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Ashmore

Falling commodity prices, rising terms of trade

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Some 70% of the largest Emerging Markets (EM) countries have experienced positive terms of trade shocks averaging more than 7% since June 2014, while developed economies have on average been adversely affected by the 27% decline in commodity prices over this period. High level talks between Russia, Ukraine, France and Germany to find a solution to the situation in Eastern Ukraine are scheduled to begin this week. Venezuela alleges that it has secured USD 20bn in fresh funding from China, while it continues to adjust to lower oil prices with low-profile changes in the FX regime. India's central bank looks set to buy more US dollars in what could prove a risky move for the longer-term. Polls in Argentina show the main candidates largely neck and neck ahead of elections this year that will mark the end of the Kirchner era.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	958	–	1.85%
MSCI EM Small Cap	1,002	–	1.13%
MSCI FM	593	–	-2.04%
GBI EM GD	6.29%	–	1.67%
EM FX spot	–	–	0.71%
ELMI+	5.19%	–	0.63%
EMBI GD	5.72%	373 bps	0.30%
EMBI GD IG	4.46%	244 bps	0.32%
EMBI GD HY	8.45%	658 bps	0.26%
CEMBI BD	5.57%	376 bps	0.15%
CEMBI BD HG	4.42%	259 bps	0.42%
CEMBI BD HY	8.22%	643 bps	-0.46%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2045	1.23%
VIX Index	17.55	-11.90%
5 year UST	1.44%	-13 bps
7 year UST	1.75%	-10 bps
10 year UST	1.97%	-6 bps
US HY	7.12%	0.53%
European HY	5.24%	0.06%
EURUSD	1.1790	-1.13%
USDJPY	119.22	-0.33%
Brent	47.84	-8.61%
Copper	137.50	0.00%
Gold	1220.42	1.59%

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

Emerging Markets

There is still a widespread perception that Emerging Markets are commodity producing countries and therefore far more susceptible to external shocks than developed economies. This perception survives despite abundant evidence that EM countries in general have become far more diverse economies over the past 25 years, while many people simply chose to ignore that many developed economies are heavily commodity dependent.

Our view is that the picture is far more nuanced. The truth is that commodities still matter a great deal for some EM countries, but that they also matter a great deal for many developed economies. Moreover, many EM countries are importers of commodities and, because EM countries are so diverse, they each buy and sell a very broad variety of commodities. It is therefore difficult to draw any firm conclusions about the implications for EM as a whole based on the performance of movements in broad commodity price indices.

To illustrate this, consider the impact of the fall in commodity prices since the summer. The widely used Thompson Reuters Core Commodity Price Index (CRB) dates back to 1957 and covers 19 of the most traded commodities. This index has dropped by 27% since June 2014. How has this impacted the terms of trade in EM and developed economies?

To answer this question we examined the terms of trade of a sample of 23 of the most traded EM countries over the same period. We found that for the full sample of EM countries their terms of trade actually improved by just over 1% and 4.4% at the median.[1] Within the sample, a total of 70% of the EM countries actually experienced a positive terms of trade shock that averaged 7.1% over this period, while the remaining 30% of countries saw their terms of trade decline by an average of 13%. In conclusion, the change in commodity prices since 2014 has been a significant positive external shock for more than two thirds of EM countries and we expect this to translate into better economic performance for those countries during 2015.

We also did the same analysis for a broad sample of developed countries.[2] For the group as a whole, terms of trade actually declined by an average of 1.6% and while the median developed economy experienced positive terms of trade shocks, the shock was less than half of that experienced by EM countries (1.8% vs 4.4% for EM).

[1] Brazil, Colombia, South Africa, Russia, Mexico, Chile, Turkey, Malaysia, India, Indonesia, Hungary, Peru, Poland, China, Thailand, Korea, Israel, Philippines, Czech Republic, Singapore, Romania, Argentina, and Hong Kong.

[2] Norway, Japan, United States, Australia, Canada, New Zealand, the Eurozone countries, Sweden, Switzerland and United Kingdom.

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Emerging Markets

We also found that fewer developed economies experienced positive terms of trade shocks than EM countries (60% of the sample versus 70% for EM countries). Moreover, the positive terms of trade shocks were on average smaller (6.3% compared to 7.1% in EM), while the developed countries that experienced negative terms of trade shocks experienced slightly more violent shocks (-13.5% vs -13% for EM countries).

