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Over to you Dilma

By Jan Dehn

The remaining downside risks in Brazil – downgrade from investment grade and presidential impeachment – moved a little closer last week. President Erdogan's strategy of going to war to restore his parliamentary majority is working so far. Argentinean Economy Minister saves President Cristina's blushes and opens the door for presidential candidate Daniel Scioli to move to the centre in politics by declaring that the holdout issue must be resolved. China's Renminbi is set for SDR inclusion after technical hurdles are overcome. The economy picks up in Russia, Poland passes legislation to make banks pay for FX losses on mortgages and India's Rajan re-iterates the need to open India's bond markets. Malays produce a big trade surplus, Uruguay acts on inflation and President Buhari in Nigeria appoints an official. Nothing fundamentally changed in the global backdrop, which remains hostile to investor sentiment towards Emerging Markets (EM).

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.6	–	-1.80%
MSCI EM Small Cap	11.5	–	0.10%
MSCI Frontier	9.3	–	0.68%
MSCI Asia	11.1	–	-1.17%
China A shares	14.4	–	0.17%
China H shares	7.3	–	-0.38%
MSCI EMEA	9.5	–	-2.08%
MSCI Latam	12.7	–	-4.14%
GBI-EM-GD	6.81%	–	-1.77%
ELMI+	4.35%	–	-0.95%
EM FX spot	–	–	-1.44%
EMBI GD	5.88%	370 bps	-0.45%
EMBI GD IG	4.59%	235 bps	-0.28%
EMBI GD HY	8.09%	604 bps	-0.69%
CEMBI BD	5.61%	362 bps	-0.18%
CEMBI BD HG	4.50%	251 bps	-0.13%
CEMBI BD HY	7.74%	578 bps	-0.28%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.8	–	-1.18%
2 year UST	0.74%	–	-0.11%
5 year UST	1.60%	–	-0.17%
10 year UST	2.19%	–	0.11%
30 year UST	2.84%	–	1.85%
US HY	7.28%	583	-0.44%
European HY	4.64%	463	-0.08%
Barclays Ag	–	226	0.06%
VIX Index*	13.39	–	1.27%
DXY Index*	97.77	–	0.27%
CRY Index*	1.0944	–	-0.15%
EURUSD	124.74	–	-0.70%
USDJPY	198.32	–	-4.25%
Brent	48.7	–	-1.76%
Gold spot	1095	–	0.27%

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

Emerging Markets

- **Brazil:** The two remaining downside risks in Brazil moved a step closer to materialising last week. The odds of the first – a downgrade to the sovereign credit rating from investment grade – shortened when an act of parliament increased the public sector wage bill. While the vote is not final, it demonstrates the parliament's power vis-à-vis President Dilma Rousseff and adds further strain to Brazil's already challenging public finances. The other risk – impeachment of Dilma herself – also increased last week as leaders of PMDB and the opposition PSDB parties began discussions on the logistics of the impeachment process itself. Some 66% of Brazilians would like to see the president impeached, though importantly there is no evidence of serious social unrest. Indeed, about a quarter of Brazilians still support the government, despite Dilma's very low personal approval ratings. But given her splintering government coalition, the damage caused to the PT party of the ongoing corruption probes Dilma is certainly ripe for the plucking.

Still, the question is not whether impeachment can happen – it can – but whether it will. Would the opposition benefit from impeaching her at this point in time? Sure, opportunities to successfully impeach a president do not come around every day, so there is an argument for striking while the iron is hot. On the other hand, Brazil is going through a serious economic adjustment, which will go on for some time, so anyone taking over the government now would quickly end up paying a high political price for power. Certainly, timing would be better, say, after the downturn in the economy has abated or closer to the next election. So far Dilma has not responded to parliament's moves against her. This is important – the president still has considerable powers, including the power to grant cabinet positions. And it just happens that a few of them became vacant recently, when two junior coalition partners left the government. Finally, it is worth bearing in mind that the whole impeachment train gained momentum as a diversion orchestrated by the president of the Lower House, Eduardo Cunha, who himself has been accused of corruption. His next steps depend on the severity of the charges against him. These charges will be known in the near future. Given the self-serving motivation behind the impeachment process it could easily be seen, in the public eye, as a kind of coup orchestrated by parliamentarians trying to save their own skin from an ongoing anti-corruption campaign run by the judiciary.

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Emerging Markets

So far, there has been no evidence of broad-based popular protests against Dilma, even though another public protest has been orchestrated to happen on 16 August, but is likely to be another middle class protest without involving the mass. Balancing all these arguments for and against impeachment, we think the opposition will certainly want to keep alive the impeachment issue as a way of sustaining pressure on the president, but it may also refrain from actually going ahead with the impeachment itself.

