Ashmore

Chile prepares for index inclusion

By Jan Dehn

Chile is consolidating its domestic government bonds into larger, more liquid issues in order to qualify for index inclusion. Temer's appointment as Brazil's chief congressional negotiator bodes well for reform and stability. Russia has tightened repo rates to manage the recent ferocious rally in Russian assets. There are rumblings in Odessa, state elections in Nigeria and stable inflation in China. The ICSID rules against Argentina, Ghana wins IMF approval and Mexico rides the ECB QE gravy train by issuing a 100-year EUR bond. India's Cabinet gave a thumbs up for an important bill to regulate real estate. Term yields are falling in Europe due to QE; this reduces cash flows and drives up the present value of liabilities for pension funds.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,042	–	3.61%
MSCI EM Small Cap	1,106	–	4.03%
MSCI FM	597	–	-0.65%
GBI EM GD	6.23%	–	-0.73%
EM FX spot	–	–	-0.91%
ELMI+	4.53%	–	0.00%
EMBI GD	5.37%	340 bps	0.67%
EMBI GD IG	4.11%	208 bps	0.03%
EMBI GD HY	7.65%	580 bps	1.61%
CEMBI BD	5.25%	347 bps	0.55%
CEMBI BD HG	4.12%	232 bps	0.18%
CEMBI BD HY	7.48%	572 bps	1.25%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2102	1.08%
VIX Index	12.58	-14.65%
5 year UST	1.42%	11 bps
7 year UST	1.75%	10 bps
10 year UST	1.97%	8 bps
US HY	6.43%	0.60%
European HY	4.38%	0.56%
EURUSD	1.0547	-4.24%
USDJPY	120.82	1.38%
Brent	58.95	0.83%
Copper	274.30	2.60%
Gold	1198.46	-1.78%

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

Emerging Markets

- **Chile:** In a world of very low yields and a growing share of passively managed portfolios, belonging to an index has distinct advantages. After all, passive investors will literally invest in anything provided it appears in an index. Smarter issuers in Emerging Markets (EM) are taking advantage of such simplistic investment practices. Chile is the latest EM country to spot the opportunity. Following wide-ranging consultation, the Chilean government appears to have understood that Chile's exclusion from the main EM local currency fixed income indices is not to its advantage. Chile has been excluded from JP Morgan's GBI EM GD index, because the index provider deems that Chile's bonds are too small and numerous for investors to be able to replicate a benchmark index of these securities. Chile has now begun to address this problem, starting with a major change to the size and frequency of its auctions of government bonds and central bank paper. The first of these new auctions – CLP 450bn 5-year central bank paper – was well received by the market with a bid to cover ratio of 4.2 times and a cut off yield in line with the yields in the market ahead of the auction. The next auction will involve CLP 755bn (USD 1.2bn) of 10-year Treasury paper. Over time, the new larger benchmark issues will likely replace the myriad of smaller, illiquid bonds to pave the way for Chile's inclusion in the GBI EM GD This makes enormous sense, in our view. Beyond the ability to tap passive money, Chile will benefit from its status as a safe-haven country within the Latin American region. In other words, during periods of risk aversion investors will increase exposure to Chile's bonds. Since bouts of risk aversion often coincide with lower prices for commodities, which matters a lot for Chile, the safe-haven bid will usefully relieve pressure on Chile's current account during such events. Other EM countries that already have or are in the process of granting greater access to their local markets include Colombia, China, Russia and India.

- **Brazil:** Unemployment is rapidly catching up with the broader economic weakness in the Brazilian economy. The national unemployment rate rose from 6.8% in January to 7.4% in February, amidst falling labour market participation. Economic weakness is necessary in order to squeeze excess demand out of the Brazilian economy. While painful for Brazil, this is good news for investors. We also take a positive view of the appointment of Michel Temer as chief of staff in the government. Temer is president of PMDB, a key government ally. He will be in a better position to control PMDB politicians and thus help deliver stability in congress as the government undertakes fiscal adjustment and other reforms. Brazil could adjust with less of an impact on the labour market if it had a more flexible economy, a more investor friendly investment climate and higher credibility of policymaking, but after years of incompetent economic management Brazil will have to rebuild credibility from scratch. Fitch, the ratings agency, downgraded the outlook for Brazilian debt to negative from stable.

