Issued: 14 September 2015

WEEKLY INVESTOR RESEARCH

Ashmore

The Rise of the Judiciary

By Jan Dehn

The Judiciary is on the rise in countries such as Romania, Brazil and China. This reflects the mood at a time of economic and political transition, but there is more to the story. The process of development itself suggests that the rule of law will become more and more important as countries get richer. Investors should therefore embrace the ongoing campaigns by prosecutors across Emerging Markets (EM). We also discuss Brazil's downgrade to junk, the strange sudden shift in sentiment about China, Nigeria's upcoming expulsion from the JP Morgan GBI EM GD index and a host of other developments in EM.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.3	–	1.88%
MSCI EM Small Cap	11.1	–	3.59%
MSCI Frontier	8.9	–	0.86%
MSCI Asia	10.6	–	2.89%
Shanghai Composite	11.6	–	1.28%
Hong Kong Hang Seng	6.7	–	6.11%
MSCI EMEA	9.2	–	0.32%
MSCI Latam	12.3	–	-1.05%
GBI-EM-GD	7.17%	–	-0.21%
ELMI+	4.61%	–	0.14%
EM FX spot	–	–	-0.05%
EMBI GD	6.05%	384 bps	0.15%
EMBI GD IG	4.84%	256 bps	-0.07%
EMBI GD HY	8.04%	599 bps	0.44%
CEMBI BD	6.02%	406 bps	-0.16%
CEMBI BD HG	4.74%	276 bps	-0.21%
CEMBI BD HY	8.46%	655 bps	-0.08%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.0	–	0.58%
1-3 year UST	0.71%	–	0.01%
3-5 year UST	1.50%	–	-0.06%
7-10 year UST	2.18%	–	-0.32%
10+ years UST	2.94%	–	-1.02%
US HY	7.59%	619 bps	0.40%
European HY	5.02%	502 bps	0.19%
Barclays Ag	–	226 bps	-0.07%
VIX Index*	23.20	–	-2.41%
DXY Index*	95.13	–	-1.10%
EURUSD	1.1331	–	1.45%
USDJPY	120.21	–	-0.72%
CRY Index*	196.72	–	-1.78%
Brent	47.7	–	0.08%
Gold spot	1108	–	-1.00%

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

Emerging Markets

Power is shifting decisively from the Executive and Legislative branches of government towards the Judiciary in a number of EM countries. Right now this is most visible in Brazil, where federal judge Sergio Moro is reaping victims across wide swathes of the political and corporate landscape in connection with the Petrobras scandal. But a very similar process is underway in Romania, where Sorin Oprescu, Mayor of Bucharest, was arrested last week for allegedly taking bribes. Prime Minister Ponta has already been charged with corruption. Judges in Turkey last year launched a series of attacks on the Erdogan administration. A similar process appears to be underway in Poland and anti-corruption drives are playing an extremely important part in effecting change in China too.

These are not just random isolated events. The original inspiration for many of these operations is the so-called 'Mani Pulite' ('clean hands') campaign by Italian prosecutors in the 1990s that placed more than half of the members of the Italian parliament under indictment. 'Mani Pulite' ultimately felled governments, dissolved political parties, saw their leaders sentenced and led to charges against hundreds of officials and business people.

Versions of 'Mani Pulite' are now being implemented across a number of EM countries with varying degrees of success. While the specific circumstances differ in each case the most successful campaigns so far – those in Romania and Brazil – have several important common features.

Firstly, prosecutors start with business people and junior officials before moving upwards through the hierarchy of power. The point is to reach top level perpetrators through their soft underbellies rather than to attack 'their horns'. In other words, the strategy deliberately seeks to avoid the risk of a full-on political backlash that would shut down the campaign before it has even begun. Turkey illustrates this risk. Attempts by the judiciary in Turkey to charge important people within the government appear to have foundered precisely because they aimed too high to begin with. Instead of achieving its objective, the Judiciary was itself attacked and neutered.