Fig 1: **Terms of trade shocks since June 2014 (%)**

	Average	Median
EM	1.0	4.4
EM countries with positive shocks	7.1	5.3
EM countries with negative shocks	-13.0	-3.3
DM	-1.6	1.8
DM countries with positive shocks	6.3	4.9
DM countries with negative shocks	-13.5	-8.9
CRB commodity price index	-26.7	–

Source: Ashmore, Thompson Reuters, Citibank, Bloomberg.

We are not making the argument that developed economies are more prone to commodity shocks than EM countries, although a strict reading of the data would lead to that conclusion. However, a more sober reading of the data would conclude that investors should not immediately leap to the conclusion that changes in commodity prices are bad for EM. Indeed, the data shows that EM countries – like developed economies – are a very large and highly diverse group – where some are importers of commodities, while others export them. And within each of these groups of importers and exporters there are in turn great differences between the levels of exposure to individual commodities. This means that predicting the overall impact on each individual country on the basis of large moves in broad commodity price indices can be highly misleading.

Equally important, while shocks – which are after all inevitable – matter to economic performance the level of preparedness to shocks and the quality of the policy response matter far more, in our view. Oil's major move since June 2014 means that oil producers are a good illustration of these points.

The level of preparedness to the current oil shock has differed significantly across EM's oil producers, which can be categorised at least into three groups. The first group consists of countries that have managed their oil windfalls well by paying down debt and building big pools of savings. Saudi Arabia is a case in point. Saudi Arabia has used the windfalls of the past decade and a half to reduce its domestic sovereign debt stock from 103% of GDP in 1999 to 1.6% in 2014. The second group of oil producers have been consuming revenues roughly in line with their current export revenues during the good times, but have at least resisted the temptation to exploit their good fortunes to borrow excessively. Nigeria is an example of a country in that camp. Finally, there are EM oil producing countries that have not only spent all their oil money, but also used the good times to increase their borrowing. Venezuela falls into that camp.

This brings us to the policy responses. Ultimately, the policy responses to the shocks are far more important for economic performance than the shocks themselves. The forward-looking approach of the Saudi Arabian government means that the country has considerable room to weather temporary commodity price movements using fiscal policy. Nigeria on the other hand has to adjust both its external and domestic balances, but once the adjustment is done Nigeria is back to normal.[3] Finally, countries like Venezuela face the largest adjustment of all. Experience from the past, however, shows that countries like Venezuela have worse shocks than this and still come out of the difficulties with their sovereign debt stock intact.

Ukraine: Ahead of talks between the foreign ministers of Ukraine, Russia, France and Germany scheduled for this week to try to find a solution to the situation in Eastern Ukraine, Russia is seeking to strengthen its bargaining position. According to unnamed sources, Russia is saying it will demand immediate repayment of a USD 3bn bond owed to it by Ukraine on the grounds that conditions of the bond – including a requirement that Ukraine's debt to GDP ratio does not exceed a certain threshold – have been broken (in part due to costs associated with the ongoing conflict in Eastern Ukraine). Economic arguments are now being employed actively by both sides. This marks a major contrast with last year, when politicians on all sides of the conflict were keen to escalate politically, including stepping up military confrontations. Now all sides are smarting from the economic consequences of the war. As such, we think the Russian statement about the USD 3bn bond – attributed to anonymous source – should be seen as part of the bargaining position ahead of the talks, which may yet be followed up by a meeting of heads of state, depending on the progress made by lower ranked officials.

Venezuela: While not providing any details, President Nicolás Maduro announced that he has secured USD 20bn in fresh financing from China. The funds are likely in part at least to be tied to particular projects. The inflow, if confirmed, will provide short term relief to Venezuela; but without a meaningful adjustment of the currency and domestic demand Venezuela will continue to see mounting pressure on its stock of FX reserves, because at the

[3] See *"The quintessential Nigerian distribution problem"*, Weekly Investor Research, 1 December 2014.

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Emerging Markets

current lower oil prices the outflow of Dollars via imports exceeds the inflow from oil revenues. The challenge facing Maduro is how to reconcile the required economic adjustment with his political objectives ahead of elections later this year. So far, the government has pursued a gradual approach. Under a new FX law, sales of foreign currency from PDVSA, the state oil company, to the Central Bank can be made at any of the official exchange rates. The parallel rate is about 10 times weaker than the 'strongest' official rate, so this change will make a significant difference to PDVSA's finances. China is likely to view Venezuela from a longer-term perspective. Venezuela has the largest oil reserves in the world and the oil is readily accessible onshore.

