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Growth revisions suggest chronic over-estimation of EM risks

By Jan Dehn

The IMF made large downwards revisions to US growth, while maintaining its forecast for China to grow 6.8% this year. G7 currency volatility is now greater than Emerging Markets currency volatility – not a new thing, by the way. We put the volatility in the Chinese stock market into context. Turkey's external balances are comfortable, but the outlook for TRY depends on other issues. Europe, the IMF and the ECB ask Greece to make draconian reforms in the coming weeks in exchange for staying in the Euro. This is a positive development for global sentiment but Greece is likely to remain in the headlines as the country rebuilds 'trust' by implementing a series of measures between now and September. In the US, recent trends in continuing claims and capacity utilisation give some grounds for concern.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	13.5	–	-3.22%
MSCI EM Small Cap	20.5	–	-3.68%
MSCI Frontier	10.8	–	-0.84%
MSCI Asia	12.3	–	-3.77%
MSCI EMEA	12.9	–	-1.64%
MSCI Latam	22.1	–	-1.26%
GBI-EM-GD	6.74%	–	0.04%
ELMI+	4.11%	–	-0.18%
EM FX spot	–	–	-0.20%
EMBI GD	5.77%	333 bps	0.04%
EMBI GD IG	4.55%	204 bps	0.02%
EMBI GD HY	7.86%	558 bps	0.08%
CEMBI BD	5.55%	336 bps	-0.04%
CEMBI BD HG	4.47%	226 bps	0.13%
CEMBI BD HY	7.58%	541 bps	-0.33%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.3	–	0.03%
2 year UST	0.68%	–	0.13%
5 year UST	1.71%	–	0.39%
10 year UST	2.45%	–	0.64%
30 year UST	3.24%	–	1.62%
US HY	7.02%	552	-0.39%
European HY	4.79%	467	-0.11%
Barclays Ag	–	441	0.05%
VIX Index*	16.83	–	0.04%
DXY Index*	96.38	–	0.08%
CRY Index*	218.25	–	-6.30%
EURUSD	1.1076	–	0.01%
USDJPY	123.46	–	-0.75%
Brent	57.5	–	1.61%
Gold spot	1156	–	-1.37%

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

Emerging Markets

While commentators once again gorged themselves on yet another speculative feast about a hard landing in China – this time on account of volatility in the A-share market – the only meaningful downwards revisions to growth took place in developed economies. In its mid-year World Economic Outlook update, the IMF downgraded growth in developed market by 0.3%, which is three times more than for Emerging Markets (EM) which is down just -0.1%. The IMF now estimates EM to grow 4.2% in 2015, which is twice as fast as developed economies. Moreover, the IMF saw no reason to downgrade the outlook for Chinese growth, while the outlook for the US was revised down sharply (at -0.6% it was one of the largest in the world).

The chronic over-optimism about developed markets and excessive pessimism about EM also manifests itself in excessive bearishness about EM local markets. For example, G7 currencies have steadily become more volatile compared to EM currencies over the past two years. Indeed, measured by the 3 month at-the-money forward volatility, EM currency volatility is now lower than G7 currency volatility (9.2% versus 10.3%, respectively). The declining trend for EM FX volatility has been in place since H2 2013 over which period EM FX volatility has declined by more than 20% cumulatively, while G7 FX volatility has increased by about 3%. This dovetails well with the observation that, after four years of relentless appreciation, the strong USD is now hurting the US economy. There may now be less upside for the USD versus EM currencies as well as volatility for the Greenback. Net net, this makes for a more balanced outlook for EM currencies versus developed market currencies going forward, in our view.

Local currency government bonds in EM currently yield about 6.75% based on the JP Morgan GBI EM GD index and compares to a yield of about just 1.6% for 5 year US treasury bonds.

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Emerging Markets

Fig 1: **Cumulative volatility (3 month moving average ATMF volatility)**

Source: Ashmore, Bloomberg. ATMF is at-the-money forward volatility.

- China: China's stock market rebounded last week, but may still take some time to settle to normal levels of volatility. Stock suspensions contributed, but so did the cumulative effect of other policy interventions and the gradual return of value. Stock suspensions are not ideal, nor are they uncommon. For example, authorities have closed entire stock exchanges in places like Greece or Egypt in the past. Stock suspensions are a way for authorities to compensate for an insufficiently broad institutional investor base and excessive dominance of retail investors. As such, they are a volatility management tool, not an instrument for preventing markets from clearing. Or, put differently, they are a symptom of markets that have not yet reached full maturity. Investors should therefore discount such practices somewhat. Moreover, in China companies can request suspension for three days ahead of a major announcement. We expect that many 'suspended' companies will be forced to start trading again at the end of the respective three day period. The surge and subsequent violent correction in the Chinese stock market has largely been driven by abundant access to margin financing and a drive to encourage stock market investment as a means of capitalising SOEs. Given the government's large reserves, the volatility does not pose a serious risk to the Chinese economy as a whole.

