Issued: 29 February 2016

WEEKLY INVESTOR RESEARCH

Ashmore

The China train is leaving – are you on board yet?

By Jan Dehn

China's dismantling of bond markets quotas is very good news, because fixed income investors now have a safer and better-yielding alternative to the bubble markets in developed economies. Argentina has sent a package of laws to Parliament that would, if passed, give permission to strike a final deal to end the holdout saga, which has kept the country out of global capital markets for fifteen years. India's domestic bonds are to settle on Euroclear as the second largest bond market in the Emerging Markets (EM) takes another step towards global capital market integration. Real wages and the current account deficit continue to fall faster than expected in Brazil. In the global backdrop section, G20 nations called for measures to safeguard financial stability and support growth, but they are running out of policy options.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.8	–	-0.09%
MSCI EM Small Cap	10.5	–	0.03%
MSCI Frontier	8.7	–	1.26%
MSCI Asia	10.3	–	-0.09%
Shanghai Composite	9.9	–	-3.24%
Hong Kong Hang Seng	5.6	–	-0.96%
MSCI EMEA	8.3	–	-0.24%
MSCI Latam	10.8	–	1.55%
GBI-EM-GD	6.86%	–	-0.19%
ELMI+	4.18%	–	0.28%
EM FX spot	–	–	-0.15%
EMBI GD	6.33%	454 bps	0.96%
EMBI GD IG	4.76%	289 bps	0.69%
EMBI GD HY	8.55%	689 bps	1.27%
CEMBI BD	6.44%	484 bps	0.46%
CEMBI BD IG	4.74%	315 bps	0.35%
CEMBI BD Non-IG	9.53%	792 bps	0.65%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P500	14.4	–	1.63%
1-3yr UST	0.80%	–	-0.07%
3-5yr UST	1.24%	–	-0.08%
7-10yr UST	1.75%	–	-0.11%
10yr+ UST	2.62%	–	-0.58%
10yr+ Germany	0.12%	–	0.88%
10yr+ Japan	-0.06%	–	2.50%
US HY	9.67%	836 bps	1.54%
European HY	6.58%	673 bps	0.47%
Barclays Ag	–	227 bps	0.28%
VIX Index*	19.81	–	-0.72%
DXY Index*	98.31	–	0.93%
EURUSD	1.0889	–	-1.28%
USDJPY	113.09	–	-0.15%
CRY Index*	161.67	–	2.04%
Brent	35.6	–	2.54%
Gold spot	1231	–	1.87%

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

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- **China:** China is making a habit of surprising markets, perhaps because the consensus is far too bearish about China. Following its qualification for inclusion in the IMF's SDR basket earlier than expected last year, China has removed the quotas that have until now restricted access for foreign institutional investors to its bond market. Almost all foreign real money investors will now be eligible to enter the market, including commercial banks, securities brokers, asset managers, pension funds, charitable funds, insurance companies, endowments and foundations and others. Access is now granted at registration rather than requiring pre-approval and foreign investors will be able to trade in the highly liquid interbank market, not just in the illiquid exchange traded market. Only a few minor obstacles – short minimum holding and withdrawal periods – now prevent Chinese government bonds from being included in the main benchmark indices. Investors should not waste time by not investing in this market, however. Today, PBOC announced that reserve requirements are reduced by 50 bps. China's markets are a juggernaut and the remaining obstacles to index inclusion will likely be overcome very soon, in our view.[1] King Canute famously did not succeed in holding back the tide; neither will the index providers.

At USD 1.5trn in size, the Chinese onshore government bond market is likely to enter JP Morgan's GBI-EM GD index with a hefty 10% weight. But China's bond market is more than an EM bond market. Due to China's enormous importance to all aspects of global economic activity and the RMB's inclusion in the SDR, we believe China's local currency bonds will soon feature in multiple other indices, including most Global IG and Developed Markets IG treasury benchmark indices.

