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Ashmore

A return to rationality

By Jan Dehn

The market's two largest convictions going into 2014 were a stronger US and a crisis in Emerging Markets (EM). Both these views are unravelling. US manufacturing dropped sharply following two quarters of significant inventory accumulation. US non-farm payrolls disappointed for the second month in a row. If this run of US bad data continues the markets will soon begin to ask why the Fed began to taper. Meanwhile, money is still flowing out of EM. Why does weak US data matter for EM investors? Not because EM needs QE flows or low US treasury yields. After all, most of the QE money went into the US stock market, developed market bonds, and G3 currencies. Also, EM rates already price far higher Treasury yields than we will see this year. No, the real importance of these weak US numbers is that they help to restore rationality. The irrational selling of EM over the past 10 months has only been equalled by the build-up of irrational exuberance about the US outlook. Now, perhaps, we can begin to hope for a return to rationality.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	937		1.15%
MSCI EM Small Cap	991		1.66%
MSCI FM	608		1.29%
GBI-GD	7.03%		1.99%
ELMI+	3.50%		0.91%
EMBI GD	5.90%	342 bps	1.20%
EMBI GD IG	4.91%	225 bps	1.11%
EMBI GD HY	8.22%	604 bps	1.40%
CEMBI BD	5.70%	344 bps	0.39%
CEMBI BD HG	4.75%	249 bps	0.31%
CEMBI BD HY	7.54%	533 bps	0.25%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1797	3.26%
VIX Index	15.29	-28.68%
5 year UST	1.45%	1 bps
10 year UST	2.67%	9 bps
DAX	9337	1.64%
10 year Bund	1.66%	2 bps
EURUSD	1.3636	0.87%
USDJPY	102.16	0.97%
Brent	109.08	3.06%
Copper	333.77	1.44%
Gold	1272.87	1.04%

Emerging Markets

What does it take to turn the sentiment around about EM? The market is unlikely to turn on one single event. Usually a series of things have to fall into line. What are those things and how far are we away from a return to rationality about EM?

We think five conditions have to be satisfied and that most of them are there or thereabouts. First, the technical position in the market has to turn. This is largely achieved, though we do not rule out that outflows from the asset class may continue for a bit longer. (See next section for an update on flows.) Second, we think fundamentals have to look okay. We expect EM to grow faster in 2014 than last year, at around trend growth rates close to 5%. Thirdly, we think the market has to get comfortable with the 'headline' credits, notably the so-called 'Fragile Five'. All of these countries have now raised rates, devalued their currencies, implemented fiscal adjustment where needed, and so on. None of these countries have a crisis per se, meaning unsustainable debts, running out of reserves, experiencing collapsing banking systems, or suffering wholesale corporate defaults. They face mainly macroeconomic disequilibrium and they are fixing these issues. Fourth, valuations have to be attractive. With spreads twice pre-crisis levels for external debt and corporate debt and local bonds yields above 7% we think there is value. And finally, the opportunity cost of being invested in EM, that is, not being invested in EM, has to become less attractive. This also appears to be happening, judging by the latest US data. See the global section below.

We are not in the business of calling turning points. It is a fool's game. Even if you correctly call a turning point the likelihood is that you cannot trade enough bonds at that point. The sensible way to approach the uncertainty about timing is to decide on the allocation one wants to make to the trade and then chop it into a number of bite sized pieces. This way one is sure to get invested when it is cheap, without risking shooting all of the powder too early.

- **Flows:** Retail outflows from EM fixed income continued last week, according to EPFR data. We believe this means that all the retail money that flowed into EM fixed income between Q1 2012 and the start of outflows in May 2013 has now left. This money entered when yields averaged 5.8%. It is now leaving as yields have risen to 7.06%, or 6.2% below where it bought in price terms. Sadly, this pattern of investing is very consistent with the general observation that many investors prefer to buy at the top and sell at the bottom.

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Emerging Markets

- **Chile:** Chile was recently identified by the *Financial Times (FT)* as one of the 'Fragile Eight' countries in EM. Chileans and others found this very odd. After all, Chile is an extraordinarily well-run economy. The country has a net debt burden of negative 7.3% of GDP. Inflation in Chile is under control and recently dropped from 3.0% in December to 2.8% in January. The fiscal balances are very healthy but the government is about to raise taxes, which will further strengthen the public finances. The economy is growing roughly in line with trend growth of 4% of GDP. The *FT's* main source of concern must have been the current account deficit of about 4.5% of GDP (about USD 12.5bn) plus Chile's mainly private external refinancing requirements, because jointly these financing requirements add up to more than 100% of Chile's USD 40bn of FX reserves. However, this analysis is very superficial. The *FT* appears to have forgotten that (a) Chile has USD 27bn of foreign assets in its sovereign wealth fund; (b) Chile's pension funds have USD 63bn of foreign assets and have in the past shown willingness to buy into weakness during bouts of EM currency weakness; (c) Chile's corporates have significant Dollar assets and very low levels of currency mismatches and most foreign loans are inter-company loans (parent to subsidiary). And Chile has a flexible exchange rate that insulates its economy significantly from changes in commodity prices.[1]

[1] Our comments draw on Rafael de la Fuente's excellent report *"Chile: Externally vulnerable, really?"* UBS Investment Research 6 February 2014.