In terms of the impact on consumption, stocks comprise only 15% of total wealth and China's propensity to consume is far lower than in other countries due to the country's 49% savings rate. Indeed, the rally over the past twelve months did not boost consumption, nor will the slump have much impact, in our view. The financing links are also limited. The Chinese stock market is only 5% of total social financing in China and only 1% of company loans have been put up with stocks as collateral. Stock markets finance just 2% of Chinese Fixed Asset Investment. One factor may be negative, however, is that some corporates/banks are said to have postponed capex investment to invest in the stock market. If true, realised losses could lead to a cutback in capex by those entities, although it is worth remembering that China's A-share market is still up 75% from this time last year.

Investors should remember that China is a rapidly developing country in the midst of the most ambitious reform process ever implemented, including massive liberalisation of financial markets and opening of the capital account. The recent experience may shift attention back to institution building in China – further pension reforms, for example. If so, that would be very positive, in our view.

The Chinese government has certainly made mistakes and may continue to make mistakes – just like all other governments – but they are enlightened and will learn from those mistakes. A systematic meltdown seems extremely unlikely given China's many policy options and the longer-term outlook remains extremely positive on account of the intense focus on reforms.

Value is also starting to emerge as PE ratios have moved back to reasonable levels and, longer term, the recent bout of volatility will be seen simply as a blip. It will not change the course of internationalisation and maturing of the market, in our view. In other news, inflation picked up in June to 1.4% yoy from 1.2% yoy in May.

Real interest rates in China remain high and further easing is likely due to softer growth amidst draconian economic reforms.

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Emerging Markets

- **Turkey:** The current account deficit in May widened marginally to USD 4bn from USD 3.5bn in April, but continues to show improvement on a year to date cumulative basis compared to the same time last year (USD 18.5bn versus USD 20.4bn in 2014). Despite the gradual improvement in the current account, the outlook for TRY is likely to be determined elsewhere. Considerable uncertainty clouds the outlook for Turkey in multiple directions. Most importantly, the market is waiting for a decision by Erdogan's AKP whether to enter into coalition government or call a snap election for later this year. The possibility of fresh elections in turn reduces the odds of economic reforms and increases the possibility of a Turkish military intervention in Syria. The uncertain political outlook also reduces odds that the central bank will move in a more orthodox direction, in our view. Finally, there is potential upside from better relations between the West and Iran, which should benefit Turkey by increasing trade flows through Turkey, by stimulating Turkish construction activity in Iran and by lowering oil prices.

Snippets:

- **Brazil:** The BRL adjustment continues. In classic fashion, the labour market has been the last to break, but is now showing signs of genuine adjustment. The unemployment rate rose to 8.1% in the three months to May, up from 7% at the same time last year. Real wages are now contracting. Inflation is in the process of being broken. Once this has been established unequivocally, the central bank will begin to ease policy, in our view. As such, the fact that IPCA inflation (Brazil's equivalent of CPI indices in other countries) was below expectations in June was relief for authorities in June. The print was 0.79% mom compared to 8.3% expected. Even so, at 8.9% the yoy inflation rate remains far too high still, so the central bank is likely to remain hawkish, in our view.

- **Hungary:** The monetary council of the central bank last week extended the interest rates swap (IRS) market out to 10 years. This is a positive move, which will allow investors to take both sides in the fixed income market. The IRS market also enables investors to receive fixed rates, which should have direct benefits for the liquidity in the bond markets too (liquidity is typically the square of the number of markets that can be arbitraged).

- **India:** Industrial production decelerated from 3.4% yoy in April to 2.7% yoy in May. The government is making progress in shortening a backlog of stalled projects, which should ensure that private investment picks up in coming quarters.

- **Malaysia:** The central bank left rates unchanged at 3.25%. The domestic economy is expanding "on a steady growth path", according to the central bank. Inflation is currently higher than desired due to the recent introduction of value added tax and fuel tax adjustments. These effects will drop out. As usual, the central bank highlighted the potential risks arising from fickle global sentiment. It is a steady headache for EM policy makers that they have to deal with senseless ups and downs in global investors' sentiment due to factors that are entirely external to their own economies, particularly since that volatility now rarely has any fundamental impact.