Institutional investors with long investment horizons – insurance companies and pension funds and sovereign wealth funds – should bear in mind that China's economy – and therefore its markets – will be more than four times larger than those of the United States within the next 25 years. Size matters. We think it is inevitable

[1] It is a core view of ours that China's main capital market policy objective this year is to qualify for inclusion in the main benchmark indices. For more details, see China section of *"Fixed Income Outlook 2016"*, Annual Outlook 2016, January 2016.

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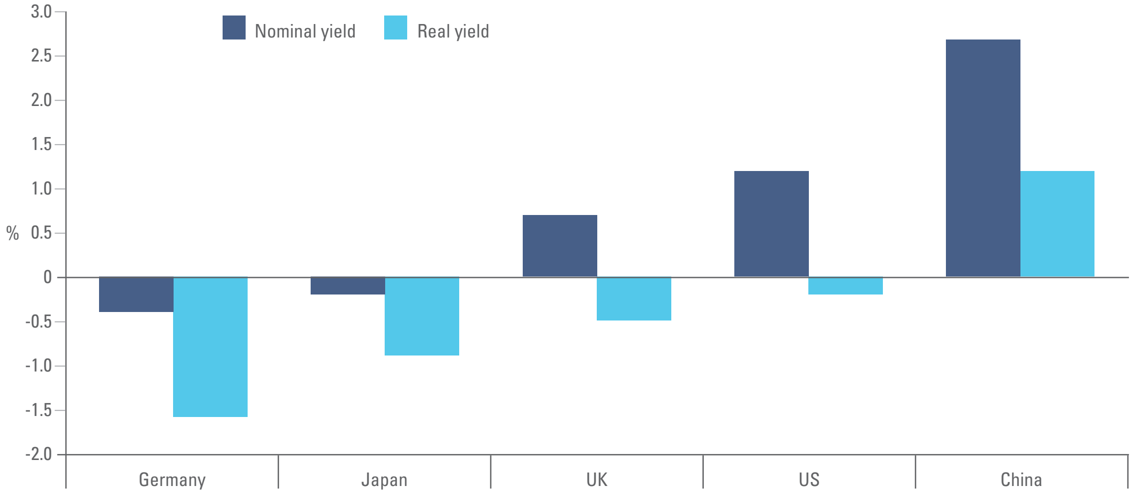
that the Chinese government bond market and the RMB will replace the US Treasury market and the USD as the world's preferred benchmarks for both government bonds and currencies, respectively. This prospect serves to highlight the amazing technicals that currently prevail in the Chinese government bond market, where, today, due to a combination of prejudice, ignorance and overly conservative and inflexible investment practices, most institutional investors still have no meaningful onshore exposure in China. As of November 2015, foreigners owned only 1.6% of outstanding local bonds compared to 30-40% of bonds in some other EM local markets, such as Indonesia and Mexico.

Fig 1: **5 year government bonds yields: China versus developed markets**



Source: Ashmore, Bloomberg.

The case for investing in Chinese bonds is not purely technical, however. There is also a value argument. Chinese government bonds offer a far superior risk-reward proposition to bonds in other major global reserve currency economies. Chinese 5-year bonds offer superior yields to those in Germany, the UK, Japan and the United States. Chinese bonds are also the only bonds in the SDR group to pay meaningful positive real yields.

China's government bonds also have value as a hedge against Quantitative Easing (QE). China still has one of the fastest growth rates in the world, very low levels of central government debt and huge external reserves. For every effort at monetary easing in the QE economies, China does a structural reform. And China remains the only significant member of the SDR basket not to engage in rampant money printing (QE). The outlook for RMB over the medium term is very bullish indeed, particularly versus the QE currencies.

The opening of China's capital account has been well flagged. Capital account liberalisation is a central avenue on the roadmap of reforms that the government has been pursuing for several years.[2] China's economic strategy rests on a basic assumption that the country's era of export-led growth is drawing to a close. This is the case because Western economies are too indebted to continue to consume at the same pace as they did in the past quarter of a century and because QE policies eventually push down the QE currencies versus the non-QE RMB. This is why China is turning to domestic demand, notably consumption.