- **Ratings actions:** Moody's raised **Mexico's** sovereign credit rating from Baa1 to A3 citing the broader tax base and the opening of the oil sector following the reform efforts of President Pena Nieto over the past 18 months. Meanwhile, S&P downgraded the outlook on **Turkey's** sovereign debt from neutral to negative citing a less predictable policy environment. Fitch downgraded **Ukraine** from B- to CCC on account of the on-going political and economic crisis in the country.

- **Ghana:** The government of Ghana this week raised interest rates by 200bps to 18% and introduced controls on the capital account to stem capital flight. The country has a massive fiscal deficit and huge current account deficit. Real rates are now 4.5%, but without fiscal tightening the pressure on the Cedi will continue, despite a recent sharp depreciation. Capital controls have not been extended to repatriation of proceeds from local bond coupons and principal repayments. Ghana's uniquely defining characteristic is that it has the most extreme fiscal business cycle in the entire world. The country has been able to muddle through in the past few years, but now it is facing genuinely tough choices. If you want to find a genuinely fragile economy in EM right now Ghana is it.

- **Ukraine:** Ukraine's central bank imposed capital controls to stem outflows as the country gets sucked deeper and deeper into increasingly bitter confrontations between the West and Russia over the influence of the strategically placed country. Immediate and severe domestic political tensions are making it impossible for the Yanukovich administration to fix the broader economic challenges in Ukraine. This has rendered Ukraine dependent on sponsorship from external parties that are pursuing national interests. However, Ukraine has been unable to firmly commit one way or the other. The EU's offers have been too challenging from an economic policy perspective, while Russia's overtures are unpopular among large sections of Ukraine's population. The introduction of capital controls has to be seen in this light: They are a means of imposing a measure of stability on FX reserves pending a solution to the broader political impasse.

Global backdrop

US data started the year on a weak note, and in the past week the US data took a significant turn for the worse. Non-farm payrolls came at 113K compared to 185K expected following a miss in the previous release as well. This means that payrolls have missed by 190K relative to expectations over just two months. Moreover, ISM dropped sharply from 56.5 to 51.3 with the new orders component recording the largest decline since 1980. One hypothesis is that all this is weather related, but there is at least one other plausible explanation, namely that the US is slowing. Recall that this very poor manufacturing print comes on the back of very strong inventory accumulation in the last two quarters of 2013 (in fact inventory accumulation was the main source of upside surprises to GDP in both quarters). Unless consumption now accelerates very strongly US firms will have to slow hiring and capital spending in order to work off what turns out to be excess inventories. Our view is that US households are still deleveraging (at least until Q2 2016) and, with labour markets now clearly slowing, household demand could well be heading into a temporary moderation. If this interpretation is correct then one of the big consensus trades of 2014, namely a sizzling hot US economy may be well on the way to being upended. This is important for EM investors, because one of the reasons why investors have shunned EM in the past 10 months is that they have become so bullish on the US.

The German Constitutional Court referred a complaint against the ECB's bond purchase program (Outright Monetary Transactions, or OMT) to the European Court of Justice. The ECJ will likely take considerable time to process the question, but, we think, ultimately approve OMT. Hence, this decision removes a major source of

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Global backdrop

uncertainty from the European outlook. The OMT program was established by the ECB to act as buyer of last resort for European periphery debt. Thus the OMT is solely responsible for obscuring, for now, the risk of a European debt crisis from the radar screen of investors. In our view, the European debt crisis has not gone away. It is likely to return with a vengeance once global interest rates rise more decisively, but we think this is still some time away. We believe the ECB is fully aware of the underlying vulnerability of heavily indebted European economies to higher rates, which is why the ECB responds with aggressive forward guidance each time the US Fed takes a further step forward on tapering.

The ECB left policy rates unchanged. The European economy is getting stronger and while inflation rates are moderating in the Eurozone Europe is still very far from outright deflation (core inflation is 0.8% yoy). Moreover, we think the most recent ECB rate cut was in response to the rise in EURUSD from 1.20 to 1.35 rather than because of deflation or weaker growth. The ECB is unlikely to cut rates again unless the EUR rallies significantly against the US dollar, in our view. The reason why a stronger EUR causes the ECB to cut is that a stronger EUR tightens financial conditions. The other scenario where ECB might consider a rate cut would be a very significant further decline in inflation rates or if the economy starts to stutter badly. None of those scenarios look particularly likely now (see comment on European PMIs below).

Global PMIs declined to 52.1 in January from 53.2 in December. Aside from the weak US ISM print, which was the most important cause of the fall in global PMIs, European PMIs actually rose strongly to 54 from 52.7. This shows that the business cycle in Europe is still accelerating and that US-European business cycles may now be parting ways. German, French, Spanish, and Italian PMIs either rose or remained at strong levels. In Japan, the PMI also rose to the highest level since 2006 (1.5 points higher at 56.6). In EM, China's manufacturing was in line with expectations at 50.5 (but lower than December's 51 print). China's mom decline was modest and probably due to the Chinese New Year, which took place in January this year compared to February last year. Across EM as a whole, PMIs moderated to 50.8 from 51, because of very soft prints in Russia and Turkey, while the rest of EM saw PMIs rise. India, Korea, Indonesia, Singapore, and Taiwan all had strong prints and Brazilian PMI also rose, but Mexican manufacturing softened. South Africa was unchanged, while Czech Republic, Poland, and Hungary all rose sharply.

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