- **Mexico:** Inflation was just 0.17% in June, lower than 0.2% expected by the market consensus. Headline inflation is running at a yoy pace of 2.87%. The attainment of sub-3% inflation is a major achievement, in our view. The economy is showing signs of a gentle upswing, which has more room to continue than in many other countries due to high levels of credibility on the part of the central bank and major reform efforts in the past couple of years. Consumer confidence and manufacturing improved in June.

- **The Philippines:** Exports contracted by a much larger than expected 17.4% yoy in May. However, weaker demand from China and EU is partially offset by lower imports due to moderate energy prices. Net trade should therefore be stable and GDP growth should comfortably exceed 5% in real terms this year. Inflation was 1.2% in June, well below the 1.5% yoy expected in the market.

- **Russia:** The current account surplus in Q2 2015 was much stronger than expected. The surplus was USD 19.2bn versus USD 12.14bn in the same quarter last year. The boost to the external surplus is impressive given the collapse in oil prices over the past twelve months and testifies to the decisive action taken by the government to adjust domestic demand to combat a less benign external environment. Inflation continues to fall. In June, the yoy rate was 15.3%, down from 15.8% in May.

- **South Korea:** Bank of Korea left rates unchanged at 1.5% citing sluggish domestic demand (partly due to MERS) and external headwinds.

- **Venezuela:** FX reserves rose nearly USD 500m last week to reach USD 16.3bn, but reserves remain close to the lowest level since 2003. The government has drawn USD 1.5bn from its SDR holdings at the IMF and swapped some USD 1.5bn of gold holdings into cash. With no policy adjustment, the current pace of decline in reserves would take total reserves to all-time lows by the time of the election in early December. In a positive development, the government raised gasoline prices in the regions bordering Colombia, where smuggling out of Venezuela of nearly free fuel (due to subsidies) is rampant.

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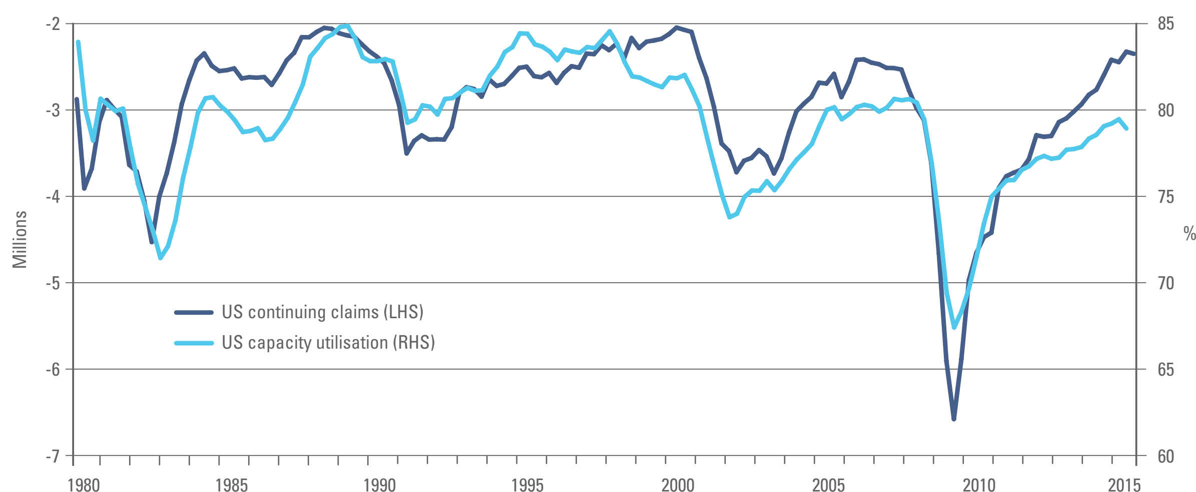
Global backdrop

Sentiment has been extremely volatile in global markets in the past week. This has impacted growth expectations and subsequently weighed on commodity markets. The three concerns driving investor sentiment were: (a) softer than expected US data; (b) the potential impact of Greece on European growth; and (c) fears that stock market volatility will derail growth in China. We believe it is unlikely that these events will have much of an impact on global growth, however.