Secondly, plea bargaining plays a critical role in encouraging confessions. Low level suspects are offered leniency, even the prospect that charges are dropped in exchange for complete and truthful disclosure. If suspects do

Continued overleaf

Emerging Markets

not cooperate and are later found to be guilty, or even if they are found at a later stage to have provided incomplete or inaccurate confessions, the punishment can be extremely severe. Plea bargaining was only recently approved as a legitimate instrument in Romania and Brazil. Once prosecutors have obtained very strong evidence they then move on to attack the next level in the hierarchy of corruption.

Thirdly, the prosecutors actively and deliberately exploit the media's love of scandal to generate the broad popular backing to escalate the campaign. This tactic is crucial in order to keep public opinion on the prosecutor's side and to prevent politicians from changing the law in their favour or to undermine the judiciary through other avenues. Using the media also creates a prisoner's dilemma for the politicians, because they tend to 'turn their backs to the setting sun', that is, dissociate themselves from fellow politicians that are caught with their hands in the till. Suddenly isolated and abandoned by former friends, the vilified suddenly have strong incentives to rat on their former colleagues in exchange for leniency.

Clearly, one of the assumptions in this approach is that abuse emanates from the top, so that each successive round of prosecutions exposes culprits higher and higher up until the investigation reaches the origin of the problem.

It is probably no accident that corruption has emerged as a major issue in some EM countries at this very point in time. The judiciary is rising in countries, where one dominant group has been in power for some time and where economic circumstances have recently become more difficult. The rise of the Judiciary therefore finds broad support in populations looking for scape goats for disappointments and broken promises. But there is more to this than just the business cycle. This is the stuff of EM – that is part of development itself as rising middle classes naturally begin to demand better institutions as manifested in street protests in Brazil, Turkey, Mexico and many other countries.

Investors should therefore expect more of the same in the future. Ultimately, the rise of the Judiciary is a good thing, because it has the potential to dramatically increase the importance of the rule of law in EM countries. It also carries risks. Governments that find themselves under attack from the law could be tempted to simply shut down the Judiciary. This, then, is another reason for taking a very active approach to investing in EM countries.

- Brazil: Brazil's sovereign debt spread increased to 419bps over US treasuries after S&P, a ratings agency, downgraded the country's long-term external debt rating to junk (BB+ with a negative outlook). Local bond yields and USDBRL also rose. Fitch and Moody's still maintain an investment grade rating. Petrobras, the national oil company, was downgraded two notches to BB with a negative outlook. A downgrade by one or both of the other ratings agencies seems likely and will trigger outflows from Investment Grade-only mandates with Brazil exposure. An estimated USD 16bn is benchmarked variously to the JP Morgan EMBI Investment Grade, JP Morgan CEMBI Investment Grade, Barclays US Aggregate and Barclays Global Aggregate indices. Passive Investment Grade mandates will only sell once a second downgrade happens (usually the month following the downgrade albeit some funds will have provisions to reduce exposure gradually). But most EM mandates are likely to be actively managed and many will have gone underweight Brazil lately (after all, the erosion in the macroeconomic situation in Brazil goes all the way back to the days of Guido Mantega's disastrous spell as finance minister). Others will have hedged with Credit Default Swaps (CDS). High yield funds will also now have to buy names such as Petrobras. So net net while it is difficult to place a precise estimate on future outflows in the event of second downgrade to junk we think actual flows will be far lower than USD 16bn, perhaps half of that amount. To put this number in context, Brazil has USD 371bn in foreign exchange reserves. The S&P's downgrade was attributed to a plethora of issues, including the recession, fiscal deterioration and the government's weak political position, which makes it difficult to effectively manage the required adjustment. On the other hand, this is ultimately a cyclical adjustment and S&P's downgrade removes yet another one of the expected downside risks. Indeed, there are signs that the economy is beginning to adjust to the medicine of adjustment. In addition to the marked improvement in the external balances, inflation is now clearly slowing. In August, IPCA inflation came in at 0.22% mom, down from 0.62% mom in July and 0.79% mom in June. This decline is partly seasonal in nature, but even on a seasonal basis monthly inflation tends to rise in August, not fall. The central bank also reduced its 2016 target for ICPA inflation to 4.5% yoy, which sends a hawkish signal at the margin. And it matters for the prospect of political stability that President Dilma Rousseff last week admitted publicly that the current situation is due to measures taken by her government in its first time.