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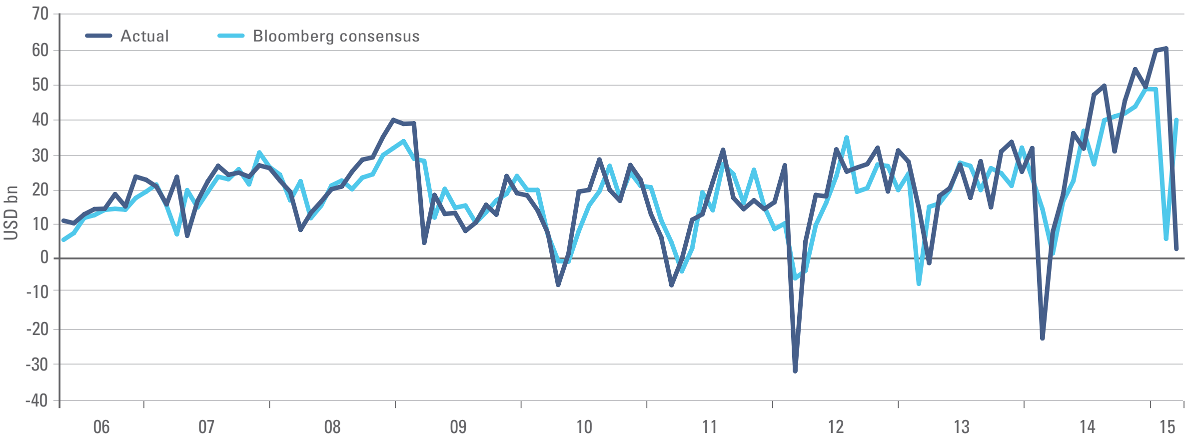
- **Russia:** Following a ferocious rally in sovereign debt, the currency and local bond markets, the central bank (CBR) hiked the repo rates from LIBOR+100bps to LIBOR+150bps. The effect of this policy change is to remove much of the upside to the cross-currency repo trades that has fuelled the recent rally. It makes a great deal of sense that the central bank is intervening; after all oil prices have been range-trading at around USD 55 per barrel this year, which is nearly 50% lower than the price that prevailed at this time last year. Russia therefore needs import compression via higher real rates and a weaker RUB, or risks losing reserves very quickly. The CBR's intervention suggests that it fully appreciates the situation. Perversely, given the very strong technicals among foreign investors, the biggest risk that the CBR could face right now is that the Ukraine situation improves further resulting in a dismantling of sanctions, which in turn could induce greater inflows from foreigners, and thus put further upwards pressure on the RUB, even as oil prices remain at current levels.

- **Ukraine-Russia conflict:** Ukrainian authorities said last week that 39 people had been arrested for planning a pro-Russian rebellion in the southern port city of Odessa. Odessa has been rocked by mysterious explosions in past months. This bears monitoring: the probability of a resumption of fighting after armed conflict is always greatest in the immediate aftermath. For now, we think the hurdle for significant further sanctions against Russia is high. The recent deal between the US and Iran is indirectly a positive for Russia. The deal gives strong incentives for the US not to confront Russia directly in exchange for Russia leaning on Iran to stick with the deal. If the Iranian deal falls apart, President Obama would lose an important potential foreign policy prize as the end of his term in office draws closer. S&P, the ratings agency, reduced Ukraine's foreign currency sovereign credit rating to CC from CCC- with a negative outlook.

- **Nigeria:** Initial results of the state elections in Nigeria this weekend are positive. The All Progressives Party (APC) of Muhammudu Buhari held Lagos and gained Kaduna and Katsina, though Rivers State remained under control of the PDP, President Jonathan's party. State elections are important, because Nigeria's states are powerful under the country's constitution. State governors lend their support to the central government in exchange for oil money. Given the results so far, the odds are that President-elect Buhari is able to implement prudent policies appears to have improved on account of the strong showing of his supporters.

