Ashmore

Lemons and cherries in global asset allocation

By Jan Dehn

The Chinese word for crisis is made up of two characters: 'danger' and 'opportunity'. Another week of data from Emerging Markets (EM) shows that the summer's sell-off was more of the latter than the former. We highlight a few important developments, including improving trade numbers in India, falling inflation in Brazil, Mexico, and Czech Republic, debt problems in Serbia, an innovation in Brazilian politics and the latest development in Argentina's legal battle with holdout investors. We then present our view on Janet Yellen's candidacy for Fed Chair and we apply her insights about adverse selection to global asset allocation. The results are both insightful and disturbing.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,022		1.70%
MSCI FM	564		0.50%
GBI-GD	6.46%		0.54%
ELMI+	3.39%		0.37%
EMBI GD	5.73%	301 bps	0.67%
EMBI GD IG	4.79%	208 bps	0.42%
EMBI GD HY	9.13%	663 bps	1.18%
CEMBI BD	5.70%	347 bps	0.28%
CEMBI BD HG	4.83%	258 bps	0.20%
CEMBI BD HY	7.69%	551 bps	0.63%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,703	1.67%
VIX Index	15.72	-19.01%
5 year UST	1.42%	2 bps
10 year UST	2.69%	6 bps
10 year Bund	1.86%	6 bps
EURUSD	1.3566	-0.11%
USDJPY	98.18	1.51%
Brent	$110	0.39%
Copper	$331	-0.63%
Gold	$1287	-2.82%

Emerging Markets

The Chinese word for 'crisis' is made up of two characters; one means danger, the other means opportunity. With every week that passes the so-called Emerging Markets crisis of this summer looks more and more like an opportunity. Emerging Markets economies are coping well with the huge technically driven outflows, while the few countries requiring adjustment have acted decisively and are beginning to see results.

For example, this week we learned that India's trade deficit improved sharply in September to USD 6.8bn from USD 10.9bn in August, mainly due to a sharp fall in imports. This is precisely what one would expect from a standard macroeconomic adjustment program to restore domestic and external equilibrium after a period of excess demand stimulus.

Specifically, tighter fiscal and monetary policy combined with allowing the currency to adjust, lowers domestic demand, including the demand for imported goods. Thus Indian imports fell 18.1% yoy in September from -0.7% yoy in August, while exports rose at a pace of 11.2% yoy. As one of the so-called 'Fragile Five' EM countries, India is undergoing a perfectly standard macroeconomic adjustment. Whilst such an adjustment would be called a recession in a developed economy, in EM it is quickly labelled a crisis. It is obviously no crisis. Indeed, this past week India was able to ease liquidity conditions by cutting the marginal standing facility rate by 50bps to 9.0% in response to improving financial conditions.

Inflation is a constant source of worry for EM investors. But EM inflation continues to be remarkably benign. Inflation in the Czech Republic surprised to the downside at -0.4% mom (1% yoy) in September compared to a consensus expectation of 1.2% yoy. Mexican inflation was also below expectations at 3.39% in September from 3.46% in August. But the most interesting observation was that Brazil's inflation also declined for the third month in a row. The decline took the headline year-on-year 'IPCA' inflation rate back below 6% for the first time in eight months. At 5.9% yoy inflation is now well below the 6.5% upper limit of the central bank's target range. The fly in the ointment is that core is also sitting at 5.9%; so more needs to be done by the central bank. This is why the COPOM – the central bank's policy rate setting committee – this week raised rates by 50bps to 9.5% without changing the statement, suggesting that further rate hikes are possible at the November meeting. In our view, there is little doubt about the government's intention to keep inflation under control.

Inflation has remained elusive across EM despite widespread currency weakness and relatively low policy rates in many countries. The reason, in our view, is that the global environment is fundamentally deflationary for EM. Why? Because it is characterised by high levels of risk aversion, strong preferences for allocating to 'risk free' developed markets, fear of currency volatility in less liquid EM markets, and generally tighter financial conditions due in part to regulatory biases against EM.

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Emerging Markets

The notable exceptions where countries do have inflation problems are cases where inflation is self-inflicted due to deliberate policy actions or sheer gross ineptitude (such as in Argentina and Venezuela). These countries are few in number and exposure to their local markets is easily managed through active management.

Turning to credit worthiness, Eastern Europe is still the most vulnerable region in EM as several Eastern European countries came close to believing themselves to be 'developed', that is, 'risk free' before 2008/2009. Based on this illusion these countries gorged on cheap credit, and several are still struggling with the consequences. For example, this week it became clear that, due to its current and past fiscal profligacy, Serbia will probably need to turn to the IMF for support. These days it is very rare indeed that EM countries need IMF support. In fact, EM countries are more likely to fund the IMF than the other way around. Other countries in the EMEA region that also face debt-related challenges include Hungary (household debt), Ukraine and Croatia.

Turning to political developments of note, in Brazil Marina Silva, a left-leaning presidential candidate, joined forces with Eduardo Campos, president of the socialist PSB party. The Silva-Campos combo may pose a genuine challenge to President Dilma Rousseff in next year's presidential elections, not least by splitting the left. A large number of Emerging Markets countries face elections in 2014, so watch this space.

