not include a balance of payments crisis.

• Saudi Arabia: The government has removed water subsidies for the government, industrial and large corporate sectors with effect from December 2015. The adjustment is part of a fiscal response to much lower oil prices. Unlike other oil producers, Saudi Arabia has not devalued its currency, so the adjustment will have to be entirely domestic. However, it does not have to be immediate because Saudi Arabia has very low debt levels – therefore it can smooth the transition to lower domestic demand using fiscal policy.

• Myanmar: Early indications suggest that the ruling Union Solidarity Development Party (USDP) has lost to the National League for Democracy (NLD) in the first democrat parliamentary elections in Myanmar for decades. The last time the NLD won an election, the military cancelled the result leading to widespread unrest and a clampdown on the democracy movement led by Aung San Suu Kyi. In recent years, however, Myanmar has made genuine progress towards a more representative government.

• Malaysia: Export growth was more than twice as strong as expected in September, rising 8.8% yoy versus 3.6% yoy expected. At MYR 63.9bn, the ytd trade surplus is now even larger than last year's trade surplus (MYR 61.5bn) despite a sharp fall in oil prices over the period. Industrial production in September was also strong, rising 5.1% yoy which was well ahead of expectations and much stronger than the 2.3% yoy print recorded in August. We recently showed that 26/29 of the most traded EM markets have benefitted strongly from the overvalued US dollar by recording major improvements in their external balances, particularly since the start of QE.[1] Malaysia was one of the countries whose trade surplus has yet to improve, partly due to very severe negative terms of trade effects for the oil producer, but Malaysia may now be catching up with the rest of EM. The central bank left rates unchanged at 3.25%.

• Indonesia: Economic growth accelerated marginally to 4.73% yoy in Q3 from 4.67% yoy in Q2. The performance was a little bit better than expected with government spending and investment accounting for the outperformance.

• Ecuador: The government has been saddled with a USD 1.1bn liability following a final ruling from ICSIC, an arbitration court, in favour of Occidental Petroleum. The government has said it will honour the ruling, but it has not yet indicated where it will find the money.

• Romania: The National Bank of Romania kept rates unchanged at 1.75%. Prime Minister Ponta resigned after a lengthy period of sustained political pressure following allegations of corruption. A caretaker Prime Minister is likely to take over until parliamentary elections scheduled for December 2016. It is getting progressively more difficult for political leaders in EM to rule with impunity.

• Russia: CPI inflation declined by 0.1% to 15.6% yoy in September. Further declines in inflation are coming and when they materialise the Russian central bank will cut rates. Manufacturing PMI returned to above 50 for the first time in nearly a year (50.2 in October from 49.1 in September).

• Zambia: The central bank hiked policy rates by 300bps to 15.5% in a bid to stop a slide in the Kwacha. Many African central banks are reluctant to be pre-emptive in their policy moves, because if they are wrong they get blamed for having impeded growth unnecessarily. On the other hand, they tend to react with decisiveness after the fact, because all parties abhor macroeconomic instability in countries with larger numbers of people unable to protect themselves from the consequences of the business cycle (inflation, unemployment, etc). Zambia is a case in point.

• Mexico: Congress has de facto fully liberalised gasoline prices two years ahead of time. Adopting a new tax regime that allows fuel prices to fluctuate with global prices of gasoline that are now likely to contribute to lower inflation next year.

Snippets:

- Argentina: Moody's, a ratings agency, raised the outlook for Argentina's sovereign to stable from negative on prospects for better policies when a new government takes office next year.
- Chile: The rate of inflation declined to 4.0% yoy in October from 4.6% yoy in September.
- Czech Republic: Retail sales surged to 6.3% yoy in September from 3.7% yoy in August.
- Dominican Republic: Real GDP surged to 6.7% yoy for the January to September period and 7.4% yoy versus the same quarter in 2014.

[1] For further details, see *"Nothing stays the same: EM's dramatic external rebalancing"*, Emerging View, November 2015.

