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Ashmore

Default rates for HY corporates move sharply in EM's favour

By Jan Dehn

Default rates are falling among Emerging Markets (EM) HY corporates, while they are rising among US HY corporates. EM FX reserves are rising again, including China's. Peru's first-round Presidential election appears to have produced a better than expected outcome with two pro-market candidates – Keiko Fujimori and Pedro Pablo Kuczynski – set to face off in a 5 June second round election. In Brazil, the focus is firmly on a possible impeachment vote against President Dilma Rousseff in the third week of April, while President Zuma's victory in the National Assembly's impeachment vote should not be regarded as a sign of strength. Ukraine's economy is looking better, but the recovery will only be sustainable if the political situation improves. The global backdrop is worsening as markets are growing increasingly concerned about limited options available to policy makers in the event of renewed weakness in developed economies.

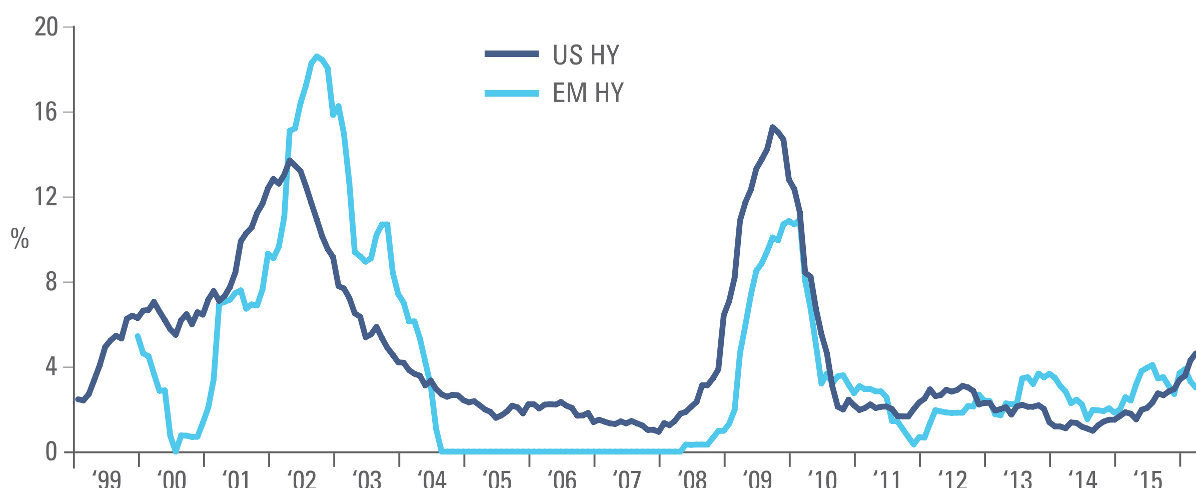
Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.6	–	-1.08%
MSCI EM Small Cap	11.3	–	0.14%
MSCI Frontier	8.6	–	-0.28%
MSCI Asia	11.0	–	-0.81%
Shanghai Composite	11.8	–	-0.63%
Hong Kong Hang Seng	6.5	–	-3.31%
MSCI EMEA	9.6	–	-0.09%
MSCI Latam	12.1	–	-2.83%
GBI-EM-GD	6.51%	–	-0.43%
ELMI+	3.99%	–	-0.17%
EM FX spot	–	–	-0.45%
EMBI GD	5.86%	412 bps	0.06%
EMBI GD IG	4.38%	257 bps	0.12%
EMBI GD HY	7.92%	631 bps	-0.02%
CEMBI BD	5.79%	425 bps	0.14%
CEMBI BD IG	4.36%	284 bps	0.15%
CEMBI BD Non-IG	8.24%	668 bps	0.12%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.2	–	-1.15%
1-3yr UST	0.71%	–	0.08%
3-5yr UST	1.17%	–	0.26%
7-10yr UST	1.73%	–	0.53%
10yr+ UST	2.57%	–	0.96%
10yr+ Germany	0.11%	–	0.58%
10yr+ Japan	-0.09%	–	0.44%
US HY	8.72%	754 bps	0.46%
European HY	5.56%	568 bps	0.11%
Barclays Ag	–	234 bps	0.47%
VIX Index*	15.36	–	2.26%
DXY Index*	94.19	–	-0.32%
EURUSD	1.1391	–	0.00%
USDJPY	108.13	–	2.97%
CRY Index*	171.04	–	3.01%
Brent	41.8	–	10.98%
Gold spot	1250	–	2.83%

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

Emerging Markets

Fig 1: **EM vs US high yield default rates**



Source: BAML, Ashmore.

