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WEEKLY INVESTOR RESEARCH

Ashmore

Role reversal

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The rise of the USD in the past few years is now helping to restore competitiveness in Emerging Markets (EM) countries, while the US now faces exactly the type of issues many argued posed a threat to EM countries a few years ago, namely an overvalued exchange rate, lack of reform, a current account deficit and declining productivity. Roles have been reversed. The slowdown in global growth can mainly be attributed to the severe misallocation of global capital caused by Quantitative Easing (QE) policies.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	6.92%
MSCI EM Small Cap	12.0	–	3.77%
MSCI Frontier	8.8	–	1.78%
MSCI Asia	11.4	–	5.74%
Shanghai Composite	12.5	–	2.94%
Hong Kong Hang Seng	7.4	–	7.43%
MSCI EMEA	9.8	–	9.47%
MSCI Latam	13.6	–	9.50%
GBI-EM-GD	6.80%	–	5.39%
ELMI+	3.83%	–	3.24%
EM FX spot	–	–	4.30%
EMBI GD	6.01%	389 bps	1.62%
EMBI GD IG	4.71%	251 bps	1.79%
EMBI GD HY	8.18%	625 bps	1.40%
CEMBI BD	6.05%	419 bps	1.04%
CEMBI BD HG	4.58%	271 bps	0.47%
CEMBI BD HY	8.64%	679 bps	2.02%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.5	–	3.30%
1-3 year UST	0.64%	–	-0.18%
3-5 year UST	1.40%	–	-0.41%
7-10 year UST	2.09%	–	-0.70%
10+ years UST	2.92%	–	-1.42%
US HY	7.96%	663 bps	2.55%
European HY	5.40%	541 bps	1.24%
Barclays Ag	–	226 bps	0.02%
VIX Index*	17.08	–	-3.86%
DXY Index*	94.64	–	-1.46%
EURUSD	1.1386	–	1.78%
USDJPY	120.13	–	-0.27%
CRY Index*	202.69	–	8.58%
Brent	53.0	–	7.51%
Gold spot	1165	–	2.65%

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

Emerging Markets

The strong USD of the past few years imposed numerous drags on both the US and EM economies alike. The strong USD was very valuable to the US in the first few years after the subprime crisis, because the US needed to finance big deficits by selling government bonds to foreigners. But this need is now less urgent and meanwhile the strong USD has now rendered the US economy very uncompetitive, struggling with an overvalued exchange rate, asset bubbles, a widening trade balance and declining productivity. In EM, many countries were also adversely impacted by the surge in the USD, because the resulting weakness of their own currencies encouraged flight of foreign investment capital, lower commodity prices and loss of investor confidence. But in a mirror image of what has happened in the US, the stronger USD has now slowly begun to impart benefits on EM countries by improving their competitiveness, particularly because so many EM countries managed to avoid pass-through of weak currencies to inflation. In other words, EM suffered from outflows in the capital account, but gradually regained genuine real effective exchange rate depreciation which is now improving their current account positions.

The IMF last week made significant downwards revisions to global growth (-0.6% for 2015 and 2016). The downwards revisions make eminent sense in light of the USD rally of the past few years and the resulting direction of capital flows. QE policies – and how financial markets have chosen to trade in response – have been deeply counter-productive. By drawing capital to developed markets, they add further to already overvalued asset prices and excessive debt stocks and thereby worsened the global imbalances that lie at the heart of the crisis of 2008/2009. The flows into developed economies also appreciated currencies in countries that in fact need weaker currencies in order to rotate from excessive reliance on debt fuelled domestic consumption towards export led growth. Productivity gains have become more elusive, not less so. QE has, for lack of a more diplomatic phrase, ensured that even more good money was thrown after bad. No wonder growth has been so pathetic despite hyper-easy monetary policies.

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Emerging Markets

Global growth has also been impeded by a slowdown in growth in EM, although it is noteworthy that the IMF revised down the US growth for 2015-2016 by 60% more than the growth rate for EM countries (-0.8% versus -0.5%, respectively). The misallocation of global capital due to QE is directly to blame. Many global asset allocators jumped on the QE bandwagons set in motion by the central banks of the developed world and reduced their allocations to EM. This inflicted financial tightening on the healthiest part of the world economy and thereby undermined rather than encouraged the very growth engines that had the potential to drive a global growth recovery.