- **China:** The rate of CPI inflation was unchanged at 1.4% yoy in March. This means that China's sovereign bonds continue to offer compelling real yields relative to developed economies. China's central government 5-year bonds trade at a yield of 3.5%, implying a real yield of 210bps. By contrast, US 5-year bonds pay 1.4% amidst core inflation of 1.7% giving a negative 30bps real yield. We believe markets should discount heavily the very weak trade balance number for March – USD 3bn versus USD 40bn expected – on account of the late Lunar New Year holiday, which shaved working days off the month of March. The chart below illustrates the strong seasonal effect on the trade balance due to the Lunar New Year. As in previous years, we expect a reversal in the coming months. Meanwhile, stronger import data points to better domestic demand.

Fig 1: **China trade balance (USD bn): Actual versus expectations**



Source: Ashmore, Bloomberg.

- **Argentina:** The International Centre for Settlement of Investment Disputes ('ICSID'), an arbitration body under the World Bank, awarded USD 405m of compensation to Suez, a French utility company, in a dispute with Argentina over the nationalisation of Aguas Argentinas in 2006. Suez's original claim exceeded USD 1bn. Under ICSID rules Argentina can appeal so there is no payment due at this time. Both Argentina and Venezuela have amassed considerable liabilities on account of their policies of nationalising other people's property.

- **Ghana:** The IMF approved a 3-year, USD 918m credit facility for Ghana to help the country to repay debt and stabilise its economy. A total USD 115m will be disbursed immediately. Ghana has one of the most vicious political business cycles in the world and in the past two elections the governments have spent so much money that it has not been possible to reverse the damage in the short four year period between elections.

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- **Mexico:** The United Mexican States issued a EUR 1.5bn 100-year EUR-denominated sovereign bond. This is Mexico's third 100-year bond and traded strongly in the aftermarket. QE policies are increasing demand for EUR denominated government paper, but with European government bonds yielding far too little relative to their riskiness, Mexico is cleverly exploiting the demand for better quality, higher yielding paper.

- **India:** The Cabinet is putting final touches to a land bill, to present to congress. The bill has lingered in parliament since 2013 due to lack of upper house approval. Prime Minister Modi does not control the upper house, but it is thought the amendments will appease the opponents. The bill will be positive if passed. The real estate sector will be better regulated and should be able to attract much more funding and therefore increase real estate activity. Last week India's first submarine, built in India with French help, took to the water for the first time.

Snippets:

- **Turkey:** The current account deficit was USD 3.2bn in February, marginally wider than the USD 2.8bn expected. Industrial output rose 1.7% mom in February versus an expectation of -0.3% mom.

- **South Korea:** Moody's, the ratings agency, affirmed Korea's AA3 rating but upgraded the outlook for the sovereign to positive from stable.

- **Peru:** The central bank left the monetary policy rate unchanged at 3.25%.

- **India:** Moody's upgraded the outlook to positive from stable on the back of stronger growth. February industrial production rose 5% yoy versus 2.8% yoy in January and a consensus expectation of 3.3% yoy.

- **Philippines:** Exports disappointed at -3.1% yoy versus +1.0% yoy expected, though on a month on month basis exports improved marginally.

Global backdrop

This week Switzerland became the first country in the world to auction 10-year bonds at a negative yield. This is obviously not just a Swiss problem; many other developed economies' bonds pay yields that are negative and declining due to a combination of QE policies, zero policy rates, slow growth, unresolved structural economic problems and, for now, low inflation.

Ever declining yields reduce the cash flows from assets held by pension funds. By contrast, cash flows on the liability side do not go down (they are mainly a function of the number of people expected to retire and the cost of living at the point of retirement). As such, the combination of policies adopted by developed economies is directly contributing to ever larger pension fund deficits.

