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Ashmore

Buy Emerging Markets during the technical correction in Developed Markets

By Jan Dehn

Spikes in VIX have proven to be good opportunities to add Emerging Markets (EM) exposure. Technicals and valuations have improved after a technically driven adjustment in asset prices in developed economies. The pretext for the adjustment is geopolitics, but the broader economic picture looks better, not worse, and is doubtful, in our view, that the flashpoints in Russia-Ukraine will have adverse implications for the rest of EM. The bigger risk, in our view, is the ever greater concentration of exposure by central banks to US treasuries. Central banks now hold more than 50% of US treasuries.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,057	–	-1.12%
MSCI EM Small Cap	1,082	–	-0.73%
MSCI FM	706	–	-0.17%
GBI EM GD	6.67%	–	-0.65%
ELMI+	3.59%	–	-0.40%
EMBI GD	5.30%	286 bps	-0.55%
EMBI GD IG	4.51%	202 bps	-0.44%
EMBI GD HY	7.09%	486 bps	-0.75%
CEMBI BD	5.25%	307 bps	-0.27%
CEMBI BD HG	4.38%	218 bps	-0.05%
CEMBI BD HY	7.18%	504 bps	-0.74%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1932	-0.30%
VIX Index	15.77	4.30%
5 year UST	1.63%	-2 bps
10 year UST	2.43%	-6 bps
US HY	5.99%	0.39%
European HY	5.13%	-0.65%
EURUSD	1.3396	-0.16%
USDJPY	102.08	-0.40%
Brent	104.04	-0.19%
Copper	323.55	-1.35%
Gold	1308.27	1.58%

Additional benchmark performance data is provided at the end of this document.

Emerging Markets and the correction in Developed Markets

Only a few months ago markets would happily have ignored minor surprises in the data and the geopolitical events that are now blamed for an outbreak of considerable volatility in most financial markets around the world.

In our view, the sell-off cannot credibly be blamed on geopolitical facts and data surprises. Rather, what lie behind the material moves in the markets this past week are the large technical imbalances and bubble-like valuations in several markets, especially those of developed economies. It is only a couple of weeks ago that valuations set new highs in US high yield bonds, German and US bonds, European periphery bonds not to mention the US stock market. In fact, nearly all developed market asset prices had reached dizzying heights, amidst unprecedented low volatility. Additionally, the market had glossed over important fundamental concerns, including the very bad GDP print in the US in Q1, the Italian recession and problems with Banco Espirito Santo in Portugal.

These stretched markets are now unwinding. It is largely a technical move and broadly healthy. In fact, what is happening now is the Developed Markets (DM) equivalent of the technical unwinds we saw in EM last year.

The associated volatility in DM will create temporary volatility in EM asset prices too, but EM fundamentals look good. EM's resilience to asset price volatility was thoroughly tested last year and was not found lacking, despite the hysteria that accompanied much of the unwinding of positions. This year EM asset prices are not nearly as expensive as early last year and the technical position is much better. For these reasons, we think the on-going technical adjustment in DM offers an excellent entry point for EM investors.

Past experience shows that episodes of volatility in the US stock market can make you money. Episodes of US stock volatility can – in direct contraction to prescriptions of the Efficient Markets Hypothesis – present valuable buying opportunities in EM.

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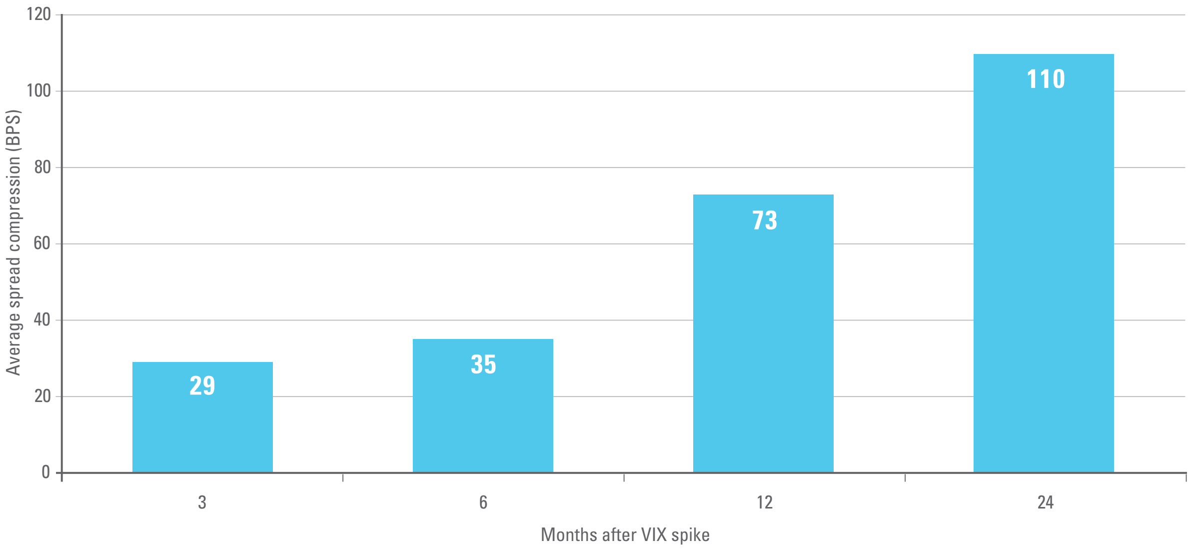
For example, an investor who consistently applied a simple rule only to add to his or her EM sovereign debt exposure during VIX spikes of 10 points or higher over the past 17 years would have been rewarded with spread compression of 29bps, 35bps, 73bps and 110bps over the subsequent 3, 6, 12 and 24 months, respectively. By contrast, if he or she had sold she would have suffered the equivalent losses). Selling when prices are low and buying when they are high is unsurprisingly a loss-making strategy.

