Issued: 14 December 2015

Ashmore

The Mars bar effect

By Jan Dehn

The 'Mars bar effect' kicked in extensively in the Quantitative Easing (QE) markets in 2015, which proved unable to produce positive returns despite enormous stimuli ranging from negative interest rates to QE. The US economy is now displaying clear symptoms of 'late cycle blues', even before rate hikes have begun. Last week saw an explosion in risk aversion as news began to filter through that a US High Yield fund had to gate. More pain is likely, in our view. Meanwhile, back on Earth the main events included a new FX regime in China, instant accountability in South Africa, a likely default on Ukraine's Russian USD 3bn bond, a bold program of reforms in Turkey, a boost for the odds of GST in India, Moody's effort to catch up with the rest of the rating agencies in Brazil, a changing of the guard in Argentina, real power for the opposition in Venezuela and another macroeconomic misstep in Nigeria.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.6	–	-4.75%
MSCI EM Small Cap	11.7	–	-5.06%
MSCI Frontier	9.0	–	-1.75%
MSCI Asia	11.3	–	-3.32%
Shanghai Composite	13.7	–	-2.56%
Hong Kong Hang Seng	6.9	–	-5.35%
MSCI EMEA	8.5	–	-10.35%
MSCI Latam	12.3	–	-4.84%
GBI-EM-GD	7.21%	–	-4.23%
ELMI+	4.79%	–	-1.62%
EM FX spot	–	–	-2.75%
EMBI GD	6.34%	419 bps	-0.86%
EMBI GD IG	5.04%	283 bps	-0.99%
EMBI GD HY	8.40%	637 bps	-0.69%
CEMBI BD	6.37%	440 bps	-0.86%
CEMBI BD IG	4.75%	279 bps	-0.25%
CEMBI BD Non-IG	9.26%	728 bps	-1.91%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	-3.74%
1-3 year UST	0.92%	–	0.19%
3-5 year UST	1.60%	–	0.60%
7-10 year UST	2.17%	–	1.14%
10+ years UST	2.90%	–	2.69%
US HY	9.17%	762 bps	-2.49%
European HY	5.42%	553 bps	-1.09%
Barclays Ag	–	227 bps	0.36%
VIX Index*	24.39	–	9.58%
DXY Index*	97.83	–	-0.82%
EURUSD	1.0952	–	0.93%
USDJPY	121.16	–	-1.70%
CRY Index*	174.86	–	-8.39%
Brent	37.5	–	-7.98%
Gold spot	1067	–	-0.90%

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

Global backdrop

Kids love Mars bars. Give your average sweet-crazed kid a Mars bar and watch him eat it with eager relish. Then give him a second Mars bar and watch him wolf it down with almost undiminished enthusiasm. Give him a third Mars bar. Now the eagerness is already waning somewhat. Still, keep going. Give the kid more Mars bars and then more still! By the time you have shoved the 11th Mars bar down his throat the kid's fondness for Mars bars will have been definitively checked. It is quite simply too much of a good thing! What the kid needs now, more than anything else, is to just stop eating Mars bars. He probably also needs some downtime to recover, to shed some pounds, to get some exercise and to switch to an altogether healthier diet.

The dynamic described above is the 'Mars bar effect', that is, the tendency even for a good thing to have a diminishing or even negative return if you get too much of it. The Mars bar effect became very obvious in developed economies in 2015: Western financial markets began to gag on more than four years of relentless financial Mars bars in the shape of zero interest rates policies and QE, accompanied by no reforms and barely any deleveraging.

The clearest evidence that the 'Mars bar effect' is in play is that the hyper-stimulatory monetary policies that produced such stellar financial returns in the QE economies in the past four years are no longer producing returns. Developed market stock and bond markets have moved well past the peak of the sugar highs and are now entering the discomfort zone between queasiness and outright nausea, or worse. US stocks are down for the year. The Dollar is far too strong. Companies have issued debt to buy back stock instead of investing in their own businesses.

Worryingly, a prominent US high yield fund last week gated following material losses and poor secondary market liquidity, pushing down global risk appetite very sharply on Friday. US HY bonds are now down 4.75% YTD. Much more pain is likely to be on the way from the over-valued credit and government bond markets in the QE economies.

Continued overleaf

Global backdrop

Abstracting from the ugly details, the big picture is that the US economy is showing clear late cycle symptoms – the credit cycle is turning and productivity is declining with manufacturing teetering on the edge of a recession. In Europe, bond market returns are flat for the year, but some 40% of government bonds now pay negative yields. A crescendo of nationalistic populism is rising across the European continent, which bodes poorly for reforms and growth. Even the free flow of labour between Eurozone member states is now in question. The US, Europe, Japan and the UK all labour under debt loads that have grown sharply since 2008/2009 as governments have failed spectacularly to use the benign environment of easy monetary policies to undertake tough reforms. Investors would be right to ask themselves: Where, exactly, is the next 10% going to come from in the Mars bar markets?