Regardless of what happens next, the process of impeachment is the following: any citizen in Brazil can start proceedings by presenting parliament with a request citing a wrong doing (the latter could be illegal campaign funding or involvement in the Petrobras scandal, for example). Cunha, as Lower House president, would then have to personally approve the request. The Lower House would then have to vote and approve the request with a two-thirds majority (342 members out of a total of 513). The vote on public sector wages last week gathered more votes than this, but we think a vote on higher public spending and a vote on impeachment are two very different things. Then two thirds of Senators – 54 out of 81 – would have to also vote in favour of impeachment within 180 days of the Lower House vote and the Supreme Court would have to ratify it in the end. The process would probably take some three months from start to finish, though it could take longer.

In other Brazilian news, the central bank increased the swaps rollover to USD 550m (from USD 300m). At this pace, if maintained for the rest of the month the full notional outstanding swaps would be rolled over (versus USD 4.0bn that would otherwise expire). The larger rollover is supportive of BRL. The economy posted another solid trade surplus of USD 2.4bn, which was marginally stronger than the market consensus of USD 2.3bn. Industrial production also surprised to the upside. The monthly rate of inflation declined from 0.79% mom in June to 0.62% mom in July mainly due to seasonal factors with annualised inflation reaching 9.6%, the highest since 2003.

- Turkey: President Erdogan's strategy to increase support for his party by engaging militarily against the Kurds and ISIS in Syria and Iraq is working. A new poll shows that President Erdogan's AKP now has 42.9% of voting intentions compared to 25-26% for the Kemalist CHP, 16-17% for the nationalist MHP and 10-11% for the Kurdish HDP. We think Turkey is heading for fresh elections later this year. Why another election so soon after the last one? The reason is that President Erdogan is uncomfortable with his current 41% share of seats in parliament, which limits his scope of effect change and carries considerable risks, including legal risks. Erdogan needs his party to garner at least 45% of voting intentions in order to restore an outright majority. Hence, he may be trying to take votes from the MHP by outdoing them in the nationalism stakes – war against IS and PKK – while Erdogan hopes to bring cross-over supporters for the HDP back to the fold by portraying the Kurds as enemies of Turkey. Ongoing coalition talks are, at best, a fall-back position in case the votes do not return.

- Argentina: In an important announcement last week, presidential candidate Daniel Scioli indicated for the first time that he wants to see the holdout issue resolved "once and for all". It is no coincidence that Scioli's comments come just days after Economy Minister Alex Kicillof said that Argentina needs to settle the holdout conflict. Kicillof's status as minister means that his announcement is de facto government policy. Thus, Scioli is now able openly to support a deal with holdout investors without appearing to be at odds with the Kirchner administration, whose votes he needs in order to become president. Kiciloff's U-turn on the holdout issue not only spared President Cristina Kirchner's blushes, but also gave a green light for Scioli to begin to woo international investors. In sum, Argentina is on track for a quick resolution of the holdout issue after the next administration assumes office, regardless of who wins. For more details please see *"A New Argentina",* The Emerging View, March 2015.

Argentina held primary elections on 9 August. At the time of writing, Daniel Scioli, the candidate most closely aligned with the Kirchner administration, was in the lead over opposition candidate Mauricio Macri. Each political group has a list of candidates and the most successful candidate on each list goes forth to contest for each of the seats in question, including the biggest chair of them all, the presidency. In addition to the presidency, one half of the members of the Lower House and one third of Upper House are up for grabs. Voting is open and mandatory, so primaries have in the recent past been excellent indicators of the outcome of subsequent general elections.

- China: The Renminbi is on track for SDR inclusion within the next twelve months or so. A number of technical issues still have to be addressed, so the IMF looks likely to go ahead with RMB inclusion, while scheduling actual implementation for Q4 2016. This timing would coincide nicely with China's G20 presidency and the end of President Obama's second term. There is no doubt that China's currency will be the world's next reserve currency. The remaining challenges are merely technical, such as updating the IMF's COFER survey to include RMB, getting BIS members to report RMB positions, developing a method to reconcile CNH and CNY flows and reviewing the weighting methodology for the SDR basket (RMB will likely enter with a weight of around 13%, in our view). The more important economic and political cases for RMB inclusion are well established. Only 70% support will be required to approve RMB inclusion and lack of full convertibility is no obstacle to reserve currency status. Recent stock market volatility is irrelevant, in our view (if stock market volatility, bubbles and excessive government intervention in markets were an obstacle most of the existing global reserve currencies would have been booted out long ago). China's effort to become a global reserve currency is enlightened. The world is likely to be desperately short of reserve currencies with integrity when QE policies become inflationary. At that point, China's RMB will be in an extremely strong position to gain greater 'market share' within the reserve currency universe.