- China: Sentiment about China continues to change dramatically. Much of the heightened coverage of the past few weeks has given way to a calmer tone that now proclaims that China may not experience a hard landing after all. One is tempted to say déjà vu. Undoubtedly we will see more shifts in sentiment, because so few investors actually invest in China. Did the world – did China – suddenly change in the past week? No. Premier Li Keqiang restated that the recent currency adjustment was linked to reforms intended to put China on track for SDR inclusion rather than devaluation per se and that China has plenty of tools to sustain the economy during the current period of intensive reforms. We agree completely and this is consistent with China's roadmap for reform.[1]

[1] See China Roadmap, Market Commentary, June 2015.

Continued overleaf

Emerging Markets

Aside from somewhat greater stability in the Chinese markets, the monetary survey data released for the month of August was encouraging. Narrow money increased at a rate of 9.3% yoy in August, which was well ahead of expectations (6.8% yoy). Narrow money is the most readily available source of liquidity for commercial activity, so this suggests that corporate credit demand is solid. Households and corporates increased deposits, while government and brokers reduced theirs. Brokers also reduced their lending – a clear sign that regulators are clamping down on margin lending and shadow banking – but elsewhere lending to households rose sharply, which is consistent with retail sales that accelerated in August to beat expectations (+10.8% yoy versus 10.6% yoy expected and 10.5%yoy last month). Surely, these are encouraging signs. The August monetary survey paints a picture of a slowing economy that is nevertheless motoring along on consumer demand despite the recent gyrations in equity and currency markets. In other economic news, inflation in August was 2.0% yoy, which was 0.2% higher than expected though mainly due to volatile components (food). Core inflation was flat at 1.7% yoy, while producer prices fell 5.9% yoy. The modest pace of core inflation in China means that there is room to cut rates if necessary; indeed, Chinese government bonds still pay a far higher real yield than bonds in developed countries, despite China's dramatically stronger public finances. On the external front, China's trade surplus increased from US 43bn in July to nearly USD 58bn in August due to weaker imports and stronger than expected exports. A positive net trade balance will contribute positively to GDP growth. Reserves stand at USD 3.56trn, down some 2.5% last month, but remain extremely strong covering the equivalent of 26 months of the current level of imports. Finally, China continued to push the reform agenda by approving a five-year plan to merge and sell shares of state-owned enterprises to the public.

- Nigeria: JP Morgan announced that it will drop Nigeria for the JP Morgan GBI EM Global Diversified index on account of difficulties in executing FX transactions. These difficulties are primarily due to the central bank's policy of restricting access to foreign exchange (rather than allowing the currency to fully adjust to lower oil prices). The index exclusion will further erode the representativeness of JP Morgan's local currency indices, which currently cover just 16 EM countries (there about 10 times as many EM countries in total). Nigeria's exclusion is clearly a regressive step for the country, but it may not be as important as many think. Nigeria is big enough as a market to be relevant for any sensible EM investor whether in or out of the index. The more important question is whether and indeed when Nigeria reverts to orthodoxy. In theory, the control regime for FX could work, but over-regulation makes the system open to corruption – Venezuela provides an excellent example of how bad it can go when countries prevent the FX from adjusting. In Caracas, the official rate is 6.30, while the black market is 700! Nigeria needs to acknowledge that oil prices have fallen and that prices, including the FX must adjust accordingly, even if it hurts in the short term. Adjustment is ultimately preferable to a heterodox system that creates perverse incentives and results in permanent and ever worsening distortions. One of the big questions many in Nigeria will be asking themselves today is: President Buhari, where are you now that we need you?