India: The central bank of India has decided to increase the ceiling on Dollar holdings in its foreign exchange reserves from 57% to 67%, citing the recent surge in the Dollar. India will reduce its holdings of Australian and Canadian dollars. The RBI's decision is reflective of broader trends in financial markets, where a strong consensus in favour of a stronger Dollar is leading to more purchases. We think this is a very risky decision; the Greenback Binge is likely to end badly, in our view. Of all the heavily indebted developed countries, the United States is most likely to recover first, but it will recover with extreme debt levels and will use inflation and currency depreciation to reduce its overall debt stock. We do not expect inflation to resurface in the US until late 2016, but by then most investors, including the RBI, will be 'limit long' Dollars with no buyers on the other side. As the RBI's actions illustrate, EM central banks tend to act very pro-cyclically. We expect them to do the same once the Greenback Binge gives way to 'Dollar Delirium tremens'. On the positive side, Prime Minister Modi has elected a new panel of experts to offer advice on economic policy. The panel is likely to push for more open private sector-led approach.

Argentina: 2015 is the year when Argentina finally turns its back on the Kirchner era. This era – first under the late Nestor Kirchner and then under his wife Cristina – witnessed the country's recovery from default in the early 2000s, but also the complete failure to manage an ordinary balanced economic expansion and a normalisation of relations with global capital markets. As a result the next government will inherit a government in sore need of macroeconomic adjustment. It does, however, have the silver-lining that debt stocks are low and the scope for capital inflows enormous, provided the next administration resolves the issue with holdout investors from the 2001 default. The three leading candidates are roughly neck and neck: Former Cabinet Chief Sergio Massa leads with 26.3% of the vote followed by Buenos Aires Province Governor Daniel Scioli with 24.5% of voting intentions. Mauricio Macri, mayor of Buenos Aires city, has 21.1% of voting intentions. The election is scheduled for 25 October 2015. Primaries will be held on 9 August.

Snippets:

- Brazil: Inflation closed the year at 6.41%, that is, within the central bank's target of 4.5% +/- 2.0%. We expect a number of fiscal measures to weaken economic activity, while reductions in subsidies may push headline inflation higher in 2015.
- Sri Lanka: Sri Lanka's government changed hands peacefully as the opposition led by Maithripala Sirisena, a former backer of vanquished president Rajapaksa. Sirisena's coalition is backed by minority groups and will be challenged to remain coherent in the coming term, in our view. But the economy has good momentum. Another important question is now whether the Sirisena-led coalition will continue the close ties with China adopted by Rajapaksa.
- Dominican Republic: The economy expanded at a scorching 7.1% pace in 2014, led by mining and construction.
- Belarus: The central bank devalued the currency by 7% and raised policy interest rates by 5%.
- Russia: Fitch, the ratings agency, downgraded Russian local and foreign currency debt to BBB- from BBB. The ratings change has no implications for the local currency and external benchmark indices (GBI EM GD and EMBI GD).
- Ecuador: The government signed agreements with China for USD 7.5bn of which about half will be fresh financing for the government budget. This leaves a financing gap of about USD 3.7bn for 2015, which is likely to be close through a combination of market bonds, budget adjustments and official sector financing.
- Indonesia: President Joko Widodo will use fiscal savings from recent subsidy cuts to capitalise a landbank with a view to boosting infrastructure spending. This is a sensible use of the fiscal savings, because by establishing a bank the government will be able to leverage the funds. A landbank could expedite some of the processes that have held up infrastructure investment in the past such as land acquisition itself.
- China: Talks have commenced to expand the Hong-Kong Shanghai Stock-Connect to Shenzhen, China's second largest stock exchange. China is pushing forward with financial sector liberalisation extremely rapidly. This push serves several purposes, including: (a) improving China's access to global financial markets; (b) aiding China's bid to make the CNY a global reserve currency by the end of this year; and (c) encouraging the development of financial markets within China. Services PMI rose to 53.4 in December from 53 in November.
- Malaysia: The trade surplus was USD 3.3bn in November, or USD 2.6bn after seasonal adjustment. This was substantially stronger than expected. Despite falling oil prices exports picked up while imports declined, mainly in intermediate goods. The decline in imports of intermediate goods suggests that investment activity in the domestic energy sector is easing.