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Emerging Markets

- **Corporate default rates:** EM High Yield (HY) default rates have improved by nearly 2% relative to US HY default rates in the first three months of 2016. While corporate default rates have declined outright in EM they have increased outright in the US. According to fresh data compiled by BAML – in our view the bank with the most comprehensive coverage of corporates – the default rate for EM corporate HY bonds fell from 3.88% in January of 2016 to 3.01% as of the end of March, while it rose for US HY corporate bonds from 3.57% to 4.62%. The long-term default rates in the two markets are 3.9% and 4.56%, respectively. Despite repeated and often shrill predictions of mass defaults among EM corporates due to a rising USD (the so-called FX mismatch problem) it would appear that US corporates are suffering more from a stronger USD than EM corporates. In fact, as the chart above shows EM corporate default rates have remained range-bound at or below their long-term average since 2010. The main oscillations in EM HY default rates over this period have been associated with episodes of sudden and dramatic financial tightening, such as the Taper Tantrum and market fears of the first Fed hike in mid-2015. In each of these episodes, however, default rates have subsequently returned to normal quite quickly. EM corporates are less sensitive to USD moves, because many EM corporates have revenues in USD, while others actively hedge their FX exposure. For more details on EM corporates see *"Switch to EM corporates from US corporates"*, The Emerging View, February 2016.

- **EM FX reserves:** New analysis from JP Morgan shows that EM countries ex-oil producers are now accumulating reserves again.[1] China's reserves also went up, though China is still experiencing moderating outflows via the capital account (see next item). JP Morgan finds that EM countries ex-oil producers – that is well over ¾ of all EM countries – accumulated reserves in Q1 2016. JP Morgan finds that the depletion of reserves among oil producers and China began to abate since Q3 2015, however. The stabilisation of EM's FX reserves is consistent with the view, we outlined in the November 2015 Emerging View (*"Nothing stays the same: EM's dramatic external rebalancing"*). As capital outflows wane and eventually reverse, we expect further reserve accumulation because EM countries have adjusted their current accounts significantly following major currency adjustments and lower domestic demand in recent years. Stronger external balances will have a positive impact on GDP (via net exports) as well as central bank reserves.

- **China:** FX reserves rose by USD 10.3bn in March, taking the total stock of reserves to USD 3.213trn. The loss of reserves last year was mainly due to three factors, which are now waning or being reversed outright. Firstly, the powerful FX valuations effects arising from the surging USD are now reversing somewhat as the USD rally has stalled. Secondly, USD debt repayments by Chinese corporates are slowing. Thirdly, speculation against CNH is clearly waning as the doomsday scenarios about China once again turns out to have been unfounded. In other news, China's services PMI index improved to 52.2 in March from 51.2 in February, while CPI inflation was unchanged at 2.3% yoy (versus 2.4% yoy expected). PPI inflation ticked up (+0.5% mom) for the first time in 30 months, taking the yoy print to -4.3% from -4.9%. This should be positive for upstream producers' profits. This week sees China release key macroeconomic data, including Q1 GDP, industrial production, trade balance, monetary financing numbers and retail sales.

- **Peru:** Keiko Fujimori won the first round of the Peruvian presidential election with early indications pointing to a runners-up place for Pedro Pablo Kuczynsky (PPK). The second round will take place on 5 June. The result of the first round, if confirmed, would be better than expected. Veronika Mendoza, a populist, had been showing good momentum in the polls leading up to the first round election, but appears to have faded at the last hurdle, based on exit polls and a partial vote count. A Keiko-PKK run-off would be welcomed by the market – both candidates are deemed to be market friendly.