But it gets worse. Low bond auction yields also push down the discount rates in some regions. European pension funds in particular are required to use market-determined discount rates to discount the future – usually based on long-term government bond yields. To see the effect this requirement has on pension fund solvency, consider (for the sake of argument) that long-term bond yields have fallen to zero. This would inflict a 'double-whammy' on European pension funds, because not only are the cash flows zero on the asset side (due to low auction yields), but at the same time the present value of liabilities will increase as the discount rate goes to zero. US pension funds have the same problem on the asset side, but they can generally select their own discount rates based on their (subjective) expected returns and therefore 'engineer' a stronger solvency status by discounting their liabilities more heavily than European pension funds. Obviously, this is an accounting trick. The first order effect is still that assets with low or zero cash flows will hurt European and American pension funds alike.

Pensioners should be very worried as the pension system drifts towards insolvency. Without a change in the rules and practices governing the investments of pension funds the effect of falling yields will be that pension funds extend duration in a bid to obtain higher yields. In Europe, perversely, this will further depress discount rates and therefore worsen rather than improve the funding status of the entire system.

In addition, the move out along the curve only increases the vulnerability of pension funds to a sell-off in the long-end of the yield curve, precisely at a time when the odds of such an outcome is increasing by the day.

Alongside ratings-based regulations that are clearly biased against EM, the system has been created to deliberately 'capture' pension assets to serve the financing needs of the most heavily indebted governments in the world. While that makes good sense for them, it is bad news for the underlying investor. The system's disastrous principal-agent problems are not the result of carelessness, it is by design.

This leaves a bleak outlook for investors in developed market bonds. Developed economies have squandered years of hyper-easy monetary policies without addressing their debt problems or taking measures to increase their trend growth rates. Instead, their choice of policies suggests that they are trying to generate inflation as

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a way out. Monetary policy now consists of quantitative and regulatory interventions as well as conventional interest rate policy and rates will likely not rise as much under previous cycles. This will allow inflation to slowly rise higher than normal, which will begin to transfer the cost adjustment to future generations by eroding the real value of their savings. The effect of keeping policy rates too low relative to inflation will be to put upwards pressure on the long end of the yield curve with devastating implications for housing in particular. To prevent this from happening additional financial repression will be required.

What then will give? If the entire curve is repressed, the currency is what gives, albeit once inflation shows up. This introduces another set of shoulders to carry America's adjustment, namely foreign central banks whose stock of US assets will experience a collapse in purchasing power (in local currency terms).

In our view, institutional investors should try as far as they can to minimise the damage by allocating away from the heavily indebted developed countries. Short term price volatility, an irritant, should not be confused for risk. Countries with lower debt, faster growth and no QE are more likely to produce positive returns as the global cycle normalises than over-indebted countries that print money instead of fixing their underlying problems.

Market data	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	6.21%	8.58%	4.04%	3.51%	2.63%
MSCI EM Small Cap	6.52%	10.36%	5.44%	6.95%	3.64%
MSCI FM	2.12%	-1.51%	-6.75%	11.50%	4.67%
S&P 500	1.71%	2.68%	17.02%	18.15%	14.33%
GBI EM GD	2.25%	-1.81%	-10.66%	-2.70%	0.95%
ELMI+	1.84%	-0.61%	-8.72%	-2.36%	-0.90%
EM spot FX	1.47%	-4.96%	-18.03%	NA	NA
EMBI GD	1.64%	3.69%	6.11%	5.93%	7.35%
EMBI GD IG	0.88%	3.50%	8.40%	5.18%	6.77%
EMBI GD HY	2.79%	3.78%	1.83%	7.12%	8.22%
5 year UST	0.10%	1.97%	4.53%	1.78%	3.87%
7 year UST	0.15%	2.54%	7.60%	2.77%	5.78%
10 year UST	0.19%	3.00%	11.04%	4.58%	7.68%
CEMBI BD	1.15%	3.54%	4.99%	5.74%	6.37%
CEMBI BD HG	0.69%	3.09%	6.40%	5.80%	6.58%
CEMBI BD HY	2.04%	4.37%	1.97%	5.81%	6.05%
US HY	0.88%	3.32%	1.84%	7.95%	8.99%
European HY	0.75%	4.19%	5.78%	13.03%	11.38%
Barclays Agg	-0.24%	-2.16%	-4.94%	-0.31%	2.29%

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

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