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WEEKLY INVESTOR RESEARCH

Ashmore

The good, the bad, and the ugly

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Are you curious about the political noise in Thailand and Ukraine? Or the dramatic turnaround in India and Indonesia's external balances? Or are you concerned about the fiscal situation in Brazil and want to get up to speed with reforms in Mexico? Perhaps you lie awake at night thinking about inflation in Turkey after the currency weakness of the summer? Then look no further, it's all here! In addition, we review the latest round of global manufacturing survey releases plus we summarise the major market moving data releases and global market backdrop of the past week.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,010		-0.33%
MSCI FM	583		0.29%
GBI-GD	6.82%		0.64%
ELMI+	4.28%		0.54%
EMBI GD	5.98%	307 bps	-0.06%
EMBI GD IG	5.04%	214 bps	-0.10%
EMBI GD HY	9.64%	699 bps	0.02%
CEMBI BD	5.68%	328 bps	-0.13%
CEMBI BD HG	4.84%	243 bps	-0.20%
CEMBI BD HY	7.59%	523 bps	0.08%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,805	0.28%
VIX Index	13.79	-3.09%
5 year UST	1.48%	7 bps
10 year UST	2.85%	6 bps
10 year Bund	1.84%	10 bps
EURUSD	1.3726	1.27%
USDJPY	103.09	0.04%
Brent	$112	0.20%
Copper	$330	1.46%
Gold	$1230	0.36%

Emerging Markets

It has been a very eventful week in Emerging Markets with sharply contrasting developments across the vast canvas of the asset class. Headlines were dominated by political unrest in Ukraine and Thailand, so we have devoted some space to explain the development and expressing some of our views on the likely outcomes. Meanwhile, last week saw truly dramatic turnarounds in the external imbalances of Indonesia and India. Has Fragile Five now been withered down to the Fragile Three? One of those three is Brazil, where the news was unambiguously bad. Brazil may have stabilised its economy after the noise of the summer, but the government has not managed to restore domestic business confidence and investment demand, so the recovery is sluggish and fiscal accounts are beginning to reflect the lacklustre economic performance. By contrast, a bit further north, in Mexico, the government passed yet another reform, which has paved the way for the piece de resistance – the long-awaited energy reform. Finally, we highlight a sharp decline in inflation in Turkey.

Political noise in Kiev

Over the past week the level of political noise in Ukraine rose to levels last seen during the Orange Revolution as many Ukrainians voiced their unhappiness at the government's rejection of a trade pact with the European Union. The rejection of the trade pact was seen as a sign that Ukraine is turning towards Russia's Eurasian Union. Many Ukrainians fear that closer ties with Russia would mean a sacrifice of the independence achieved in the Orange Revolution.

In our view, the government is playing a different game. It does not want to pick sides. Picking Europe would mean facing tough upfront IMF reforms. Picking Russia would mean losing key gas storage assets. Ukraine wants to maintain its independence, while benefitting from the fact that neither the European Union nor the Russians want to 'lose' Ukraine. But the stretched state of Ukraine's finances means that the government's only credible course of action is to play the 'crisis card'; that is giving the impression that the country is just about to commit to one side or the other. This makes for a lot of noise and it is obviously not a risk free strategy.

We think it is likely that Ukraine will extract concessions from both sides, while at the same time pursuing financing options from third parties, including private sources. In this context, we note that Prime Minister Yanukovich visited China last week.

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Emerging Markets

Thailand goes to the polls

After subsiding briefly early last week due to a series of government concessions and a desire to respect the birthday of King Bhumibol Adulyadej on 5 December the government of Prime Minister Yingluck Shinawatra announced the dissolution of parliament and fresh elections. It is noteworthy that this follows reports that the military is discussing how to handle the unrest. Thailand's parliament was due to re-open on 21 December.

The political unrest is specific to Thailand and merely the latest round in a repeating cycle. Thailand's divisive politics derive from big divisions in society at large between higher income urban dwellers and a larger group of pro-government rural-based low income voters. These socio-economic divisions are not likely to go away, even with elections, in our view.

In the current upheaval, opposition groups have demanded the dissolution of the legitimately elected and majority supported Yingluck Shinawatra administration, which they accuse of acting on behalf of exiled former Prime Minister Thaksin Shinawatra. The government has now met this demand, probably because it believes it can win. This is a positive development, although there is no guarantee that fresh elections will bring material change. The military has in the past stepped in when the level of instability in civilian circles rose to unacceptable levels.

