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Mainly good news in EM this week

By Jan Dehn

Argentina's central bank tightens monetary policy and the government strikes deals with holdout investors. Strong growth in Indonesia. Back to single digit inflation in Russia. A small decline in core inflation in Brazil and a big upside surprise for the trade balance. China continues to reform its financial markets as reserves drop less than expected. The resignation of Ukraine's economy minister is not good news, but there is no immediate fallout. Azerbaijan is downgraded to sub-investment grade. In the global backdrop we ask a simple question: How did investors manage to get so long US assets, when the economy is performing so poorly?

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.7	–	-0.35%
MSCI EM Small Cap	10.4	–	0.12%
MSCI Frontier	8.3	–	2.66%
MSCI Asia	10.2	–	-0.69%
Shanghai Composite	10.0	–	0.95%
Hong Kong Hang Seng	5.7	–	-2.24%
MSCI EMEA	8.4	–	-0.08%
MSCI Latam	10.5	–	0.49%
GBI-EM-GD	6.83%	–	1.17%
ELMI+	4.18%	–	0.58%
EM FX spot	–	–	0.80%
EMBI GD	6.52%	466 bps	-0.02%
EMBI GD IG	4.91%	296 bps	0.09%
EMBI GD HY	8.80%	707 bps	-0.14%
CEMBI BD	6.49%	484 bps	0.37%
CEMBI BD IG	4.79%	314 bps	0.29%
CEMBI BD Non-IG	9.57%	792 bps	0.50%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P500	13.8	–	-3.04%
1-3yr UST	0.71%	–	0.14%
3-5yr UST	1.22%	–	0.34%
7-10yr UST	1.82%	–	0.74%
10yr+ UST	2.66%	–	1.44%
10yr+ Germany	0.25%	–	0.74%
10yr+ Japan	0.05%	–	0.34%
US HY	9.91%	860 bps	-1.00%
European HY	6.47%	656 bps	-0.57%
Barclays Ag	–	227 bps	-0.01%
VIX Index*	23.38	–	3.18%
DXY Index*	97.06	–	-1.95%
EURUSD	1.1131	–	2.23%
USDJPY	116.60	–	3.77%
CRY Index*	161.93	–	-4.82%
Brent	33.4	–	-2.48%
Gold spot	1176	–	4.19%

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

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- Argentina: There have been major positive developments in Argentina's relations with holdout investors from the 2001 sovereign default. First, the government reached agreement with a significant proportion of holdout investors from Italy. Secondly, the government has struck a deal with two of the six remaining holdouts, which implies a payment of 70% of original principal plus past due interest for plaintiffs in the case and 70% of original principal for so-called 'me-toos' (investors with similar claims that have not been actively seeking legal redress). It remains to be seen if all the plaintiffs wish to accept the offer, or whether further rounds of talks are required in order to reach final agreement.

The new economic team in Argentina is very pro-market and very capable. The risk facing holdout investors if they choose not to agree to the deal is therefore that they are unlikely to find a more deal-friendly government, should this one fail. We view the news of the deal with holdout investors as very positive. If the economic team of the current administration has one weakness it would be that they are not politicians, so the key for success is to deliver economic growth as soon as possible. To that end, it is critical that the government strikes an early deal with the holdouts in order to get the economy going before the mid-term election (2017). A holdout deal looks likely to be approved in Congress, where the Peronists are split. For example, eighteen members of parliament belonging to Cristina Kirchner's anti-holdout deal faction of the Peronists absconded last week. A deal would open for new financing and therefore growth, which in turn would allow for more rapid tightening of monetary policy and a return of capital inflows.

The central bank is making good progress on inflation, slowing the rate of monetary expansion considerably by issuing central bank notes to soak up liquidity. A few near-term challenges could push up inflation, however, including union wage bargaining and the elimination of subsidies (although the latter has important positive fiscal benefits). One source of potential economic upside in Argentina is a very strong supply-response in

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agriculture, perhaps as much as 30% in volumes in the coming year. The policies of former president Cristina Kirchner destroyed agricultural exports with taxes and controls. Now, exports are benefitting from the weaker ARS, but all the penalties against exporters have also been lifted, so profitability has just gone through the roof.

- Indonesia: Growth was stronger than expected in Q4 2015. Real GDP expanded at a rate of 5.0% yoy in the last quarter of last year. The market had expected growth of 4.8% yoy. Many Asian economies are benefitting from much weaker currencies following the appreciation of the USD in the last few years. Indonesia additionally benefits from an aggressive infrastructure investment program.

- Russia: Inflation has now dropped back into single digits following a lengthy bout of FX pass-through after the dramatic series of falls in oil prices since mid-2014. The decline in the rate of inflation to 9.8% yoy was impressive, given the December reading of 12.9% yoy. Russia has had the most orthodox set of macroeconomic responses of any oil exporter in the world.