Final word goes to Argentina. The US Supreme Court this week formally announced that it will not hear Argentina's appeal in the dispute between holdout investors from the 2001 default and government. This brings the end to the legal battle one step closer. It is now possible that all avenues of appeal will be exhausted by Q1 2014. If the standing ruling of the second district court in New York is upheld the implication would be that coupon payments intended for holders of performing bonds could be diverted to holdout investors, triggering a technical default. This risk does not apply to local law bonds so Argentina may yet offer holders of performing New York Law bonds the option to swap their exposure into local law bonds.

Global backdrop

Four important US specific uncertainties have kept the Sword of Damocles suspended rather precariously over the global outlook over the past several weeks:

- What will be the economic fallout from the US government shutdown?
- How will Democrats and Republicans arrive at a formula to raise the debt ceiling?
- When does QE tapering begin?
- Who will be the next Fed chairperson?

These are not trivial matters. How these questions are resolved will impact, respectively, the pace of growth, the payments status of US government bonds, global interest rates and the quality of US monetary policy going forward.

This week one of these important questions was answered comprehensively and positively, when Janet Yellen was put forward by the Obama Administration to replace Bernanke as Fed chairperson. We think Janet Yellen is the right choice for two reasons.

First, the US needs a 'dove' to maintain a very easy monetary policy during the remainder of the household deleveraging process (which in our view is not over until mid-2016,). The US will also need a dovish Fed after this, because inflation will be required to reduce America's crippling debt stock of 405% of GDP. Janet Yellen's preference for a so-called 'optimal control' framework for monetary policy means that she places greater weight on reducing unemployment than fighting inflation in the current environment.

Second, Janet Yellen was the most experienced and formidable of the available candidates. She has made major contributions in many fields of economics, most notably in the literature on labour markets, where she helped to introduce concepts such as 'adverse selection' to explain persistent high unemployment. Much of this truly ground-breaking work was done in conjunction with her husband, Nobel Prize winning economist, George Akerlof.[1]

[1] Adverse selection was first introduced to the economic profession in a case study of the second hand car market in a seminal paper by Janet Yellen's husband George Akerlof in his (1970) titled *"The Market for 'Lemons' (Quality Uncertainty and the Market Mechanism"*. Quarterly Journal of Economics (The MIT Press) 84 (3): 488–500).

We believe there are major adverse selection problems in global asset allocation. Adverse selection is the tendency for asset allocators to 'select' sub-optimal or 'adverse' investments at the expense of better alternatives. The conditions for adverse selection to occur in global asset allocation are the following:

- There must be differences in the quality of issuers
- Investors must possess less information about the quality of issuers than the issuers themselves. The technical term used to describe this state of affairs is asymmetric information

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Global backdrop

Theoretically, asymmetric information and moral hazard behaviour leads to a situation where only bad quality issuers ('lemons') are able to tap markets, while good quality issuers ('cherries') become excluded from capital markets.

This outcome arises when both good and bad issuers place bonds in a market place, where prices reflects the average quality of issuers, because investors cannot accurately tell who is a good and who is a bad issuer. But since good issuers are aware of their better quality they do not want to issue at the market rate, while bad issuers are more than happy to issue at the market rate. Over time, good issuers are driven out and eventually only bad issuers are left.

Enter Emerging Markets and developed markets. Emerging Markets are widely recognised as having very different quality issuers, some of which are clearly risky investment destinations. It is also recognised that Emerging Markets are less well researched, hence characterised by asymmetric information between issuer and investor. By contrast, developed market issuers are deemed to be 'risk free', indeed by definition, because our regulatory system enshrines this status under Basel 2/3 and Solvency II. Hence, there are neither asymmetric information problems nor moral hazard problems in developed bond markets, because the problems are simply assumed away. It follows that there is no adverse selection problem either.

One of the grossest manifestations of adverse selection is that Emerging Markets – 50% of global GDP – receive but a fraction of global capital. Akerlof and Yellen's work explains why this happens: global asset allocation is de facto rigged in favour of allocating too much capital to over-indebted developed economies (the lemons) and too little capital to fundamentally much sounder Emerging Markets (cherries).

The under-allocation of capital to Emerging Markets is made worse by conventional asset management practices. Sovereign research in Emerging Markets is generally very poor. Passive management is widespread. Many investors simply do not take credit research seriously, do not want to pay for it, and opt instead to rely on ratings agencies and investment bank research both of which can be seriously flawed. To make matters worse, the use of price volatility as a proxy for the riskiness entirely fails to safeguard portfolios. Volatility is a terrible measure of risk if markets are inefficient, which they self-evidently are. Risk is large permanent loss; volatility is merely a measure of up and downward movement of prices.

As some of the largest investors in bonds issued by developed economies, Emerging Markets central banks should take special note. They are, perhaps inadvertently, perpetuating the pleasant fiction that developed market bonds are risk free by investing so many of their reserves in those markets. Emerging Markets central banks might do better to allocate to other Emerging Markets, while explicitly recognising that credit quality differs within the EM universe and hence requires focusing on credit research and employing active management.

Meanwhile, Emerging Markets issuers wanting to secure a fairer share of global capital can find respite in the fact that Akerlof and Yellen's work tells them how they can secure, at a cost in terms of efficiency, a fairer share of global capital. They can do so by signalling their better quality to investors. One powerful way to do so would be to have better informed central banks lead the charge on reserve diversification.

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