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Emerging Markets

Four Chinese banks are now ranked in the top five of global banks in term of asset size. However, Chinese banks have much lower global visibility than, say, large Western banks. This is because they are mainly exposed to domestic loans. The dominance of domestic assets is likely to change dramatically over the coming years. Chinese banks will be replacing many of their local government assets with tradable bonds that in turn they will sell to the rising asset management industry. This will free up the banks' balance sheets to engage in consumer and corporate lending, while their asset management wings will emerge as major players in global asset management on the back of the opening of China's capital account. China Development Bank and Agricultural Development Bank of China, both government institutions, will issue RMB 1.5trn in bonds to finance shanty town development, urban transportation, provision of public goods and railway construction in central China. This investment will support China's transition to domestic demand-led growth.

Services sector activity picked up strongly in July. The Caixin China Services PMI rose to 52.8 compared to 51.8 in June with strong new orders and better employment and prices too. On the other hand, exports slowed sharply in July, pointing to weaker global growth. CPI inflation rose to 1.6%, mainly due to rising pork prices. The PBOC has ample room to cut, but it is likely to do so only in a measured fashion as the government seeks to further liberalise interest rates.

- Russia: A broad range of indicators point to a pick-up in economic activity in July, including production of oil and gas, electricity consumption and railway transportation volumes. Activity in the mining sector is also improving. Services PMI picked up to 51.6 in July versus 49.2 expected. Manufacturing PMI was weaker than expected, however. Inflation surprised to the downside at 15.6% yoy. Inflation was higher than in June for technical reasons. Inflation is likely to decline sharply in the coming 12 months.

- Poland: The Lower House voted in favour of new legislation that increases the burden of FX-linked mortgage losses to banks. Their share of the losses will increase from 50% to 90%. Once the measure has been passed in the Upper House on 2-3 September it will then need to be signed by the president. Hungary successfully made foreign banks pay for foreign mortgages.

- India: The Reserve Bank of India (RBI) left interest rates unchanged at 7.25%, while Governor Rajan said that India's bond markets need to be opened to the rest of the world. We think China's ambition to achieve global reserve currency status is likely to resonate with other large EM countries, including India. One step in this direction would be to remove quotas on domestic bond markets in India. July PMI rebounded to 52.7 from 51.3 in June.

- Malaysia: The trade surplus rose to MYR 8.0bn in June, the highest in five months. Despite the improving trade balance reserves declined to USD 96.7bn amidst currency weakness arising from political noise over a probe into 1MDB, a government owned development company.

- Uruguay: Inflation hit an uncomfortably high 9% yoy rate in July. Inflation at 10% would trigger automatic increases in statutory payments. For that reason, the central bank intervened in the currency, while the government embarked on wage negotiations. Interest rate policy is relatively ineffective in Uruguay due to a high level of dollarisation in the economy.

- Nigeria: Nigerian President Muhammadu Buhari appointed Emmanuel Ibe Kachikwu as the new managing director of the Nigerian National Petroleum Corporation (NNPC). Kachikwu is a Harvard Law School PhD and former Vice-Chairman of Exxon Mobil Africa with responsibility for anti-corruption and compliance.

Snippets:

- Chile: S&P lowered Chile's long-term local currency rating from AA+ to AA. The GDP proxy index increased 2.7% yoy in June, which was a major shift higher compared to May (0.8% yoy).
- Czech Republic: Retail sales rose sharply in June to 11.1% yoy versus 7.6% yoy expected.
- Indonesia: The economy expanded 4.7% yoy in Q2, in line with expectations.
- Mexico: The data release last week disappointed. Consumer confidence softened in July after improving in both June and May, while gross fixed capital spending increased by 0.9% in the month of May.
- The Philippines: Headline CPI inflation was 0.8% yoy in July and core inflation was 2.0% yoy.
- Romania: The central bank left rates unchanged at 1.75%, but warned against a planned fiscal injection by the government.
- Thailand: The Bank of Thailand left rates unchanged at 1.5%. Headline inflation is running at -1.0% yoy.
- Turkey: Industrial production picked up smartly in June. The IP index rose 5.5% on a yoy basis, up from 2.4% yoy in May.
- Venezuela: Maria Corina Machado, an opposition leader, has been barred from running for Congress in December.