- Industrial production: After a spell of weaker data several EM countries over the last couple of months there are now signs of renewed economic vigour in a number of countries based on the latest round of industrial production (IP) numbers. India's IP expanded at a better than expected 4.2% yoy rate in July. Mexican IP was also better than expected (0.2% mom sa versus -0.1% expected). South African IP also rose for the first time after three months of decline (IP was up 5.6% yoy versus 3.7% yoy expected). In Slovakia IP rose 11.9% yoy in July versus 6.8% you expected, while Malaysian IP was up 6.1% yoy in July compared to 5.0% yoy expected). China's August IP was in line with expectation at 6.3% yoy and actually rising marginally to 6.1% mom from 6.0% mom in July. Turkey was an exception with a soft 3.7% yoy IP print compared to 5.5% yoy in June.

- Mexico: yoy inflation dropped to an all-time low of 2.59% in August. Core inflation was 2.3% yoy, well below the centre of the target range. Like many other EM economies, Mexico has had little pass-through from a weaker currency. This is mainly due to credible central banks. The budget for 2016 will have a 3.0% fiscal deficit compared to 3.5% this year, according to finance minister Luis Videgaray. The government has hedged its oil sales for next year already.

- Thailand: The next election is now scheduled for May 2017 after the National Reform Council rejected a draft of the new constitution. The delay will be accompanied by a new set of stimulatory measures, but the real boost to growth is likely to begin in early 2016 when the government's USD 94bn infrastructure investment plan begins to come into effect.

- Venezuela: Opposition leader Leopoldo Lopez was jailed for 14 years for allegedly inciting violence during protests against the government last year. Venezuela's socialist government has systematically dismantled Venezuela's democratic institutions and imprisoned members of the opposition, but so far these policies have not led to broad-based revolt again the government. The next test of the government's popularity will be the parliamentary elections in December. Polls suggest that the opposition will gain control of parliament. But much power still resides with the presidency.

Continued overleaf

Emerging Markets

Snippets:

- **Chile:** Core inflation rose marginally to 5.7% yoy following the 0.4% mom print for August.
- **Costa Rica:** Inflation declined to -0.7% yoy in August from -0.5% yoy in July.
- **Guatemala:** Remittances from abroad rose USD 4bn in August year to date. This puts the country on track to receive almost 10% of GDP in remittances this year. Guatemala elects a new president on 25 October.
- **Honduras:** Inflation eased to 3.1% yoy in August from 3.2% in July.
- **Hungary:** August inflation on a yoy basis slowed to zero from 0.4% yoy in July.
- **Indonesia:** The government announced a raft of new measures intended to stimulate the economy. The measures focus on easing constraints to execution of projects and encouraging residential investment.
- **Malaysia:** The central bank left rates unchanged at 3.25%.
- **Peru:** The central bank undertook a one-and-done 25bps hike in response to recent weakness in the currency.
- **Romania:** Inflation declined to -1.9% yoy versus -1.5% yoy expected for August.
- **Russia:** The CBR left rates unchanged at 11%, but sounded a slightly more hawkish tone. This follows recent RUB weakness and marginally higher than expected inflation last month.
- **Singapore:** The ruling People's Action Party (PAP) won a decisive victory in Singapore's parliamentary election. PAP increased its share of the vote significantly to 70% from 60% in the previous election. PAP will take 83 of the parliament's 89 seats based on this result.
- **South Korea:** Unemployment dropped to just 3.6% in August from 3.7% in July (and 3.8% expected). The main reason was strong hiring as the MERS outbreak recedes.
- **Turkey:** The current account deficit was narrower than expected (USD 3.2bn versus an expected deficit of USD 3.55bn), while FDI inflows beat expectations substantially. At 3.8% yoy, the Turkish GDP growth rate in Q2 was nearly twice as high as expected.
- **Ukraine:** Ukraine's parliament will vote on a recently proposed sovereign debt restructuring deal on 17 September, according the parliament's speaker. The deal was more favourable to investors than markets had expected. The government has a majority, so we expect the deal to pass.

Global backdrop

In the US, consumer sentiment dropped sharply in September. This follows weakness in debit and credit card spending reported by Bank of America Merrill Lynch for the month of August (spending ex-autos declined 0.8% mom sa). Wholesale inventories declined 0.1% mom in July compared to an expected increase of 0.3%. There were also more signs that the strong USD is having a deflationary impact on the economy as import prices declined 1.8% in the month of August (-11.4% yoy). On the other hand, the labour market continues to produce good numbers as job openings rose sharply. So where does this leave the 'data dependent' Fed ahead of the 17 September rate decision? Answer: with a difficult decision to make.