Given the enormous exercise in resource misallocation orchestrated by QE central banks over the past few years, what is the outlook for EM and the US from here? It is almost the inverse of what it was four years ago. The US must now find a way to restore competitiveness, either by reforming or, if that is not possible, by devaluing its currency (hoping as it does so that it can control inflation like EM countries have done). Reforms look unlikely and a big decline in the USD would be traumatic, to say the least, given the enormous exposure to the Greenback across the financial world. EM countries arguably now face a somewhat less daunting outlook. They have been through a lot of the pain, their real exchange rates are now competitive and this is already showing up in better current account numbers. The slowdown in EM growth over the past few years has brought about this change, fortunately without enormous casualties in terms of sovereign defaults, balance of payments crises and even growth rates (there are not that many recessions anywhere in EM). Most 'crises' in EM, such as Brazil, are self-inflicted problems and ultimately cyclical rather than structural in nature. Just as India's challenge two years ago and Russia's challenges last year were cyclical in nature.

The remaining question is this: Having now cheapened significantly on the back of real economic adjustment will investors now recognise that the rational way to allocate capital is out of QE markets and into non-QE markets? We guess probably not. Value has never been a major driver of flow in EM. In a very herd driven market beholding to rules of thumb what is typically more important for flows into EM is that others are allocating too. This suggests that investors will probably rotate back into EM in a highly non-linear fashion. Smarter and better educated investors are already allocating, but others are bound to chase the rally long after it has started. One potential serious drag on flows to EM right now is that the core allocations to stocks and bonds in developed markets are not doing so well this year. These allocations make up more than 90% of most investors' portfolios (EM is still a far smaller part of most portfolios than justified by either market cap or GDP weight). If these core portfolio positions are under water, investors will be nervous and nervous investors tend not to allocate to EM with great gusto.

This is bound to change, but probably not yet, barring a sudden serious collapse in the USD. Perhaps the most important driver of flows to EM will be that losses in non-EM positions begin to sustain far more serious losses. This is bound to happen. QE is not a sustainable way to get rich. If it was, we would all be sitting on a beach with a printing press. Bond and stock prices in developed economies are held up by trillions of dollar worth of hot air and increasingly fragile confidence in the Fed and other central banks. When confidence in QE central banks fails or inflation returns money will flee those markets in favour of the non-QE world in much larger volumes. Markets are almost certainly not going to be adequately prepared, so the door will be narrow. Don't say you were not warned.

The recent weakness in the USD is providing respite for commodities. Barring a collapse in US stocks or US growth (both those risks are actually rising somewhat now), it seems that commodity prices have now bottomed out. Near-term a flat to modestly rising trajectory for prices seems realistic. After all, the global economy is moving through its trough right now and demand should therefore be at or near the bottom, while supply is being reduced steadily by declining investment due to much lower prices. This is particularly important for commodities such as oil that need constant re-investment to sustain production. Longer term, the outlook for the USD will matter hugely to commodity prices. A big reason why commodity prices fell in the past year was the USD surge. If the USD is peaking, even if it is just levelling off here, it will itself make the outlook for commodities more stable. Eventually, however, as the QE currencies, including the USD, are bound to fall this bodes well for commodities over the longer term. On that view, EM countries will now have seen the worst of the commodity shock. It has merely been one of many shocks impacting EM in recent times.

So as we have seen with other shocks – such as capital outflows and declining investor confidence – falling commodity prices are not as big a risk for EM as many people had expected. There are many reasons for this, but one of the most important is that many EM countries now produce manufacturing, industrial goods and services, or import commodities, while the specialised commodity dependent countries have often responded to lower prices with the correct set of policies, i.e. reducing domestic demand and adjusting the currency. Across the EM space, of course, the quality of the policy response has varied (from excellent in Russia to terrible in Nigeria). But the point is that the old cliché that all EM countries as near-exclusive producers of raw materials is just that, a cliché.

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Emerging Markets

- Brazil: The Brazilian electoral court is now formally investigating allegedly illegal funding of President Dilma Roussef's election campaign. The case may go all the way to the Supreme Court and could take upwards of two years or more to reach a climax. Separately, Lower House President Eduardo Cunha is toying with the idea of impeachment, not least in order to distract attention away from corruption charges against his person (local media reported at the weekend that Cunha used Swiss bank accounts to receive kickbacks). Congress is also keeping alive (by not engaging in a final vote on the matter) the possibility of overturning vetoes on several of Dilma's previous vetoes that could have significant fiscal ramification. Finally, the audit court is investigating the fiscal accounts for 2014. All of these cases constitute de facto means of removing President Dilma Rousseff from office. Her removal would be a national trauma that would usher in momentum behind national reconciliation, etc. This could be quite good for Brazil. If she survives, it will be because she regains some traction in Parliament, which is also good. Inflation decelerated slightly to 9.49% yoy in September. The policy rate is 14.25%. Inflation is likely to crash next year, since much of the rise in inflation is due to changes in administered prices and FX pass-through, which should both fade next year. Prospects for growth are poor, but modest growth is ok for bond investing where a currency that stops weakening, falling inflation and rate cuts matter more.