The good news is that China has a bright future as a consumption-led economy by virtue of its 50% savings rate. The bad news is that China will face significant challenges in making the transition in the areas of macroeconomic control, productivity and capital account liberalisation. First, China must free up interest rates and developed bond markets in order to have an effective mechanism for controlling consumption. In effect, China will become more like the US economy. PBOC, just like the Fed, will control consumption by changing policy rates and the fixed income markets will transmit these changes in monetary policy to the wider economy.

Secondly, China must increase productivity. It is only possible to increase domestic demand without creating excess domestic demand, that is, inflation and unsustainable external deficits, by also increasing domestic supply, that is, by raising productivity. This is happening apace in China. Resource allocation by market mechanisms rather than dictate is a core tenet of the current five year plan and SOE reforms are ongoing (a number of new reforms were unveiled as recently as 25 February 2016). Innovation is increasingly protected by greater enforcement of intellectual property rights.

Thirdly, China is aware that rising consumption eventually dooms it to being a current account deficit country, just like the US. A current account deficit must be financed through the capital account in order to keep the overall balance of payments stable. This is why China is seeking global reserve currency status for the RMB: global reserve currencies usually get bought rather than sold during bouts of risk aversion, so achieving this status is highly desirable for any country opening the capital account.

[2] See *"Probably the best bond market in the world"*, The Emerging View, September 2014.

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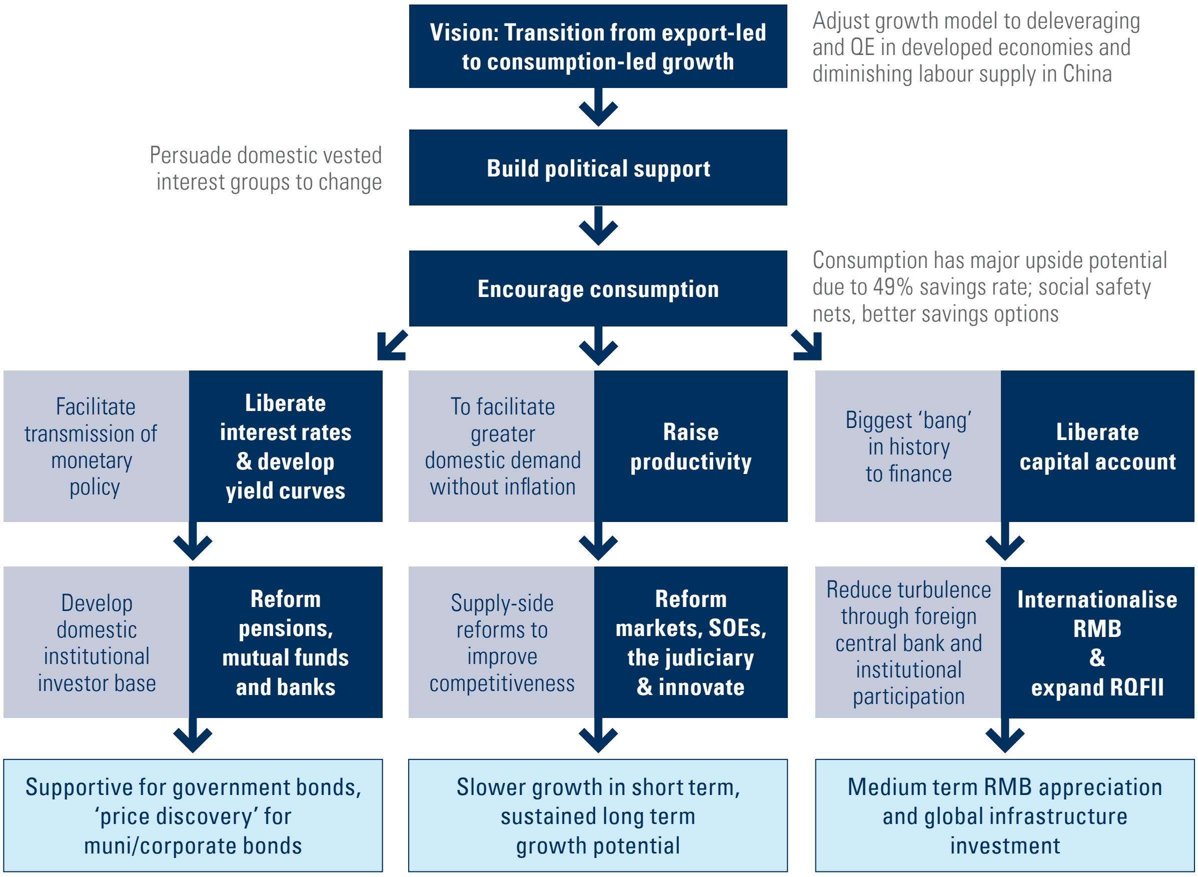
Emerging Markets