The next three months could prove challenging for Prime Minister Alexis Tsipras of Greece. Just a week after he successfully encouraged Greeks to reject European program of austerity he will now have to approve a series of measures in order to qualify for bridge financing and eventually for a full bailout program. Alternatively, Greece would face a managed exit from the EUR. Tsipras' strong mandate following the recent referendum has enabled him to commit to more austerity, while the late intervention by the IMF on the question of Greece's debt sustainability question has given room for Germany and other European nations to extend a carrot of debt relief to the Greeks. The newly minted deal apparently also includes bank recapitalisation via asset sales. The deal shows that Eurozone member states want to send a signal to other populists in the periphery that the actions taken by Greece in the past few weeks will not be tolerated. Greece now has until Wednesday to pass a package of reforms in order to qualify for bridge financing to enable the country to repay the ECB on 20 July. Further measures will then have to be approved in order to achieve a full bailout by September. This means that the Greek issue will continue to dominate global headlines in the near future. It also remains to be seen if debt relief will form part of the package – if not the entire issue may well return within a few years.

The FOMC minutes were dovish relative to expectations, allegedly on account of events in Greece and China's stock market. The FOMC also revised its growth forecasts for Q2 a bit lower. Neither the minutes, nor Fed Chairwoman Janet Yellen in a press conference later in the week, revealed when the Fed intends to hike. The 'bean counting' for Q2 GDP continues to show stronger growth in Q2, but the details do not point to scorching growth going forward. The inventory to sales ratio is rising and a recent uptick in claims for unemployment benefits will worry the Fed. Both initial and continuing claims are now rising. Moreover, capacity utilisation has not been improving nearly as fast as the improvement in continuing claims in this recovery, which implies a decline in labour productivity. In the past, this has signalled downturns in the cycle. As the chart shows, the gap has recently grown wider. Capacity utilisation itself also recently took a turn lower. The trade deficit for May also showed continuing weakness in exports, which we think is due to a strong USD. Overall, the data paints a picture of the economy lacking dynamism, despite hyper-easy monetary conditions.

Fig 2: **US, continuing claims and capacity utilisation**



Source: Ashmore, Bloomberg.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-3.94%	-1.01%	-9.81%	2.71%	2.40%
MSCI EM Small Cap	-4.66%	3.25%	-5.21%	6.24%	3.72%
MSCI Frontier	-1.03%	-4.48%	-16.60%	12.15%	6.73%
MSCI Asia	-4.15%	1.14%	-1.62%	8.22%	6.26%
MSCI EMEA	-2.86%	1.12%	-16.37%	-1.97%	0.68%
MSCI Latam	-2.35%	-8.46%	-26.21%	-8.35%	-5.73%
GBI EM GD	-0.19%	-5.06%	-15.88%	-3.86%	0.40%
ELMI+	-0.33%	-1.54%	-10.68%	-2.00%	-0.49%
EM FX Spot	-0.65%	-7.59%	-20.05%	-8.93%	-6.38%
EMBI GD	0.37%	2.04%	0.42%	3.98%	6.61%
EMBI GD IG	0.22%	0.76%	2.22%	2.81%	5.76%
EMBI GD HY	0.59%	3.73%	-3.44%	5.83%	7.85%
CEMBI BD	0.08%	3.79%	2.13%	4.94%	6.09%
CEMBI BD HG	0.14%	2.42%	3.00%	4.53%	5.97%
CEMBI BD HY	-0.03%	6.37%	0.02%	6.00%	6.51%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.71%	1.95%	7.87%	18.15%	16.42%
2 year UST	0.12%	1.01%	1.41%	0.66%	0.81%
5 year UST	0.32%	1.73%	2.98%	0.97%	2.55%
10 year UST	0.40%	0.95%	3.46%	0.97%	3.84%
30 year UST	0.50%	-4.26%	3.17%	-0.08%	5.04%
US HY	-0.18%	2.57%	-0.80%	6.60%	8.76%
European HY	0.33%	2.72%	3.01%	11.04%	11.27%
Barclays Ag	-0.36%	-3.42%	-7.25%	-0.89%	1.79%
VIX Index*	-7.68%	-12.34%	39.32%	0.54%	-31.47%
DXY Index*	0.94%	6.77%	20.19%	15.63%	15.23%
CRY Index*	-3.93%	-5.09%	-26.53%	-25.75%	-16.67%
EURUSD	-0.69%	-8.46%	-18.63%	-9.58%	-12.84%
USDJPY	-1.09%	-2.93%	-17.71%	-35.87%	-28.48%
Brent	-9.66%	0.21%	-46.14%	-43.90%	-25.05%
Gold spot	-1.50%	-2.68%	-11.48%	-27.27%	-4.87%

*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
T: +1 703 243 8800

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