- China: According to new data from SWIFT, the CNY has now overtaken the Japanese yen as the fourth most traded currency after GBP, EUR and USD. CNY will become part of the SDR by November 2016 and is ultimately destined to become the world's largest global reserve currency, though we think this will take decades. China's economy will eventually become five times bigger than that of the United States as per capita incomes converge. All investors should already now have a China specific strategy.

- Turkey: Inflation rose sharply in September. On a yoy basis, inflation rose to 7.9% yoy from 7.1% in August. Unlike most other EM countries, Turkey has pursued more heterodox central bank policies and opted to ease aggressively in response to QE in the developed economies. This is not sensible, in our view. EM countries do not have the same problems as developed economies and should therefore not ape their monetary policies. Meanwhile, the level of political noise continues to rise ahead of the general election scheduled for 1 November. A hung parliament poses serious challenges for President Erdogan, whose election strategy has been stoke nationalistic and anti-Kurdish sentiment among voters. At the weekend, a bomb at a peace rally attended by pro-Kurdish HDP party killed at least 95 people.

- Tunisia: The award of the Nobel Peace Prize to participants in the National Dialogue Quartet – a coalition of civil society groups – is well deserved. North Africa's belated emergence from Cold War style dictatorships was beset with enormous risks, because of strong vested interest groups, polarised and weaponised societies and a lack of post-dictatorship institutions. This is why so many EM countries struggled to find stability after the Cold War ended in 1989 and why so many North African countries still struggle with the same issues following the Arab Spring. The importance of Tunisia's National Dialogue in securing a peaceful transition from authoritarian rule cannot be underestimated. Home-grown democracy and domestically nurtured institutions are the only sustainable way forward.

- India: The Reserve Bank of India has eased risk weighting for individual mortgages up to INR 7.5m from 50% to 35%. There were also reductions in risk weightings for other sized loans. Some 85% of home loans will be impacted.

- Colombia: Inflation was much higher than expected in September (0.72% mom versus 0.38% mom expected). Colombia has experienced a severe, negative terms of trade shock due to its export dependence resulting in a weaker currency. The policy response has been solid, but may require a hike or two to ensure that the FX depreciation does not erode inflation expectations.

- Argentina: Argentina fully repaid the Boden 15 bond and successfully placed USD 670m of new Bonar 20 bonds at a yield of 9.21%. The government's minimum issuance size target and maximum yield tolerance were USD 500m and 10%, respectively. Recent polls now place Sergio Massa ahead of Mauricio Macri ahead of the presidential election scheduled for 25 October.

- Belarus: Approximately 84% of the Belarussians voted to keep incumbent President Alexander Lukashenko at the helm at the weekend's presidential election. Turnout was about 87%. Lukashenko first came to power in 1994. Despite economic and political challenges, Belarus has continued to service its external debt due to funding from Russia and China.

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Emerging Markets

Snippets:

- **Chile:** Inflation undershot expectations by 0.2% mom to clock up a modest 0.5% mom inflation in September.
- **Hungary:** Inflation in September was substantially lower than expected. Prices declined at a 0.4% yoy rate versus 0.0% in August. The consensus was for inflation to fall just 0.1% yoy.
- **Malaysia:** The trade surplus increased from USD 0.6bn in July to USD 1.7bn in August. Exports softened 4.6% mom due to commodity price developments in August. Industrial production rose 3.0% yoy in August versus 4.1% yoy expected.
- **Mexico:** Inflation was 0.37% mom in September versus 0.42% mom expected. This meant a yoy rate of core inflation of 2.37%, which is comfortably within Banxico's 3% +/- 1% target range.
- **The Philippines:** Exports fell more than anticipated in August (-6.3% yoy versus -2.9% yoy expected). This was due to a sharp fall in unprocessed commodities (-34.4% yoy).
- **Poland:** The National Bank of Poland left rates unchanged at 1.5%.
- **Russia:** Inflation decelerated to 15.7% yoy in September versus 15.8% yoy expected.