The Fed seems hell bent on hiking in December. This would be good news for EM. The uncertainty surrounding a small 25bps hike is tiresome. Unfortunately, the hike does not even get close to restoring upside potential in the Mars bar markets. Monetary policy will still be super stimulatory after a hike, not least due to the three trillion Dollars plus in outstanding QE liquidity available for commercial banks to distribute into the wider economy. Real rates may actually fall in the first half of 2016 as headline inflation rises on the back of base effects from the recent fall in oil prices. Most importantly, QE money is fungible across the QE economies and the ECB is on negative rates and likely to print more, while Japan and the UK are also still printing.

Emerging Markets

- China: Reforms are continuing at a furious pace in China. Over the weekend, China Foreign Exchange Trade System (CTEFS) published a new trade weighted currency index, which should, in our view, be viewed as a signal that exchange rate policy will now increasingly focus on China's effective exchange rate – that is, a trade weighted index of 13 currencies – rather than the simple bilateral exchange rate between RMB and the US dollar. In practice, this means that policy-makers will be more focused on the stability of this basket of currencies rather than solely the USDCNY or USDCNH bilateral exchange rates. The transition to a basket of currencies makes perfect sense for the following reasons:
  - China's trade partners are global, not just the United States (the weight of the USD in the new basket will be 24.6%, or 30% including the Hong Kong dollar, which is pegged to the US dollar). The EUR and JPY will have weights of 21.39% and 14.68%, respectively.
  - The USD is arguably entering bubble-like valuations, while China's policy makers tend to take longer-term views and therefore prefer FX policies that are more sustainable and therefore stable over the longer term.
  - The adoption of a currency basket should allow China to move more quickly to a flexible exchange rate and is entirely consistent with the stated objective of the RMB's formal inclusion in the SDR by October 2016.

The adoption of a broader currency basket will eventually be accompanied by further diversification of China's FX reserves away from US Treasuries, although we do not expect any immediate significant selling.

On the data front, retail sales, industrial production and fixed asset investment were above expectations in November. The monetary data for November were also better than expected, showing that money supply tightened at the centre (M0 was lower than expected), while broader measures of money (M1 and M2) expanded faster than expected. Total aggregate financing was also higher than expected. Economic activity – as far as credit is concerned – is clearly strengthening despite the relatively conservative stance at the central bank. Chinese inflation rose to 1.5% yoy in November from 1.3% yoy in October and the trade surplus was USD 54.1bn with imports falling less than expected (-8.7% yoy vs 11.9% yoy expected).

There was also news regarding China's quota regime. In an important new development, SAFE has eased rules for holders of Qualified Foreign Institutional Investor (QFII) allocations (foreign investors wishing to invest into China) such that quota allocations can now be distributed freely among open-ended funds rather than just apply to China-only funds, although the QFII system still lacks the daily dealing and no-minimum holding period freedoms that are available under the Renminbi Qualified Foreign Institutional Investor (RQFII) system. The PBOC also suspended the Renminbi Domestic Institutional Investor (RDII) program, which grants permission for investors in China to overseas markets. This restricts access to liquidity in the CNH market, which has recently become a haven for speculative positions against the currency. We expect China to continue to experience speculative attacks on account of the weakness that typically accompanies intensive reform efforts, but we believe China is well placed to handle two-way volatility in the currency. We think Chinese corporates have managed to close most of their FX mismatches this year with the help of liquidity from China's large stock of FX reserves. We also do not think currency volatility will change China's reform drive. Indeed, the RMB is destined eventually to rally sharply against QE currencies, in our view.

- South Africa: The bond and currency markets as well as ANC insiders and other members of the ruling alliance dispensed instant accountability to President Zuma in response to his decision to change South Africa's Finance Minister last week. Zuma's decision to replace Nhlanhla Nene, a trusted hand, with David van Rooyen, a little know politician, triggered such a negative reaction in the markets and within his own party that within

Continued overleaf

Emerging Markets

three days of the appointment of van Rooyen Zuma had undertaken a spectacular U-turn by replacing van Rooyen with Pravin Gordhan, a trusted and experienced former finance minister. Nene had been opposing two major transactions involving South African Airways and funding for a nuclear energy program – both projects widely seen as special interests of President Zuma – on the grounds of their potentially adverse implications for South Africa's public finances. Zuma's decision to replace Nhlanhla Nene with David van Rooyen quickly undermined the market and domestic political confidence at a time when South Africa is facing growing fiscal challenges against a general backdrop of sluggish growth and insufficient attention to reforms. General risk aversion in global markets and softer commodity prices compounded the price action. Markets will now pay close attention to Gordhan's handling of the public finances and how he intends to square the President's special interests with the need to maintain fiscal probity.