- Brazil: The gradual decline in core inflation in Brazil continued in January. Core IPCA moderated marginally to 9.02% yoy from 9.06% in December. The central bank will want to see faster moderation if it is to maintain rates at 14.25%. The Central Bank is focused on BRL, which has stabilized year to date following a strong decline in 2015. A stable currency would allow for lower pass through to inflation, limiting the need for further hikes. The government hopes that 14.25% will be enough, given that core inflation is beginning to come down. It also hopes that the collapse in imports will create a current account surplus that will shore up reserves and give the central bank more firepower to stabilise the exchange rate. The trade surplus in January reached USD 923m versus USD 500m expected, taking the 12 month surplus to USD 23.8bn from USD 19.7bn. There is no intention to change rates at all if it can be avoided. Like his predecessor, Finance Minister Nelson Barbosa will find it hard to approve anything dramatic on the fiscal front, i.e. he is simply in a holding role. There is no political capital for reforms. Brazil becomes an equity story if/when the markets believe that President Dilma Rousseff goes, e.g. via impeachment. Otherwise Brazil remains mainly a fixed income trade until there is more clarity about who comes in after 2018 (the end of Dilma's term).

- China: China's FX reserves dropped by less than expected in January. Reserves now stand at USD 3.23trn, down USD 99bn since last release (reserves had been expected to decline by USD 120bn). China has provided Dollars to its corporates in order to help them eliminate currency mismatches on their balance sheets. But borrowing costs have also declined in China as a result of the substantial rally in domestic fixed income, so Chinese corporates are now opting to refinance in RMB instead of USD. This results in a net outflow as corporates repay foreign debt, but the decline is exactly matched by the fall in China's external liabilities. As such, the declines in reserves observed now is not something to be worried about, in our view. In other news, SAFE, which manages China's FX reserves, has introduced new quota rules that scale quotas in accordance with the AUM of foreign managers, allowing up to a maximum of USD 5bn per manager. China has also made progress towards addressing impediments to the inclusion of China's A-share market in MSCI indices. Whereas China's financial reform focus last year was to gain RMB inclusion in the SDR basket, we think this year China will focus on obtaining entry to the main benchmark indices for its onshore markets, notably stocks, in a bid to dilute the retail participation. In turn, that should lead to more rational behaviour in the market. In another development, offshore RMB participating banks will now be allowed to participate in the China Interbank FX market. This will further increase participation in the Chinese market by foreign entities and should help to reduce price distortions.

People's Bank of China (PBOC), which sets interest rates, eased mortgage borrowing rules by lowering down payment requirements from 25% to 20% for first homes. Also, on the policy front the 2016 bond issuance programme for local and regional government bonds will be capped at the level of 2015. The program continues the process of replacing existing loans and short dated debt with lower interest, longer-dated bonds with greater liquidity and improved disclosure. This process is critical, because the domestic bond market is destined to become the main conduit of monetary policy in China as the country moves towards a model of consumption-led growth. Finally, China services PMI rose to 52.4% in January from 50.2 in December.

- Ukraine: The resignation of Ukraine's Economy Minister Aivaras Abromavicius last week is a negative development. Abromavicius blamed oligarchic influences within the government and we share this concern. The private interests of the oligarchs are increasingly likely to clash with the national interest, making it harder for the government to comply with IMF reform objectives. On the other hand, Ukraine debt is very under-owned and the IMF is not about to cut Ukraine loose anytime soon.

- Azerbaijan: Moody's ratings agency downgraded Azerbaijan's foreign and local currency debt ratings to Ba1 from Baa3, i.e. to sub-investment grade, with negative outlook. This follows Azerbaijan's downgrade to high yield by S&P last week. As such, Azerbaijan will exit the IG EMBI index as of 29 February, according to JP Morgan. Azerbaijan will remain within the broader EMBI indices. Some USD 44bn of assets is impacted by the downgrade. Azerbaijan waited far too long to recognise that the decline in oil prices was longer-lasting. As such, the country burned more than half of its FX reserves trying in vain to defend the currency.

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Snippets:

- **Czech Republic:** The central bank left rates unchanged.
- **Guatemala:** The trade deficit narrowed by 7.9% in 2015.
- **India:** The composite PMI rose to 53.3 in January from 51.6 in December. The Reserve Bank of India left rates unchanged at 6.25%.
- **Kenya:** FDI into Kenya overtook FDI into South Africa in January-November 2015, according to fDi Markets, an online portal tracking flows.
- **Malaysia:** The trade surplus in December was MYR 8bn, down from MYR 10.2bn in November.
- **Mexico:** The central bank left rates unchanged at 3.25%.
- **Pakistan:** IMF issues a positive verdict on Pakistan's economic outlook, predicting 4.5% growth in 2016 fiscal year.
- **Philippines:** Headline inflation slowed to 1.3% yoy in January from 1.5% yoy in December. Core inflation declined to 1.8% yoy from 2.1% yoy in December.
- **Uruguay:** Inflation reached 9.7% in January. This brings Uruguay very close to the level (10%), where wage increases are triggered. At this level, the central bank usually tightens policy. The trade deficit declined to just USD 60m in January compared to a deficit of USD 375m in the same month last year.
- **South Korea:** Inflation declined to 0.8% yoy in January from 1.3% yoy in December.
- **Thailand:** The Bank of Thailand left rates unchanged at 1.5%.
- **Turkey:** Inflation rose to 9.6% yoy in January from 8.8% yoy in December. This was mainly due to change in tobacco taxes. Core inflation was nearly unchanged at 9.6% yoy (9.5% yoy in December).