Fig 1: **Average EM sovereign debt spread compression (in BPS in spread) following 10 points VIX spikes**



Source: Ashmore, JP Morgan, CBOE.

We would never advocate following a simple investment rule, but it serves to illustrate that many 'risk off' events, especially those emanating from outside of EM, lead to irrational behaviour among many investors, which can then be exploited by more sophisticated EM investors to build positions for subsequent outperformance.

Don't lose sight of the horizon

But 'buying EM during VIX spikes' also makes sense from a longer-term perspective. EM can – and will continue to be – a volatile experience due much more to the behaviour of investors than to actual realised losses. But for those who look further than the latest bout of volatility an EM investment is ultimately an exposure to countries that: (a) do not have a debt overhang; (b) grow much faster than developed economies; (c) do not print money ad nauseum; and (d) control 80% of the world's FX reserves.

Hence, EM pays more, but ultimately it is also an insurance against purchasing power erosion in assets in developed economies. After all, developed economies responded to their debt crisis by issuing more debt and by printing unprecedented amounts of money, not, for the most part, by addressing their underlying imbalances or undertaking structural reforms. So far, the consequences of the high debt, the lack of reform and the easy money have been concealed by ultra-low interest rates, asset price inflation, household deleveraging and a good dose of investor myopia and high levels of risk aversion.

But the heavily indebted developed countries are unlikely to escape the costs of their policies. The return of inflation will be particularly important, a major shock in fact. It will then be followed by two additional shocks. The first shock will be that the US Fed is not going to do very much about inflation. Rate rises will be very moderate and very slow. After all, material increases in real rates quickly impose huge costs on such an indebted economy. Recall that the Fed has already stated that rates will not be hiked to kill bubbles, precisely because the biggest bubbles are now in US government bonds.

The second shock will come from the US yield curve, which, contrary to widespread expectations, will have to bear steepen. Bear steepening will occur because the US will not be able to return to long-term equilibrium without an intervening period of inflation and conventional business cycle dynamics, in our view.

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Liquidity in the Treasury market

Liquidity should never be taken for granted in any market. In the aftermath of last year's tapering announcement, there were periods where the only remaining buyer in the Treasury market was the Fed. Indeed, it is likely that the drop in Treasury liquidity last summer was one of reasons why the Fed cancelled tapering before the policy had even begun.

Still, few people take liquidity concerns seriously in DMs, especially in the US treasury market, despite the fact that capacity to trade has fallen as much as 70% in the US high yield market, for example.[1]

A closer look at the Treasury market would suggest that conditions are not entirely unproblematic. A 30-year rally has been extended well beyond its sell-by date by zero interest rate policies, unprecedented money printing and financial repression through regulatory changes such as Dodd Frank, Solvency II and Basel III. Along the way, the market grew dramatically in size and holdings became concentrated in fewer and more homogenous hands. This is important, because the single most important determinant of liquidity is the degree of diversification of the investor base.

According to official US data, the investor base has now become very concentrated and very homogenous. The amount of US treasury securities in the hands of the US Federal Reserve and other (foreign) official holders increased from USD 1.12trn in 2000 to USD 6.37trn in Q1 2014 and central banks now hold more than half of all the securities, 51% to be exact. The US Federal Reserve is the single largest holder (USD 2.32trn) followed by China (USD 1.27trn) and Japan (USD 1.20trn), according to the US Department of the Treasury.

As far as Treasuries are concerned, the big question is what happens when inflation returns. If, as we suspect, the US opts to manage down its debt stock via inflation, currency devaluation and financial repression then foreign central banks stand to lose a great deal.

A simple numerical example illustrates the potential losses: A central bank that invested all its reserves in, say, 5-year US treasuries and held those securities throughout the recovery would lose 19% of its total assets on the rate move alone. But actual losses could be much higher if there were temporary spikes in nominal yields and material losses from a weaker US dollar.