- Ukraine: The government looks likely to default on its USD 3bn obligation to Russia by failing to pay when the bond falls due on 20 December. The resulting default will likely be a pure bilateral issue between Russia and Ukraine, because the IMF recently changed its policy on lending into arrears to allow the institution to continue to lend under conditions that Ukraine (a) continues to show that it is serious about its own reform program and (b) makes genuine efforts to find a solution with Russia. These conditions are obviously difficult to judge objectively, so there is room for the IMF to continue to lend to Ukraine, which therefore means that holders of restructured bonds in Ukraine should not be affected by a default on the Russian bond. Ukraine currently has about USD 15bn in FX reserves and cash in the Treasury, which means that Ukraine is not in imminent need for additional financing. The important thing for holders of Ukrainian restructured bonds is that Ukraine continues to satisfy the terms of its agreement with the IMF. This requires a passage of unpopular fiscal reform, which faces competition in the Rada from a populist version, which would not meet the requirements of the IMF. Russia will likely take Ukraine to court – the bond is issued under English Law. In addition to the USD 3bn bond Ukraine is thought to owe about USD 600m in loans from Russia, which may or may not be affected by the sovereign default.

- Turkey: The government published its program of structural reforms following the recent parliamentary election, which returned the ruling AK Party to an absolute majority. The program is extremely ambitious. Between now and the end of Q1 2016, the government intends to reform campaign financing, labour markets and undertake various changes to the tax regime. In 2016, the government additionally intends to reform income taxes, the private pension system and railways liberalisation. In 2017, reforms will cover laws governing elections and political parties, public tenders, stamp duty and, importantly, the constitution. The main take-away is that economic reforms will be front-loaded, that is, they are not being side-lined by the political reform agenda. Real GDP surprised to the upside in Q3, when the economy expanded at a pace of 4.0% yoy compared to 3.8% in Q2. Turkey like other EM countries has significantly rebalanced in recent years due to the strong rally in the USD, halving the country's current account deficit a percentage of GDP terms (from nearly 10% to about 5%).

- India: The Goods and Services Tax (GST) reform bill has suddenly come to life again after a parliamentary committee produced detailed recommendations about the content of the reform. GST would in effect turn India into a single market, whereas today India's states maintain large tax barriers than create great inefficiencies. This development is therefore very positive news. If the GST bill passes parliament it will be implemented with effect from 1 October 2016 or latest 1 April 2017, in our view. The economy continues to perform well with Industrial Production up 9.8% yoy in October versus 7.6% yoy expected.

- Brazil: Moody's turned more negative on Brazil and put the sovereign on review for a possible cut in the country's sovereign bond rating. Moody's still has Brazil rated one notch above junk, while S&P has already moved Brazil to sub-IG and Fitch is one notch above junk with a negative outlook. In our view, the market should be expecting that two or more ratings agencies move Brazil to sub-IG in Q1 2016. This may lead to outflows from passive IG only funds of about USD 8-10bn. This would have no impact on Brazil per se because the bonds are traded offshore. Brazil has USD 370bn in FX reserves and FDI flows now more than cover the current account deficit. The domestic economy continues to respond only very sluggishly to the government's weak effort at adjustment (due to lack of political capital). Inflation is now running at a pace of 10.5% yoy, but expect inflation to fall sharply in 2016 and 2017 on the back of the sharp contraction in growth (-3% in 2016). On the political front, parliament appointed members to a committee, which will be tasked with evaluating the impeachment charges against President Dilma Rousseff, but the Supreme Court called a halt to proceedings in order to determine if the voting for the parliamentary committee had followed the correct process. The Supreme Court is likely to deliver its verdict within a matter of days.

- Nigeria: The government doubled up on its bet on an eventual return to higher oil prices by sharply increasing the fiscal deficit in the 2016 budget. Unlike Russia which has forced domestic demand into line with lower income as oil prices have fallen, Nigeria's government has sought to protect domestic demand at levels that are consistent with oil prices that are far higher than today. This might work, but only if oil prices surge higher, however, there is no sign of that right now. The only silver-lining is that Nigeria has a low public debt stock of 15.7% of GDP. Hence, the government has the option to stimulate demand for some time to come. Unfortunately, the failure to devalue the Naira means that non-oil export sectors are unlikely to flourish. This is why the current policy stance amounts to a gamble that oil prices rise in the course of 2016.