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Global backdrop

Statements from various ECB officials over the past seven days suggest rising odds of sovereign QE as early as January, though the size of the balance sheet expansion remains uncertain. The ECB's next decision is 22 January. ECB President Mario Draghi has been gaining support for his call for sovereign QE on deflation grounds by the timely release of a negative headline inflation print for the Eurozone in December (-0.2% yoy). In fact, it is customary for central banks to look past headline numbers towards core prices in their monetary policy decisions and core prices in the Eurozone actually rose to 0.8% from 0.7% in November. We think the real reason Draghi wants QE is that the US is raising rates and Europe needs to put in place the safety net of ECB purchases of government bonds before US rates go up. Otherwise, Europe would be seriously at risk of another sovereign debt crisis. Indeed, the reason for going ahead as early as January is precisely that Greeks go to the polls on 25 January and the most recent polls show that SYRIZA, an anti-austerity party, will win the election, while the messages from mainstream parties have begun to move in that direction too in a bid to hold on to power. Greece's sovereign debt is unsustainable; it and other heavily indebted countries would already be in default or would be suffering extreme economic distress if their bonds had not been bought by their central banks and if their regulators had not forced their domestic savings institutions to buy their bonds. By contrast, EM bond markets are largely free from implicit central bank and regulatory subsidies, ensuring not only that they pay better, but which also makes them fundamentally healthier and thus ultimately safer.

US 4th quarter GDP was revised from 2.5% qoq annualised to 3.3% qoq annualised after a smaller trade deficit and higher business inventories than expected. Imports declined due to falling prices for imported oil, while exports also fell. There are reasons to be dismissive of the trade number, however, due to the potential impact on labour disputes at West Coast ports. As for the surge in inventories they are a double-edge sword – remember that growth in Q1 2014 turned sharply negative after a surge in inventories in the last two quarters of 2013. Indeed, as wages disappoint in the United States despite stronger payrolls the future is not entirely rosy (note also that the unemployment rate declined only due to lower participation by households). What does the Fed do when wages are falling at the same time as unemployment is falling? Clearly, the latter is currently not posing a risk of higher wage inflation yet, so the only conceivable reason to hike would simply be to mark progress on the road to recovery. Minutes from the December FOMC meeting talked about 'patience' with no action in interest rates prior to April. The latest developments suggest that global financial markets have been a bit over-pessimistic in their treatment of EM, where, it seems, the sum of all fears have been priced in since the Taper Tantrum of 2013.

Emerging Markets	Month to date*	Year to date*	1 year	3 years	5 years
MSCI EM	0.21%	0.55%	2.46%	3.95%	1.65%
MSCI EM Small Cap	0.66%	0.71%	2.49%	7.72%	2.61%
MSCI FM	-3.15%	-3.16%	1.90%	12.49%	6.53%
S&P 500	-0.63%	-0.63%	13.54%	19.38%	14.66%
GBI EM GD	0.78%	0.78%	-3.81%	0.36%	2.41%
ELMI+	-0.88%	-0.88%	-7.25%	-0.90%	-0.80%
EM spot FX	-0.43%	-0.43%	-12.11%	NA	NA
EMBI GD	-0.34%	-0.34%	6.81%	6.13%	7.30%
EMBI GD IG	-0.08%	-0.08%	9.58%	5.30%	6.63%
EMBI GD HY	-0.81%	-0.81%	1.99%	7.41%	8.26%
5 year UST	1.03%	1.03%	4.39%	1.30%	3.84%
7 year UST	1.50%	1.50%	8.24%	2.26%	5.73%
10 year UST	2.02%	2.02%	13.78%	3.86%	7.48%
CEMBI BD	-0.05%	-0.05%	4.65%	6.10%	6.45%
CEMBI BD HG	0.42%	0.42%	7.32%	6.13%	6.65%
CEMBI BD HY	-1.06%	-1.06%	-0.80%	6.37%	6.27%
US HY	0.20%	0.20%	1.84%	8.26%	9.00%
European HY	0.15%	0.15%	4.98%	14.60%	11.46%
Barclays Agg	-0.04%	-0.04%	0.77%	0.93%	2.57%

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

*MTD and YTD data will be available from next week.

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