- **Brazil:** All eyes on the third week of April – this is when Lower House President Cunha could call a formal vote on impeachment of President Dilma Rousseff. Between now and then, the government will try to mobilise as much support as possible by offering ministerial positions to members of smaller political parties. A number of cabinet posts are available after the PMDB party formally decided to abandon its participation with Dilma's PT led coalition. In particular, three small political parties (PP, PR and PSD) are being targeted by Dilma. Between them, they have some 120 seats that could prove critical to the outcome of the vote. Yet, the parties are far from unified. Some 35 out of 50 members of the PP party have declared support for impeachment, for example. With municipal elections in October and the Government extremely weak, it is a very large gamble for members of these parties to join the Government side right now. Impeachment would be very positive for prospects for reforms and hence economic recovery. Impeachment should therefore be viewed as positive for Brazilian equities in particular. However, fixed income is likely to remain attractive even if impeachment does not happen, because the economy is slowly stabilising and inflation is likely to fall. Indeed, the main IPCA inflation measure came lower-than-expected at 0.43% in March resulting in a sharp decline in the yoy print from 10.36% in February to 9.39%yoy. Core inflation averaged 0.44% mom in March versus 0.79% mom in February, resulting in a lower yoy core print as well (8.4% yoy in March from 9.0% yoy in February).

- **South Africa:** President Zuma survived an impeachment attempt with a decisive 243-143 majority in the National Assembly, but this does not imply that Zuma is out of the woods. The constitutional court has ruled that Zuma as well as the National Assembly failed in their constitutional duties to uphold the Public Prosecutor's recommendation to remedy the undue benefits Zuma obtained from state spending on his

[1] *"Flows and Liquidity: The Japanese equity/yen correlation"*, JP Morgan, 8 April 2016.

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Emerging Markets

private home. Impeachment in parliament is not the ANC way. What is more important is what the party itself decides, particularly the so-called 'Six' (ANC grandees) and the National Executive Committee (NEC). Within the ANC there are deep divisions and investigations are now underway into Zuma's relations with the Guptas, an influential family, and other issues. Both the Public Protector (an ombudsman office) and Gwede Mantashe, head of ANC, are undertaking independent investigations. It is within the scope of ANC's powers to replace a sitting president if they find the case compelling, but it is not in ANC's interest to replace Zuma unless it has a strong demonstrable case and a plan for succession.

- Ukraine: Policy risks and the real economy are showing signs of going in opposition directions. There are now clear green shots to be seen in the real economy with export and import volumes growing, industrial production picking up and consumption and real wages recovering. However, the government coalition in the Rada has split leaving the Poroshenko administration a lame duck. Prime Minister Yatzenyuk's resignation, announced at the weekend, may offer some room for Poroshenko to form a new administration by leaning on Volodymyr Groysman, Rada Speaker, which would be positive. The government needs to pass new fiscal measures in order to remain within the IMF program and obtain further disbursements. Poroshenko does not have many possible coalition partners available without turning to oligarchs, whose interests are private rather than national in nature, thus they do not favour deep reforms. One option is to call fresh elections, but polls suggest that new elections would weaken rather than strengthen Poroshenko. While the better economic data is encouraging, any green shoot will quickly wither unless the policy uncertainty is removed. In general, we are not bullish on the longer term outlook for Ukraine, which has failed to come to terms with deeply entrenched corruption.