Global backdrop

Maybe markets have been a tad too bullish on the US? Non-farm payrolls took a major dive and Bill Dudley of the New York Fed last week reluctantly acknowledged that financial conditions have tightened. That is one way of putting it. Another would be that stock prices started declining last year and have continued to decline this year. Corporate defaults are also rising and manufacturing is in recession. Growth has slowed to a pace far slower than expected and the Fed's own forecasts for rate hikes this year now look completely off. The US faces a possible recession and asset price bubbles, at the same time. Conditions may warrant a change in the Fed's decision on interest rates, Dudley said. Indeed, the Fed is now testing how the financial system would cope with negative rates, having exhausted all other easing options.

The largest consensus positions in global financial markets are long US dollars, long US equities and long US credit.

No wonder markets are nervous at the start of 2016. The QE programs have gone on for so long and institutional investors have chased bubbles for so long that even the most hardened momentum jockeys are now questioning where returns are going to come from and this is rightly so. Ten years ago most investors would not have been seen dead with a portfolio of securities at current valuations, given the economic conditions and the limited room to ease in the event of a downturn. Elsewhere, a new poll shows that UK voters did not find Prime Minister David Cameron's proposal for EU reform sufficiently ambitious to make them want to stay within the EU. Cameron's referendum on EU membership counts as one of the most reckless examples of populism in Europe in recent times. Designed to put an end to infighting within the Conservative Party the referendum proposal may yet end up inflicting enormous economic losses on the entire UK economy.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.35%	-6.82%	-22.62%	-9.03%	-5.50%
MSCI EM Small Cap	0.12%	-7.76%	-15.73%	-4.99%	-4.02%
MSCI Frontier	2.66%	-4.36%	-16.03%	0.50%	-0.61%
MSCI Asia	-0.69%	-8.29%	-19.25%	-3.55%	-1.60%
Shanghai Composite	0.95%	-21.92%	-10.50%	7.11%	2.22%
Hong Kong Hang Seng	-2.24%	-16.60%	-29.55%	-8.59%	-5.37%
MSCI EMEA	-0.08%	-4.26%	-26.65%	-14.64%	-9.11%
MSCI Latam	0.49%	-4.12%	-31.96%	-21.26%	-14.01%
GBI EM GD	1.17%	1.52%	-14.71%	-9.86%	-2.99%
ELMI+	0.58%	-0.58%	-6.56%	-6.08%	-3.28%
EM FX Spot	0.80%	-0.48%	-16.50%	-13.47%	-9.48%
EMBI GD	-0.02%	-0.20%	-0.44%	1.53%	5.38%
EMBI GD IG	0.09%	0.91%	-2.19%	1.25%	4.79%
EMBI GD HY	-0.14%	-1.62%	2.28%	1.91%	6.30%
CEMBI BD	0.37%	0.01%	0.20%	1.87%	4.37%
CEMBI BD IG	0.29%	0.35%	-0.01%	2.54%	5.01%
CEMBI BD Non-IG	0.50%	-0.58%	0.72%	0.51%	3.24%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P500	-3.04%	-7.85%	-6.90%	9.82%	9.78%
1-3yr UST	0.14%	0.89%	1.07%	0.62%	0.76%
3-5yr UST	0.34%	2.04%	2.10%	1.84%	2.41%
7-10yr UST	0.74%	3.93%	2.88%	3.32%	6.12%
10yr+ UST	1.44%	6.76%	-0.20%	6.59%	11.16%
10yr+ Germany	0.74%	7.20%	0.89%	9.66%	11.41%
10yr+ Japan	0.34%	3.66%	7.40%	7.20%	6.15%
US HY	-1.00%	-2.79%	-8.68%	0.31%	4.16%
European HY	-0.57%	-1.30%	-1.36%	5.94%	8.40%
Barclays Ag	-0.01%	0.45%	-1.66%	2.88%	4.76%
VIX Index*	15.74%	28.39%	35.22%	79.57%	47.88%
DXY Index*	-2.56%	-1.60%	2.49%	20.95%	24.43%
CRY Index*	-2.89%	-8.07%	-27.98%	-46.21%	-51.98%
EURUSD	2.77%	2.48%	-1.71%	-16.72%	-18.30%
USDJPY	3.89%	3.10%	1.75%	-20.51%	-29.37%
Brent	-3.89%	-10.43%	-42.23%	-71.92%	-66.58%
Gold spot	5.14%	10.80%	-5.11%	-29.48%	-13.80%

*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

Bogota
T: +57 1 347 0649

Dubai
T: +971 440 195 86

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

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