Despite Thailand's very unconventional political dynamics Thailand's tourism and other industries have been able to thrive through the episodes of political volatility in the past. We expect the same to be the case this time. Government economic policy has tended to be very conservative. We expect growth to remain modest in Thailand next year due to the political situation. The upside would come in the event of a restoration of political stability, which could usher in a go-ahead for a massive program of infrastructure investment, which is currently held up by political and legal obstacles.

India and Indonesia – turnaround in balance of payments

Has the Fragile Five become the Fragile Three? Brazil, Turkey, South Africa, Indonesia, and India were labelled disaster zones in 2013, though none of them are in crisis. All five, however, required macroeconomic adjustment after self-inflicted excess domestic demand problems and resulting trade deficits.

Of the five, however, Indonesia and India went on to undertake material policy changes intended to restore external and domestic economic equilibrium. These efforts now appear to be bearing fruit in our view.

India published Q3 balance of payments data last week and the improvement is shocking. India's current account deficit shrank from USD 21bn (5% of GDP) in Q2 to USD 5bn (1.2% of GDP) in Q3. Not only did imports decline but exports rose too, precisely the type of economic reaction one would expect from a successful policy intervention. India is now on track to improve its overall balance of payments position by a factor of two in just one year.

Meanwhile, Indonesia's trade balance swung into outright surplus in October. The market expected a deficit of USD 775m, but the number was a surplus of USD 42m, which was achieved as a result of strong export growth and contracting imports. Both improvements are probably attributable to the adjustment policies including the reduction of energy subsidies, dropping the soft peg and hiking policy rates undertaken by the government since the outbreak of EM pessimism in May of this year. Consistent with this interpretation was the declining headline inflation print for November. Inflation was lower than expected at 8.4%, while core inflation was largely flat at 4.8% yoy. The big gap between headline and core inflation is due to the removal of energy subsidies by the government. This pushes headline inflation temporarily higher, but then creates very favourable base effects on inflation 12 months out.

As an aside, Malaysia also made significant further reductions in fuel subsidies in the past week as the fiscal consolidation continues.

Focus on Fiscal in Brazil

Brazil's primary surplus shrank from 1.6% of GDP in September to 1.4% of GDP in October on a 12 month cumulative basis. Higher than expected spending accounted for the deterioration, but the additional expenditure mainly consisted of one-off outlays to satisfy court judgements. Besides, seasonal factors are likely to boost revenues in the coming months, so the fiscal picture may improve at the margin in the next few months, in our view. Even so, the government is likely to miss its 2.3% of GDP primary surplus target this year by some 0.7% of GDP, discounting special items.

The silver lining is that Brazil is still running a significant primary surplus and the fiscal numbers are deteriorating from a position of considerable strength. Total (private and public) foreign debt as a percentage of GDP is just 22.5%, net general government debt as a share of GDP is just 35%, and Brazil has USD 375bn in FX reserves.

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Emerging Markets

The real culprit behind the worsening fiscal numbers is the broader growth picture. The economy only expanded at a pace of 2.2% yoy in Q3, which was below expectations. Details showed that the softer than expected number was due to declining investment (-2.2% qoq) and falling net exports (-1.4% qoq). Consumption rose 1.0% qoq. This means that Brazil now looks set to grow about 2.0% in 2013. This is more than twice as fast as last year's growth rate, but a 2% handle for growth is disappointing for an EM country.

Brazil's growth problems – and by extension its fiscal problems – are entirely self-inflicted. They have nothing to do with the economic problems in the global economy or in some other EM economies. The government inherited an extremely strong economic position from the previous administration, but greater intervention in prices, exchange rates, and the erosion of central bank monetary policy independence have sharply undermined business confidence.

Government intervention in the state oil company Petrobras is a case in point. Petrobras last week announced fuel price hikes of 4% and 8% for gasoline and diesel prices, respectively. The price increases, which apply at refinery level, will translate into price increases of roughly half this amount at pump levels. This will have a modest one-off impact on inflation and will ease the finances of Petrobras, but the price hikes are not sufficient to close the gap between domestic and international prices. Hence, Petrobras's finances continue to be under stress. The government's management of inflation in part via controlled prices in companies such as Petrobras is heterodox, economically inefficient, and undermines Petrobras' ability to invest and operate on commercial principles.

Policies of this kind means that it is now hard for the economy to return to previous higher growth rates, even after major adjustments in its currency, interest rates, and capital controls. Investment demand remains subdued. November's manufacturing PMI weakened in November. We do not expect any major changes in the direction of economic policy ahead of elections. But investors should also put Brazil's situation into its correct context: The government has demonstrated – and will likely continue to demonstrate, in our view – that it is determined to avoid any extreme macroeconomic outcomes, which could be politically disastrous. Investors are likely to continue to participate in the market albeit in smaller size and probably in different ways than in a more bullish growth scenario.