Global backdrop

The September Fed minutes were marginally more dovish than expected, though public statements from Fed officials suggest that the Fed still intends to hike at least once this year. That message is being softened, however and the market does not believe it at all. One reason is that all is not quiet on the data front. The US trade deficit widened sharply to USD 48.3bn in August (from USD 41.8bn in July) – a consequence of falling productivity and a 40% rally in the USD versus most other currencies. ISM services also declined to 56.9 in September from 59 in August and the Atlanta Fed's GDP estimate as of 9 October now puts Q3 GDP at just 1.0% qoq annualised (about 0.25% growth in the quarter itself). Clearly, the sluggish pace of the economy under such easy monetary conditions has to be a concern, not least because the only remaining easing option available to the US authorities – barring a return to QE – is to weaken the currency.

In Germany, export orders dropped sharply (5.2% mom in August). There may be holiday effects at play. Factory orders also weakened in August. European PMIs softened to 53.6 from 54.3 (September versus August).

In a very positive development, 12 Pacific Rim nations reached agreement on trade (the Trans-Pacific Partnership, or TPP). The TPP will have to be ratified by the US Congress in H1 2016. It is not clear that it will pass as the US Lower House descends into increasingly ideological disarray over factional infighting within the Republican party. As always, trade agreements have big positive effects that accrue gradually. The TPP is good news if it is implemented because it provides better access to developed markets: Vietnam, Singapore, Malaysia and Brunei will get preferential access to domestic markets in US, Japan, Australia and Canada. Also, the TPP should result in increased capital flows into the EM countries. FDI flows will likely follow trade as more production shifts to lower income countries from high wage developed economies. Finally, the TPP may spur other similar arrangements – such as China's Regional Comprehensive Economic Partnership (China has welcomed the TPP).

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	8.55%	-8.03%	-12.37%	-2.14%	-2.12%
MSCI EM Small Cap	5.21%	-4.95%	-10.43%	1.06%	-1.58%
MSCI Frontier	1.71%	-12.14%	-22.10%	6.44%	2.03%
MSCI Asia	7.37%	-5.89%	-5.74%	2.72%	1.67%
Shanghai Composite	4.27%	-0.07%	35.30%	17.63%	5.60%
Hong Kong Hang Seng	10.65%	-10.49%	2.35%	5.36%	-0.49%
MSCI EMEA	10.17%	-3.62%	-12.68%	-5.14%	-3.82%
MSCI Latam	12.37%	-20.22%	-33.51%	-14.17%	-11.09%
GBI EM GD	6.51%	-9.37%	-15.99%	-6.65%	-2.65%
ELMI+	3.42%	-4.32%	-9.89%	-4.11%	-2.55%
EM FX Spot	4.73%	-12.37%	-19.68%	-11.20%	-8.53%
EMBI GD	2.23%	2.16%	0.79%	2.07%	4.92%
EMBI GD IG	2.71%	0.56%	0.95%	1.13%	4.17%
EMBI GD HY	1.60%	4.31%	-0.25%	3.48%	6.02%
CEMBI BD	1.28%	2.13%	0.31%	2.88%	4.40%
CEMBI BD HG	0.67%	1.85%	1.40%	2.99%	4.65%
CEMBI BD HY	2.30%	2.54%	-2.11%	2.79%	4.05%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	5.01%	-0.54%	6.68%	14.19%	13.94%
1-3 year UST	-0.05%	0.90%	0.79%	0.55%	0.70%
3-5 year UST	-0.15%	2.55%	2.74%	1.51%	1.65%
7-10 year UST	-0.33%	3.20%	4.66%	1.95%	3.92%
10+ years UST	-0.80%	-0.35%	5.54%	3.13%	6.77%
US HY	1.98%	-0.34%	-2.08%	4.11%	6.77%
European HY	1.52%	1.69%	2.31%	8.41%	9.64%
Barclays Ag	0.32%	0.02%	0.87%	2.97%	4.13%
VIX Index*	-30.29%	-11.04%	-19.59%	5.82%	-9.77%
DXY Index*	-1.77%	4.85%	10.16%	18.80%	22.34%
CRY Index*	4.61%	-11.86%	-26.46%	-33.88%	-31.94%
EURUSD	1.82%	-5.90%	-10.11%	-12.08%	-17.89%
USDJPY	0.38%	0.24%	11.79%	53.15%	46.79%
Brent	9.47%	-7.64%	-41.30%	-53.80%	-36.59%
Gold spot	4.48%	-1.95%	-5.18%	-33.59%	-13.54%

*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.

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