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Emerging Markets

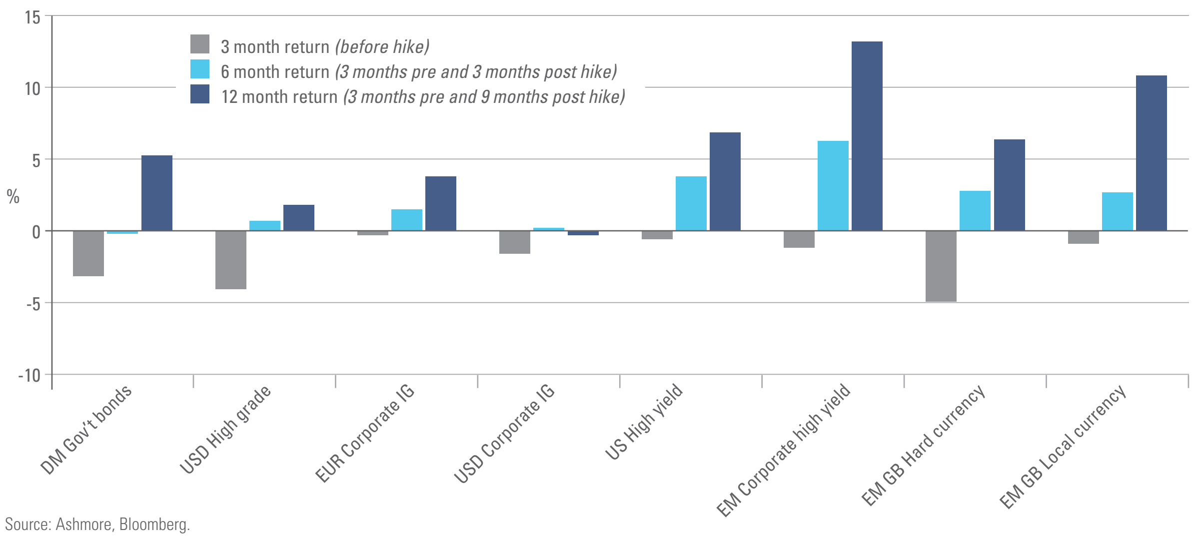
- **Hungary:** The Hungarian central bank eased lending conditions for local banks in a bid to increase economic activity. Hungary's domestic economy has been slow to respond due to already high levels of debt.
- **Paraguay:** Inflation moderated to 3.2% yoy in October from 3.7% yoy in September.
- **Peru:** Inflation moderated to 3.7% yoy in October from 3.9% yoy in September.
- **Philippines:** Inflation remained unchanged at 0.4% yoy in October.
- **South Korea:** Core inflation rose marginally to 2.3% yoy in October from 2.1% yoy in September.
- **Thailand:** The Bank of Thailand left rates unchanged at 1.5%.
- **Turkey:** Headline inflation moderated slightly to 7.6% yoy in October from 7.6% yoy in September. Core inflation remains elevated at 8.9% yoy as the central bank continues to struggle with credibility.
- **Uruguay:** The fiscal deficit narrowed to 3.4% of GDP in September from 3.6% of GDP in August.

Global backdrop

Friday's labour market data in the US was strong. The odds of the first Fed hike in more than half a decade at the FOMC meeting in December have now significantly improved. Earlier in the week, Fed Chairwoman Janet Yellen had indicated that a December hike was a "live" possibility. ISM services were also unusually strong, though initial claims disappointed, manufacturing disappointed relative expectations and lending standards tightened for corporates. Even so the data was stronger than expected and markets are now placing a 70% probability on a hike in December.

We think it will be good for EM if the Fed gets on with raising rates. The stylised facts of EM's response to rate hike cycles are very clear: the uncertainty in the run-up to the first hike is negative, but once hikes get on the way EM tends to perform well. This is illustrated in the chart below, which shows how EM (and other markets) responded to the sustained rate hike cycle in 2004 – which saw the Fed hike the Fed funds rate from 1% in 2004 to 5.25% by 2006 in a series of sustained 25bps moves. Only very late stage rate hikes tend to pose fundamental challenges in EM.