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Global backdrop

Global sentiment remains negative for investor sentiment towards EM amidst low August liquidity. Unstable commodity markets, approaching Fed hikes and poor YTD performance for many of the most popular global consensus trades left markets unsettled for yet another week.

In the real US economy, after 85% of US company results Q2 earnings are 3.3% lower than last year and revenues are trailing last year's earnings by 4.1%. Both numbers are also weaker than Q1. Productivity is falling. The trade balance disappointed once again, undoubtedly due to the strong QE-sponsored Dollar. ADP was softer than expected at 185K versus 215K anticipated and ISM was softer than expected. Services ISM was strong, but Markit's services PMI was weaker. Personal spending lost momentum in June. The main market mover was a call by former FOMC member Lockhart that the Fed would raise rates in September. This increased 5 year US Treasury yields by 5bps to 1.64%. Friday's payroll number was close to consensus and offered nothing new to the market, which remains divided between a September and a December hike. Puerto Rico defaulted on a USD 58m payment on its USD 72bn debt stock.

European economic indicators were mixed in July after a lengthy spell of strength. Industrial production declined in both Germany and France on a month on month basis, but German industrial orders rose 2.0% mom and PMIs were generally strong.

The bigger picture is unchanged. Global markets have now believed for more than four years that printed money has real value. In accordance with this view, QE means real asset demand, i.e. a sound foundation for asset price appreciation. The popular QE trades – long US stocks and long USD in the US and going long core government bonds in Europe – all hinge on this view. One marvels why it has taken humanity thousands of years to discover that one can get rich simply by printing money! This is very good news. Printing money is so much easier than doing reforms, deleveraging and other kinds of hard work!

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.80%	-5.75%	-13.50%	-0.23%	0.14%
MSCI EM Small Cap	0.10%	0.05%	-6.71%	4.94%	1.81%
MSCI Frontier	0.68%	-5.65%	-18.14%	11.56%	5.22%
MSCI Asia	-1.17%	-2.27%	-5.65%	5.82%	4.40%
China A shares	0.54%	15.39%	65.53%	21.27%	8.41%
China H shares	-0.35%	-3.48%	5.77%	9.28%	2.33%
MSCI EMEA	-2.08%	-2.82%	-15.53%	-5.08%	-1.97%
MSCI Latam	-4.14%	-17.63%	-33.49%	-12.75%	-8.88%
GBI EM GD	-1.77%	-8.96%	-17.38%	-6.20%	-1.29%
ELMI+	-0.95%	-4.60%	-11.97%	-3.57%	-1.79%
EM FX Spot	-1.44%	-11.33%	-21.68%	-10.70%	-7.67%
EMBI GD	-0.45%	1.71%	1.15%	2.72%	5.63%
EMBI GD IG	-0.28%	0.65%	2.68%	1.63%	4.91%
EMBI GD HY	-0.69%	3.07%	-2.13%	4.43%	6.70%
CEMBI BD	-0.18%	3.47%	2.70%	4.19%	5.52%
CEMBI BD HG	-0.13%	2.43%	3.28%	3.90%	5.53%
CEMBI BD HY	-0.28%	5.42%	1.25%	5.03%	5.65%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.18%	2.14%	11.03%	16.48%	15.51%
2 year UST	-0.11%	0.47%	0.49%	0.44%	0.66%
5 year UST	-0.17%	1.56%	2.30%	1.27%	1.83%
10 year UST	0.11%	1.83%	4.55%	1.57%	4.49%
30 year UST	1.85%	0.72%	10.58%	2.54%	8.04%
US HY	-0.49%	1.51%	-0.41%	5.64%	7.90%
European HY	-0.18%	3.38%	4.42%	10.52%	10.68%
Barclays Ag	0.06%	0.15%	2.01%	3.69%	4.66%
VIX Index*	10.48%	-30.26%	-15.09%	-9.16%	-40.14%
DXY Index*	0.44%	8.31%	20.12%	18.43%	21.00%
CRY Index*	-2.10%	-13.76%	-32.18%	-34.29%	-27.16%
EURUSD	-0.36%	-9.55%	-18.24%	-10.94%	-16.57%
USDJPY	-0.68%	-3.93%	-18.09%	-37.25%	-31.21%
Brent	-6.82%	-15.14%	-53.68%	-56.93%	-38.88%
Gold spot	-0.12%	-7.87%	-16.32%	-32.44%	-8.56%

*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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