The US outlook is both positive and worrisome. On the one hand, the economy is likely to continue to recover. When the US subprime market collapsed in 2008/2009, the government decided to bail out the banks, while the Fed lifted mortgage-related securities off their balance sheets through QE operations. Households were therefore in effect able to default on their obligations and achieve significant deleveraging. Combined with house price appreciation and a tighter labour market the US is now on track to be able to produce inflation by late next year. Hence, the Fed needs to begin to raise rates, this week or not too long afterwards.

But here is the problem. Stock markets have become addicted to cheap money. The USD has already strengthened so much that export growth is seriously impeded and the real effective exchange rate is hurting growth. Productivity is low and investment rates remain pitifully low, while aggregate debt levels are enormous, because governments in the US and other QE economies did not use the good times to reform. A meaningful tightening of monetary policy is therefore likely to extract more than just a 'pound of flesh' in terms of growth and asset prices. The issue is not the first hike per se. The real issue is what to do when inflation resurfaces.

Continued overleaf

Ashmore

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.81%	-14.25%	-22.86%	-3.60%	-1.83%
MSCI EM Small Cap	0.57%	-9.16%	-17.97%	0.61%	-0.83%
MSCI Frontier	0.85%	-10.90%	-21.93%	8.57%	3.52%
MSCI Asia	-0.45%	-11.20%	-15.44%	2.31%	2.20%
China A shares	-0.17%	0.38%	40.78%	17.80%	6.33%
China H shares	-0.12%	-16.51%	-9.18%	5.07%	-0.38%
MSCI EMEA	-4.18%	-11.76%	-25.48%	-8.82%	-3.76%
MSCI Latam	-4.58%	-26.62%	-42.27%	-16.32%	-11.08%
GBI EM GD	-2.26%	-14.29%	-21.93%	-8.35%	-2.67%
ELMI+	-0.64%	-7.49%	-14.25%	-4.98%	-2.18%
EM FX Spot	-1.63%	-15.46%	-24.20%	-12.27%	-8.48%
EMBI GD	0.08%	1.32%	-0.47%	2.05%	5.41%
EMBI GD IG	-0.26%	-0.79%	-0.38%	0.90%	4.47%
EMBI GD HY	0.54%	4.18%	-1.62%	3.74%	6.78%
CEMBI BD	-0.22%	1.82%	-0.05%	3.17%	4.84%
CEMBI BD HG	-0.22%	1.48%	1.30%	3.25%	5.04%
CEMBI BD HY	-0.23%	2.44%	-2.90%	3.21%	4.59%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.47%	-3.34%	0.21%	13.38%	14.44%
1-3 year UST	0.13%	0.67%	0.76%	0.47%	0.70%
3-5 year UST	0.23%	1.89%	3.16%	1.30%	1.93%
7-10 year UST	0.43%	2.17%	5.77%	1.69%	4.45%
10+ years UST	0.37%	-1.58%	8.71%	2.35%	7.00%
US HY	0.62%	0.65%	-2.00%	4.73%	7.59%
European HY	0.14%	2.66%	2.37%	9.39%	10.27%
Barclays Ag	0.39%	-0.16%	1.55%	3.34%	4.49%
VIX Index*	-18.40%	20.83%	74.31%	59.89%	7.61%
DXY Index*	-0.73%	5.38%	12.92%	20.65%	17.32%
CRY Index*	-2.66%	-14.45%	-30.22%	-38.70%	-29.78%
EURUSD	1.13%	-6.36%	-12.38%	-13.70%	-12.91%
USDJPY	0.87%	-0.31%	-10.82%	-34.79%	-30.95%
Brent	-11.97%	-16.85%	-50.91%	-59.14%	-39.78%
Gold spot	-2.27%	-6.73%	-10.26%	-37.42%	-12.76%

*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

Other locations
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper