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Ashmore

The journey from fear to fact

By Jan Dehn

Sell-offs in Emerging Markets (EM) often start simply because investors are ignorant about how EM will respond to changes in the global environment, such as Fed tapering. In the face of uncertainty, investors turn to out-dated notions of EM fragility and let themselves be guided by past behaviour. Selling ensues, regardless of the state of affairs in EM. This irrationality only goes so far, however. Fact eventually defeats fear with rewards to those who pay attention to value. 2014 is likely to be the year when fact defeats fear. Meanwhile, away from EM the combination of weak payroll data in the US and the re-commencement of Fed tapering increases the risk of a stock market correction in the US, and in Europe the ECB took out further insurance against another attack from Bond Vigilantes.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	977		0.49%
MSCI FM	604		0.64%
GBI-GD	6.83%		0.83%
ELMI+	4.05%		0.38%
EMBI GD	5.85%	296 bps	0.21%
EMBI GD IG	4.98%	210 bps	0.37%
EMBI GD HY	9.20%	655 bps	-0.11%
CEMBI BD	5.64%	321 bps	0.21%
CEMBI BD HG	4.79%	236 bps	0.26%
CEMBI BD HY	7.40%	501 bps	0.26%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,842	0.90%
VIX Index	12.14	-10.41%
5 year UST	1.63%	-6 bps
10 year UST	2.86%	-10 bps
10 year Bund	1.85%	-6 bps
EURUSD	1.3673	0.32%
USDJPY	103.42	-0.77%
Brent	$107	0.02%
Copper	$338	-0.40%
Gold	$1249	0.89%

Emerging Markets

Every time a major change occurs in the global macroeconomic environment the level of uncertainty temporarily rises. The rise in uncertainty prompts a few investors to inquire about the possible implications for Emerging Markets. This is eminently sensible. Unfortunately, most investors immediately latch onto pre-conceived and outdated notions of EM fragility and sell. Immediately. Notions of EM fragility are strongly influenced by past experience, often dating back as far as the Cold War era nearly a quarter of a century ago. Back then EM economies were genuinely vulnerable to developments in global variables, such as commodity markets, global sentiment, flows from developed economies, changes in US interest rates, etc. but much has changed in the intervening period and knee-jerk selling is completely irrational.

A growing number of investors are now much better informed about EM fundamentals, but some of those are prepared to bet that the market will over-react in the same way that it has done so many times in the past. Others, notably hedge funds, welcome a bit of volatility because they are trading momentum rather than value. And banks' market makers, who get paid the bid-offer spread, who positively love a good old sell-off and happily exploit prejudice and ignorance in a bid to jack up trading volumes and hence their own profits.

Uncertainty thus quickly begets knee-jerk selling. Once the flows begin nothing else seems to matter for a time. The resulting volatility often spooks weaker institutional hands, because volatility can pose career risk for asset allocators in institutions with poorly constructed incentive schemes. Other asset allocators tragically suffer from the great misfortunate of having been educated in modern finance theory, which says that volatility is the same as risk.

The volatility of the EM asset class – as opposed to its risk, i.e. large permanent loss – remains the single most important detractor for existing investors to add to positions in EM and for new investors considering an inaugural investment in EM.

But volatility also creates the greatest opportunities. Somewhere along the familiar journey from fear to fact that always follows change in the global environment sophisticated EM investors begin to spot opportunities. Usually EM fundamentals remain pretty solid – after all, there are more than 65 investable countries in the asset class and they are so different that no change in the global environment will ever have the same impact on all of them. Once the initial surge of outflows abates and the asset class has re-priced the mismatch between fundamentals and prices begin to become obvious. Facts begin to displace fear. Investors with good knowledge of the EM universe and a keen sense of value begin to buy, locking in great future returns soon after the market stabilises.

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Emerging Markets

Technicals are now extremely benign. When the rally starts in earnest those who sold in fear will be forced back in, or risk under-performing. However, they usually end up buying near the top, having sold near the bottom.

EM has been through this journey from fear to fact many times before, and unless EM markets start trading more rationally it will happen many more times in the future. In 2008/2009, the market wrongly believed that EM would collapse when the subprime crisis erupted. In fact, the ensuing sell-off turned out to be the biggest buying opportunity in EM for twenty years. In 2011, the market wrongly believed that EM would blow up when Greece defaulted. Instead, the irrational sell-off led to stellar returns in 2012.

In 2013, the Fed announced its intention to taper, yet another major change in the global macroeconomic environment. Once again the market chose to shoot first, having not really asked the right questions. Perhaps we can help: EM fundamentals were largely unaffected by anything the Fed did in 2013. A few of EM's 65 readily investable countries have self-inflicted macroeconomic problems, including Brazil, Turkey, and Indonesia. EM real GDP growth averaged 4.5% for the year. This was a healthy rate of growth and we expect even stronger growth in 2014. Not a single EM country defaulted, not a single EM central bank ran out of reserves, or lost control of its balance of payments. Not a single EM country had unsustainable debt burdens or saw its banking system collapse, and there were no systemic corporate defaults anywhere in EM. Neither do we think EM fundamentals will be particularly affected by anything the Fed is likely to do in 2014.

Asset prices obviously told a different story. But that is precisely the point: EM asset classes re-priced sharply in 2013. The seeds have already been planted for the next EM outperformance. We expect 2014 to be the year when facts decisively defeat the fear. Performance should follow. For those are more interested in the opportunity set in 2014 keep your eyes peeled for our Market Prospects 2014, which will be published in due course.

In country specific EM news, Zambia joined Algeria, Botswana, Nigeria, Angola, Equatorial Guinea, Gabon, Libya, Sudan, and Chad in setting up a sovereign wealth fund to oversee the investment of proceeds from dividends of state owned enterprises.

- **China:** China's trade surplus increased to CNY 260bn for the year of 2013 compared to CNY205bn at the end of 2012, despite continuing currency appreciation and reform efforts to rotate the economy more towards domestic led growth. Inflation in December fell to just 2.5%, down from 3.0% in November. Ultimately, we think the main driver of the unwinding of global imbalances – meaning reversal of the reserve accumulation in EM and debt accumulation in developed economies – will take place through currency realignment that will favour EM currencies.

- **Brazil:** Inflation ended the year at a rate of 5.91% compared to 5.84% at the end of 2012. Core inflation rose to 6.1%, which remains significantly above the central bank's target of 4.5%, albeit within its band of tolerance. The level of Brazilian inflation is far from worrisome, but the failure to bring down inflation in a year of weak economic activity and material increases in policy rates testifies to the lack of confidence in the government's economic management by a large part of the business community. This credibility problem is entirely self-inflicted. Despite Brazil's underperformance relative to its potential, Brazil remains eminently investable although investors will obviously see different opportunities than in the past when conditions were stronger. Brazil has no crisis; it has modest levels of debt, a fiscal surplus, and strong reserves. We believe even a small change in direction of policy could sharply improve sentiment, but an election later this year means that major changes in the direction of policy in the next few months are unlikely.

- **Colombia:** Recorded a significantly stronger than expected GDP growth rate in Q3 2013 of 5.1% yoy (versus 4.3% expected). The upside surprise was due to strong investment and construction. Colombia continues to benefit from (a) deep economic reforms implemented over the last few years and (b) a very modern, business friendly approach to attracting domestic and foreign capital into infrastructure projects in the country.

Global backdrop

In an almost exact copy of how it responded to the announcement of Fed tapering in May 2013 the ECB this past week responded to the Fed's latest attempt to taper by strengthening its dovish forward guidance on monetary policy.

Why does the ECB get more dovish when the Fed threatens to taper? There are two reasons: one tactical, the other more fundamental. The tactical reason is that the ECB knows that the US bond market could, in the short run, push yields higher than the Fed wants. After all, this is exactly what happened last summer when the US bond market summarily dismissed Bernanke's reassurances that tapering is not the same as rate hikes. The ECB forward guidance is intended to pre-empt any 'contagion' of rising yields in the US bonds markets into the European bond markets.

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Global backdrop

The fundamental reason for ECB dovishness is that Mario Draghi understands very well that Europe is in no position to stomach higher real rates (unlike EM which is already financing in local markets yields are close to 7%). The European banking system is insolvent and unlikely to be fixed any time soon. There are near-intractable political obstacles to eradicating the bad legacy assets on the balance sheets of banks in several major European countries (but not in all of them, hence the political difficulties in fixing the problem).

The other major highlight from the past week was the release of US labour market data. In a sharp reversal of recent stronger economic data Friday's payroll numbers were soft, participation rates declined, hours worked fell, and hourly earnings were softer than expected. The US economy only added 74K new jobs compared to expectations of 197K. Expectations had been ratcheted higher in the course of the week following a strong ADP print on Wednesday of last week. Winter weather only explains part of the disappointment. Sure, the unemployment rate declined, but this was mainly due to another sharp drop in labour participation rates, which are now down to a shocking 62.8%.

There are strong reasons to not assign too much importance to payroll data in any given month. But the weak payroll print serves as an important warning at a time of extreme bullishness about the US economy and the Dollar. After a strong rally in 2013 the S&P500 is now trading at P/E ratios close to levels last seen during the Tech Bubble. Companies are buying back stock rather than investing in machinery and equipment. The Fed has embarked on tapering, yet the correlation between US stock market indices and the Fed balance sheet is worryingly high. The US data strengthened following the Fed's U-turn in tapering in September 2013, probably because the U-turn sparked a relief bounce, but much of this bounce is surely now in the price. Besides, inventory accumulation has been very strong (last week November's wholesale inventories rose 0.5% compared to 0.4% expected). All in all, the relationship between prices and fundamentals in the US is becoming more stretched.

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