The central elements in the China roadmap are summarised in the chart below:



Source: Ashmore.

China's reform agenda is extremely ambitious and far-sighted. Financial market participants are, for the most part, far too myopic to recognise their importance, preferring instead to focus on the short-term challenges. Similarly, the rapid pace of change within China will inevitably dampen demand in the short term, particularly investment demand. It is precisely because of the cautious sentiment which prevails during the transition that we like the fixed income markets in China. But given that China's current challenges are transitional in nature, it is equally true that equity investors are likely to be rewarded handsomely if they begin to position for China's future as a consumption-led economy.

- Argentina: In a sign that a final deal with holdout investors is now very close, the government has sent a package of laws to the Lower House that would allow it to strike a deal with holdout investors. Passage would also enable the government to pay coupons to exchange bonds, whose debt service has been held in escrow since a US judge barred intermediary banks from processing debt service on Argentina's sovereign bonds last year. We expect Parliament to approve the laws by early March. Roughly 53% of Argentinians support a deal with holdout investors, according to a new poll. Argentina is likely to issue around USD 15bn in new bonds as part of the deal. We also expect issuance from Argentina's provinces. Argentina used to be the largest market for Dollar bonds in the whole of EM.

- India: The Union Budget in India maintained the 3.5% of GDP fiscal target for 2016-2017, a tightening relative to the current fiscal year's target of 3.9% of GDP. The budget allows for injection of capital in India's state banks. These are positive developments. In addition, the government and Euroclear have reached agreement to a formula that would allow Indian government bonds to be settled internationally. In addition to recapitalising state banks, the adoption of Euroclear settlement is an important preliminary step towards opening the Indian bond market to foreign investors. India still maintains quotas, but we think India is (slowly) moving in the same direction as China. India, like China, can realise massive potential upside from including their domestic markets in the global capital markets, in our view.

- Brazil: Moody's belatedly recognised that things have deteriorated a bit in Brazil by downgrading the sovereign two notches. Meanwhile, real wages fell at a pace of 9.9% yoy in January. The effect will be to push inflation down and shift the current account into surplus this year, in our view. IPCA core inflation was unchanged at 9.0% yoy in February and we expect core inflation to drop towards 7% during the course of 2016. The current account deficit in January was USD 4.8bn versus USD 6.0bn expected. FDI inflows were USD 5.45bn.

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Snippets:

- **Colombia:** The trade deficit widened to USD 15.9bn in 2015 from USD 6.3bn in 2014. Colombia has failed to sufficiently adjust domestic demand in response to lower oil prices.
- **Honduras:** The real economy expanded by 3.8% in 2015 compared to 2.7% in 2014.
- **Hungary:** The central bank left rates unchanged at 1.35%, but signalled future easing.
- **Jamaica:** The fiscal deficit in the first nine months of the fiscal year was 1.5% of GDP versus the government's target of 1.9% for the period.
- **Malaysia:** Inflation undershot expectations in January (3.5% yoy vs 3.7% yoy expected).
- **Mexico:** The current account deficit widened due to deterioration of the energy trade balance. Mexico has not undertaken as many domestic demand adjustments in response to lower oil prices as, say, Russia. Real GDP rose 2.5% yoy in Q4 2015 (in line with expectations). Retail sales were softer than expected.
- **Paraguay:** The January trade surplus surged by nearly 30% to 0.5% of GDP from 0.3% of GDP in January last year.
- **Singapore:** The economy expanded at a faster than expected pace in Q4 2015. The rate of growth was 6.2% qoq versus 4.5% qoq expected.
- **South Africa:** The government budget was received with scepticism in the market, but ratings agencies did not see the budget as relevant to South Africa's credit rating. The budget was austere, but the test comes with its implementation. There is an important conflict within the ANC government between more technocratically-minded party members and others that seek to hijack the state for their own ends.
- **Thailand:** The trade surplus narrowed to USD 238m in January from USD 1.49bn in December mainly due to falling prices of Thailand's exports, many of which are derivatives of oil.
- **Turkey:** The central bank left rates unchanged (repo rate at 7.5%, o/n lending rate at 10.75% and o/n borrowing rate at 7.25%).
- **Venezuela:** The government continues to identify new sources of finance that keeps the ability to pay intact. Last week, Venezuela raised as much as USD 5bn in a deal with a mining company, according to the government. Venezuela repaid the 2016 bond in full on Friday.
- **Zambia:** The government has approved help from the IMF to design the 2016 economic program.

Global backdrop

The G20 called for policy action to support global growth, but could offer no specifics. That, of course, is precisely the problem. Having cut rates, printed money, run fiscal deficits and accumulated debt, the easy options are gone. Asset prices have been successfully re-inflated, but the underlying problems are the same. The only difference is that we no longer have any policy room in case the economy subsides. Developed markets are a slow-moving train wreck.

German Finance Minister Schäuble's comments ahead of the G20 Summit are absolutely correct. He said that fiscal as well as monetary policies have reached their limits in developed countries, and that to grow sustainably, there are no shortcuts which avoid reforms. He added that talking about further stimulus just distracts from the real tasks at hand and said that the debt-financed growth model has reached its limits. It is even causing new problems, increasing further the debt load, causing bubbles and excessive risk taking and 'zombifying' the economy, according to Schäuble.

The debt mountain – with its promise of higher future taxes and/or inflation and currency debasement – lie at the very heart of the growth crisis facing developed economies today. Unfortunately, there is no appetite for anything other than more and more monetary easing. Indeed, the ECB is likely to offer even more monetary easing at its upcoming meeting on 10 March, particularly as German inflation rates have now dropped below zero. As for reforms, forget it. Politicians fear reforms, because reforms create major political opposition and would almost certainly also trigger recessions. More fiscal spending is always possible since governments can force pension funds and other institutional investors to buy even more of their negative yielding debt (financial repression), but with debt levels already through the roof in developed economies, this is hardly the stuff of sustainable growth.

The threat to global growth also has an important international dimension. Capital has been grossly misallocated on a global scale since 2008/2009. Global capital flows have proven far more sensitive to the lure of short-term stimuli than fundamentals with the result that more good money has been thrown after bad. Specifically, global asset allocators have chased QE-supported assets in the heavily indebted and reform-challenged developed markets by reducing exposure to the less indebted, faster growing and healthier economies in the non-QE markets, including EM. This disastrous misallocation of capital has predictably resulted in a major slowdown in global growth. Moreover, the longer it continues, the worse the outlook for global growth.

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Global backdrop

There is no imminent cliff-edge like Subprime in the immediate horizon in developed economies, though a sudden collapse of the QE confidence trick cannot be ruled out. Still, it is becoming more and more difficult to see how developed economies will ever regain their former dynamism when they continue down the path of stimulus over reforms.