Fig 1: **Cumulative returns after the start of the sustained rate sell-off that began in April 2004**



Source: Ashmore, Bloomberg.

In this cycle, we expect the Fed to move very slowly due to multiple drags on the US economy. As such, the prospect of late cycle rate hikes is no concern at this stage. The reasons for slow normalisation are:

- low productivity – productivity declined to just 0.4% yoy in Q3 from 0.8% yoy in Q2
- real exchange rate overvaluation following a very strongly front-loaded US dollar rally over the past four years
- excessive debt – the US economy carries nearly 400% of GDP in recognised debt, not counting some 200% of GDP in unfunded medical liabilities coming due in the next couple of decades
- over-inflated financial markets following years of QE

A fast pace of hikes under these conditions would likely impact the US economy and her markets adversely, putting the recovery at risk. On Friday, the US 10 year Treasury yield rose to 2.33% following the strong labour market data and the US dollar rose – both had a negative impact on the stock market. The real risk facing investors in US dollar denominated assets is that the unresolved fundamental problems listed above will prevent the Fed from raising rates as much as it would do in a normal business cycle, so that inflation comes back and with it, a weaker US dollar.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.56%	-8.71%	-11.61%	-2.74%	-3.23%
MSCI EM Small Cap	0.37%	-3.95%	-6.54%	1.24%	-2.34%
MSCI Frontier	-0.34%	-10.75%	-15.34%	7.32%	1.69%
MSCI Asia	0.86%	-4.56%	-4.75%	2.89%	0.84%
Shanghai Composite	6.14%	12.73%	50.32%	22.63%	5.33%
Hong Kong Hang Seng	1.53%	-9.21%	2.98%	3.27%	-2.19%
MSCI EMEA	-1.56%	-9.23%	-16.69%	-7.72%	-5.78%
MSCI Latam	0.84%	-24.03%	-31.05%	-15.80%	-12.73%
GBI EM GD	-1.26%	-12.18%	-16.95%	-7.98%	-3.45%
ELMI+	-0.89%	-6.12%	-9.54%	-4.70%	-3.14%
EM FX Spot	-1.21%	-15.37%	-20.12%	-12.06%	-9.30%
EMBI GD	0.04%	2.71%	0.98%	2.00%	4.70%
EMBI GD IG	-0.06%	0.37%	0.37%	0.87%	4.00%
EMBI GD HY	0.16%	5.89%	0.96%	3.65%	5.77%
CEMBI BD	0.15%	3.25%	1.19%	2.97%	4.51%
CEMBI BD HG	-0.12%	2.43%	1.76%	2.94%	4.69%
CEMBI BD HY	0.59%	4.57%	-0.40%	3.08%	4.24%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.02%	3.76%	5.51%	16.13%	13.72%
1-3 year UST	-0.44%	0.34%	0.28%	0.39%	0.59%
3-5 year UST	-0.87%	1.25%	1.68%	1.15%	1.33%
7-10 year UST	-1.36%	1.40%	3.28%	1.43%	3.63%
10+ years UST	-2.81%	-2.87%	3.65%	2.19%	7.46%
US HY	-0.25%	-0.06%	-2.40%	4.07%	6.38%
European HY	0.52%	3.58%	3.85%	8.56%	9.81%
Barclays Ag	-0.68%	-0.35%	0.75%	2.63%	4.09%
VIX Index*	-4.91%	-25.36%	9.22%	-23.00%	-24.90%
DXY Index*	2.07%	9.62%	12.91%	22.13%	27.78%
CRY Index*	-2.34%	-16.93%	-29.42%	-34.63%	-40.14%
EURUSD	-2.03%	-10.88%	-13.23%	-15.19%	-22.14%
USDJPY	2.33%	3.00%	7.57%	55.28%	52.06%
Brent	-3.65%	-16.71%	-42.74%	-56.35%	-45.94%
Gold spot	-4.16%	-7.86%	-5.72%	-36.77%	-23.07%

*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.

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

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
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