Yet more reforms in Mexico

The Mexican senate approved a political reform with a 106-15 majority last week. The political reform will now go to approval in the lower house in the next few days. The importance of this bill lies not in its content, but in the fact that its passage was a pre-condition from the opposition PAN party for supporting the government's crucial energy reform, which is next on the legislative agenda.

The energy reform is the final major reform on the agenda of the PRI administration, which took office in July 2012. Given the importance of this reform – which could completely change the energy situation in the country – it is likely that the level of political noise could rise somewhat in the coming weeks. The left-wing opposition PRD party has collected signatures in a bid to prevent reform of PEMEX, while PRD leader Andres Manuel Lopez Obrador has allegedly suffered a heart attack, which could certainly increase sympathy for his cause. Despite the noise, we expect the reform to pass, because between them the PRI and the PAN have enough votes.

Turkey turns

Inflation in Turkey surprised to the downside in November, clocking a rise of just 0.01% against expectations of 0.5% monthly inflation. This reduces the yoy rate from 7.7% in October to 7.3% in November. Core inflation also declined to 7.1%. Inflation is expected to fall further in Q1 due to base effects from last year's hike in tobacco prices. The benign inflation print is extremely important, in our view. It will allow the central bank to keep rates in check, and thereby avoid hurting domestic growth at a time of considerable external head winds for Emerging Markets and Turkey in particular.

The main focus in Turkey going into 2014 is going to be the local elections scheduled for March 2014. These elections are a key test for the popularity of Prime Minister Erdogan and the ruling AK party. A strong showing is likely to result in business as usual for the government, but a poor showing could trigger a broad range of changes, including monetary policy, the election schedules, and in the leadership of the AK party.

Given the importance of the March elections we think the central bank will try as far as possible to deliver economic stability in Turkey. This will translate, into stable rates and a weaker currency. The main risk to this view is that the US Federal Reserve signals a delay in tapering. A delay in tapering would probably usher in a decent rally in TRY, which in turn could lead the central bank to cut rates.

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Global backdrop

Over the past week, a large number of Emerging Markets and developed countries issued manufacturing survey data for the month of November. In aggregate, the data showed that the environment for global manufacturing is continuing to improve. November's aggregate global Purchasing Manager Index (PMI) reached the highest level since May 2011, pushing above its long-term average. This extends the most recent upturn, which has been on-going since the index bottomed out in Q2 of 2013. Indeed, the disappointing growth recorded by both developed and Emerging Markets in the first few months of 2013 was largely due to this trough in global manufacturing.

Turning to the details, in the developed economies US ISM manufacturing picked up more smartly than European PMIs, while Japan's PMI numbers rose to the highest level since 2006.

In EM, PMIs rose for the fourth consecutive month with the strongest prints in Asia and Eastern Europe. China's PMI was unchanged mom at 51.4, while India, Korea, and Taiwan also rose. Mexico's PMI rose, but Brazil's declined. Russia declined, but Turkey and South Africa improved. Hungary, Czech Republic, Poland rose strongly. Egypt's PMI number reached an all-time high for the month of November.

What should investors make of these numbers?

- Firstly, they suggest that EM countries are entering 2014 with positive tail winds from manufacturing in contrast with the start of 2013, when there was a distinct manufacturing headwind.
- Secondly, investors should be wary of reading too much into differences between PMI numbers across countries. If manufacturing is picking up in one part of the world odds favour an imminent pick-up elsewhere too. The supply chain is truly global.
- Finally, a pick up on manufacturing is still not a good indicator of underlying trend GDP dynamics. Instead, they are a good an indicator of the intra-year inventory dynamics around these underlying GDP growth trends.

Aside from manufacturing numbers, market sentiment about the US economic outlook improved on the back of Friday's stronger than expected non-farm payroll print and the decline in unemployment to 7%. This helped to push the yield on the 10-year US treasury bond up, reaching 2.88% by the end of the week. Still, the sell-off in US treasuries was less pronounced than one might have expected, while the reaction in stock markets and in other currencies such as EURUSD and EM currencies was decidedly bullish following the payroll print. This market reaction is telling: It speaks volumes not just about the technical picture in EM after many months of fast money selling. It also underlines the point that economic recovery combined with an expected continuation of easy monetary policy – which is expected under a Yellen Fed – is ultimately inflationary and therefore bad for the Dollar. With PCE core inflation rising at a modest pace of just 1.1% per year inflation is still contained, but this will end when the deleveraging drags on consumers fade in earnest. Even then, however, the Fed may find itself on the dovish side, because the US economy carries far too much debt to sustain a conventional normalisation of monetary policy, in our view.

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