There is a way out of this maze, however. Given the inability of developed economies to undertake major deleveraging and reforms, the only realistic way to get growth back is to channel global capital to where it produces more 'bang for its buck' in terms of growth. This can only be done with a change in the global currency framework, because currencies now guide so much of global capital. Sadly, in a classic Emperor's New Clothes moment, the G20 leaders completely failed to discuss currencies other than a bland statement about not engaging in competitive devaluations. This misses the point; the world is not devaluing, the US dollar is irrationally re-valuing.

This means that the most effective mechanism for restoring global growth today is halting and then reversing the irrational Dollar rally. This would stimulate global growth by channelling investable capital to the part of the global economy with potential to grow, stimulating US exports, manufacturing and the beleaguered energy sector and supporting equity prices by pushing up commodity prices.

It is an intellectual failure of gargantuan proportions that the G20 and the IMF still fail to recognise the central role played by currencies in the global misallocation of capital and the resulting adverse implications for global growth. The longer global leaders fail to address the currency issue, the worse the misallocation of global capital. A failure to address the issue eventually pushes the global economy into an even larger crisis than the one suffered in 08/09. But this time there will be absolutely no policy support available, so all the work will be done through a highly destructive and disorderly realignment of the global currencies.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.22%	-6.70%	-23.47%	-8.27%	-4.96%
MSCI EM Small Cap	-0.57%	-8.39%	-17.49%	-5.02%	-3.21%
MSCI Frontier	4.15%	-2.98%	-16.24%	1.14%	0.78%
MSCI Asia	-0.38%	-8.00%	-19.97%	-3.13%	-0.47%
Shanghai Composite	1.09%	-21.80%	-14.77%	9.30%	1.68%
Hong Kong Hang Seng	-2.49%	-16.82%	-32.25%	-6.76%	-4.76%
MSCI EMEA	0.38%	-3.83%	-27.44%	-13.24%	-8.97%
MSCI Latam	2.25%	-2.43%	-30.86%	-19.66%	-13.99%
GBI EM GD	1.02%	1.37%	-13.21%	-9.61%	-3.13%
ELMI+	0.42%	-0.74%	-6.82%	-5.83%	-3.34%
EM FX Spot	0.41%	-0.86%	-15.54%	-13.19%	-9.64%
EMBI GD	1.66%	1.47%	0.91%	2.06%	5.78%
EMBI GD IG	1.58%	2.41%	-0.89%	1.71%	5.07%
EMBI GD HY	1.76%	0.25%	3.57%	2.51%	6.84%
CEMBI BD	0.94%	0.58%	0.00%	1.82%	4.46%
CEMBI BD IG	0.79%	0.84%	0.11%	2.51%	5.10%
CEMBI BD Non-IG	1.22%	0.14%	-0.22%	0.41%	3.34%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P500	0.67%	-4.32%	-5.72%	11.49%	10.41%
1-3yr UST	0.16%	0.91%	1.13%	0.61%	0.74%
3-5yr UST	0.34%	2.04%	2.86%	1.78%	2.30%
7-10yr UST	1.29%	4.49%	4.98%	3.09%	5.85%
10yr+ UST	2.60%	7.99%	4.41%	6.18%	10.57%
10yr+ Germany	3.14%	9.75%	3.32%	10.05%	11.52%
10yr+ Japan	3.42%	6.84%	11.25%	7.68%	6.71%
US HY	-0.11%	-1.92%	-9.47%	0.44%	4.18%
European HY	-0.68%	-1.41%	-3.22%	5.53%	8.16%
Barclays Ag	0.32%	0.77%	-1.23%	2.67%	4.58%
VIX Index*	-1.93%	8.79%	48.50%	27.72%	7.96%
DXY Index*	-1.30%	-0.32%	3.17%	19.97%	27.86%
CRY Index*	-3.05%	-8.22%	-27.85%	-44.81%	-54.15%
EURUSD	0.54%	0.25%	-2.64%	-16.60%	-21.13%
USDJPY	7.12%	6.30%	6.23%	-18.15%	-27.69%
Brent	2.39%	-4.59%	-43.16%	-68.06%	-68.18%
Gold spot	10.11%	16.04%	2.03%	-22.05%	-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.

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