The lessons of history are worth remembering: All issuers of reserve currencies have abused their privilege. The last time the global currency system re-aligned the Dollar lost 50% of its value against the then re-emerging currencies of the world, the German Mark and the Japanese Yen, Today, the global imbalances are twice as big and rising (the monthly US trade deficit still exceeds USD 40bn, while China's monthly trade surplus last week was a massive USD 47bn).

Faced suddenly with rising nominal (but falling real) yields, rising US inflation and a weaker Dollar, EM central banks, being homogenous institutions, would likely act at roughly the same time. They would sell en masse into a market with very few, if any buyers, other than, perhaps, the US Federal Reserve. A major disruption in the Dollar and the US bond market would be a real risk. Indeed, this is precisely how a liquid bond market turns into an illiquid market in a very short time. The better way for investors – and EM central banks alike – to guard against a disorderly Dollar collapse is to use the current very high valuations in the US bond market to exit in favour of cheaper and higher quality assets in EM.

Geopolitics

The most immediate concern is the situation in Russia and Ukraine. Russia and the West are still in the tit-for-tat stage of the conflict, which commenced as a diplomatic necessity following the Russian annexation of Crimea (not least to conceal the fact that the West can do nothing to reverse the annexation).

Tit: Russia annexes Crimea.

Tat: Mild Western sanctions.

Tit: Russian support for Ukrainian separatists.

Tat: Tougher Western sanctions.

Tit: Russian ban on Western food imports.

This process continues until the cost reaches a point where one or both sides decide to back down or settle. As we mentioned last week, we think a resolution could be closer than many think, though this does not mean that it actually happens. The changes on the ground in Ukraine plus the various diplomatic signals suggest that there is still room for compromise. Specifically, the US could have drawn out its latest announcement of sanctions, but chose not to. Russian could have banned flights, but chose not to. Merkel and Putin spoke last week. Clearly, there is room for further escalation, but also room to reach out to various olive branches being extended by both sides. Ultimately, we think the conflict between Russia and the West over Ukraine will be resolved diplomatically, because both Russia and Europe have too much at stake.

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[1] *The Credit Liquidity Trap, The Revolver, Macro Credit Research,* RBS, 23 July 2014.

But it will not be a clean solution. For example, the Crimea question cannot be resolved, so it is likely to be kicked into the long grass. Crimea itself is likely to end up much like other Russian enclaves carved out of neighbouring countries, such as Transnistria, South Ossetia and Nagorno-Karabach. No one will recognise them as Russian immediately, but no one will challenge Russian influence either. Eventually they could formally become Russian, like Kaliningrad. Russia will only cede influence in Eastern Ukraine against assurances about continuing security of transit of gas to Europe and a commitment that Ukraine does not join NATO. Peacekeepers would have to be deployed in Eastern Ukraine.

We do not expect the Cold War dynamics on display in Ukraine to spread to EM more widely, because the superpowers do not have the financial strength or political will to re-impose hegemony.

As for Ukraine ex-Crimea, the country is likely to end up as a neutral entity, which will continue for some time to receive strong Western support in a bid by the West to create a friend on the Russian border by creating economic success (this would help to turn the humiliation of being unable to reverse Russia's annexation of Crimea into something resembling a victory). Near-term, this means more IMF money, which should keep Ukraine supported for the next couple of years. Constitutional reform and elections is next, then a return to 'normal' Ukrainian politics, which probably means growing influence from oligarchs and therefore progressively poorer compliance with the IMF program requirements. Ultimately, Ukraine could once again lose market access and slip back into Putin's arms.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.8%	6.3%	13.6%	4.8%	7.1%
MSCI EM Small Cap	-0.6%	8.2%	11.6%	4.7%	8.9%
MSCI FM	0.2%	22.7%	30.3%	16.1%	9.9%
S&P 500	0.13%	5.78%	16.16%	22.56%	16.24%
GBI EM GD	-0.83%	4.00%	1.09%	0.76%	5.96%
ELMI+	-0.50%	0.84%	0.60%	-0.69%	1.81%
EMBI GD	-1.03%	7.98%	9.63%	6.78%	9.17%
EMBI GD IG	-0.69%	7.58%	8.38%	5.28%	7.70%
EMBI GD HY	-1.65%	8.78%	12.22%	9.46%	11.48%
5 year UST	0.65%	2.34%	1.56%	1.25%	4.03%
7 year UST	1.02%	4.84%	3.13%	2.21%	5.67%
10 year UST	1.33%	8.30%	5.74%	3.80%	6.64%
CEMBI BD	-0.52%	5.77%	8.03%	5.75%	8.45%
CEMBI BD HG	-0.07%	6.30%	8.16%	5.72%	7.83%
CEMBI BD HY	-1.46%	4.61%	7.75%	6.11%	10.42%
US HY	-0.07%	4.33%	8.90%	10.44%	12.56%
European HY	-1.02%	4.55%	10.78%	14.39%	14.83%
Barclays Agg	0.58%	4.60%	4.69%	1.64%	4.25%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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