Continued overleaf

Emerging Markets

- **Argentina:** The governor of the Central Bank, Alejandro Vanoli stepped down to allow economist Federico Sturzenegger to replace him. Sturzenegger indicated that the government will seek upfront financing to build reserves before letting the currency weaken (as it must, in our view). Reserves have steadily declined from more than USD 50bn to less than USD 25bn as a result of extremely poor economic policies pursued by the former government led by Cristina Kirchner. Mauricio Macri was sworn in as President of Argentina.
- **Venezuela:** The electoral commission confirmed that the opposition coalition secured a 2/3 majority in the National Assembly. This transfers tremendous powers to the Legislature, including the authority to appoint judges and dismiss ministers and to call a constituent assembly. A constituent assembly could change the constitution, for example, to shorten President Maduro's term (members of the assembly would have to be elected within 30 days). The opposition now also has the power to appoint new Supreme Court judges, as many as required in order to build a majority.

Snippets:

- **Colombia:** The real economy expanded by 3.2% yoy in Q3. This marked an acceleration in growth compared to Q2 (3.0% yoy).
- **Costa Rica:** Annual inflation declined to -1.2% yoy in November from -0.9% yoy in October.
- **Ecuador:** Vice President Jorge Glas said that Ecuador has reached agreement with China about the disbursement of USD 2.8bn in fresh loans through February 2016.
- **Guatemala:** The rate of growth in October accelerated to 4.2% yoy on the back of healthy activity throughout the economy. Growth was 4.2% in 2014 and 3.7% in 2013.
- **Malaysia:** Industrial production moderated to 4.2% yoy in October from 5.1% yoy in September.
- **Panama:** Tourism revenues are 14.2% yoy higher in the January to August period than in the same period last year. Tourism is now 17.5% of Panamanian GDP.
- **Philippines:** Unemployment dropped to a new low of 5.6% in October. This is the lowest print since the monthly data series began in 2005.
- **Russia:** Russia trade surplus was USD 10.1bn in October versus USD 9.4bn expected. The fact that Russia has a major trade surplus at the current low oil prices testifies to the quality of the Russian policy response. The Central Bank left rates unchanged at 11%. The European Union delayed a decision on extending sanctions over Ukraine due to internal differences within the membership.
- **South Korea:** Bank of Korea left rates unchanged at 1.5% in line with consensus expectations.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-4.97%	-17.10%	-15.95%	-6.70%	-4.40%
MSCI EM Small Cap	-4.68%	-11.14%	-10.55%	-1.90%	-3.25%
MSCI Frontier	-1.32%	-15.53%	-14.31%	4.89%	0.62%
MSCI Asia	-2.92%	-11.24%	-10.14%	-0.71%	0.11%
Shanghai Composite	-0.31%	7.86%	19.25%	21.44%	6.44%
Hong Kong Hang Seng	-4.93%	-19.94%	-14.74%	-1.75%	-2.53%
MSCI EMEA	-13.29%	-24.98%	-24.70%	-14.08%	-9.10%
MSCI Latam	-3.13%	-30.08%	-28.86%	-18.31%	-13.20%
GBI EM GD	-3.46%	-15.99%	-16.91%	-10.06%	-3.41%
ELMI+	-1.19%	-7.68%	-8.25%	-5.46%	-2.78%
EM FX Spot	-1.92%	-17.94%	-19.05%	-13.14%	-9.26%
EMBI GD	-1.52%	1.06%	1.52%	1.08%	5.17%
EMBI GD IG	-1.46%	-1.29%	-0.54%	0.12%	4.48%
EMBI GD HY	-1.59%	4.25%	4.16%	2.44%	6.22%
CEMBI BD	-1.20%	1.33%	1.28%	2.08%	4.49%
CEMBI BD IG	-0.48%	1.43%	1.32%	2.45%	4.94%
CEMBI BD Non-IG	-2.44%	1.06%	1.12%	1.42%	3.72%

Continued overleaf

Ashmore

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-3.19%	-0.27%	0.96%	14.49%	12.50%
1-3 year UST	0.17%	0.61%	0.55%	0.41%	0.66%
3-5 year UST	0.39%	2.18%	2.10%	1.32%	2.08%
7-10 year UST	0.69%	3.14%	3.10%	1.63%	5.24%
10+ years UST	2.12%	1.30%	2.43%	2.96%	9.38%
US HY	-2.73%	-4.75%	-3.73%	1.87%	5.60%
European HY	-1.41%	2.17%	2.08%	7.13%	9.67%
Barclays Ag	0.03%	0.48%	0.84%	2.73%	4.84%
VIX Index*	51.21%	27.03%	15.70%	43.47%	38.50%
DXY Index*	-2.33%	8.38%	10.72%	22.94%	23.27%
CRY Index*	-4.21%	-23.96%	-28.26%	-40.70%	-45.27%
EURUSD	3.71%	-9.49%	-11.95%	-16.80%	-18.34%
USDJPY	-1.62%	1.10%	2.58%	45.07%	45.24%
Brent	-15.98%	-34.62%	-39.40%	-65.66%	-58.91%
Gold spot	0.27%	-10.18%	-11.64%	-37.09%	-23.97%

*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