Snippets:

- Argentina: The government is expected to start a road show this week to make the case for the bonds the sovereign wishes to issue in order to pay holdout investors. The bonds will to all intent and purposes mark the end of the Argentina debt crisis, which began with a spectacular default in 2001.
- Chile: Consumer prices rose just 0.4% in March. This was lower than expected (0.5% mom). The number was also lower than last year's March inflation rate of 0.6% mom. As a result, the yoy print declined to 4.5% last month from 4.7% in February. Core inflation eased to 4.8% yoy from 5.0% yoy.
- Colombia: Inflation was higher than expected in March. Inflation rose to 7.98% yoy from 7.59% yoy in February. Colombia has not been willing to sufficiently reduce domestic demand in response to lower oil prices, mainly due to political considerations (the government is close to striking a peace deal with the FARC. A deal would have to be approved in a referendum, hence the government's reluctance to inflict pain on the economy at this time.
- Croatia: The government is finally becoming aware of the country's slowly eroding credit quality. Finance Minister Maric said that the key goal for this year will be to improve Croatia's credit rating, which is on negative outlook from all three ratings agencies.
- Dominican Republic: President Danilo Medina has hinted at reforms of taxes and subsidies after the election scheduled for 15 May 2016. In particular, Medina aims to close tax exemption loopholes and reduce electricity subsidies. The latter has become more feasible due to lower oil prices.
- Hungary: Inflation surprised to the downside in March. The monthly rate of CPI inflation was -0.2% in March compared to +0.3% in February. The market had expected +0.1% inflation. The core inflation rate is a modest 1.3% yoy.
- India: The Reserve Bank of India cut rates by 25bps and cut the reserve ratio for banks from 95% to 90%.
- Malaysia: The trade surplus rose to USD 1.8bn in February from USD 1.2bn in January, mainly due to sharply rising exports (+20.3% qoq).
- Mexico: Core inflation was 0.36% mom in March versus 0.40% mom expected. The government submitted the preliminary 2017 Budget proposal to Congress. The proposal was orthodox.
- Philippines: Foreign exchange reserves reached USD 82.6bn at the end of March compared to USD 80.7bn at the end of 2015 and USD 80.5bn in March 2015. Core inflation was steady at 1.5% yoy in March.
- Russia: Inflation fell to 7.3% yoy in March from 8.1% yoy in February. The market has expected inflation of 7.5% yoy.
- Turkey: Inflation in March was 7.46% yoy, which was much lower than the consensus expectation of 8.2% yoy.

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Global backdrop

The release of the so-called 'Panama Papers' exposing the widespread use of overseas tax havens by the rich and powerful the world over will only further undermine confidence in establishment politicians and hence increase the risks of further economic populism, especially in developed countries where, for some strange reason, no one seems to price in such risks.

The market is also worried about the waning effectiveness of 'conventional' unconventional policies that have helped to stabilise conditions in developed economies since 2008/2009. What, exactly, will developed economies do if they run into renewed economic weakness? This is an extremely important question, because economic cycles are inevitable. A downturn will happen, sooner or later.

Developed economies therefore find themselves at an important juncture now. Having almost uniformly failed to fix their underlying economic problems during the QE period – such as excessive debt and falling productivity – will they now grab the bull by the horns and deal with the deeper economic issues, or will they double down on the populism and become even more interventionist?

Sadly, most indicators suggest that they will do the latter. On its part, the Fed continues to surprise to the dovish side as the US economy slumps. It is currently tracking just 0.1% annualised real GDP growth in Q1 (following a wider than expected trade deficit in Q1 and poor inventory data), which almost guarantees that the US growth for 2016 as a whole will be substantially softer than the average mediocre growth rate of just 2% in recent years. It is not encouraging for future growth prospects either that the leading US presidential candidates are increasingly committing themselves publicly to protectionism and other policies that are outright bad for growth.

In Japan, 'Abenomics' appears to be in deep trouble and JPY is finally, it seems, embarked upon the return leg of its 80 to 120 roundtrip versus the USD. And in Europe, populist pressures are splitting the European Union apart precisely at a time when European countries should be investing in building better institutions.

Most concerning of all, policy-makers in all three regions are running precariously low on political capital as well as policy options. Previously unimaginable policies, such as so-called 'Helicopter Money' – that is, direct financing of households or governments by central banks – are now openly being considered. As we have been maintaining for years, the end game that results from excessive reliance on monetary stimuli in ever more reckless forms in lieu of reforms and deleveraging is inflation and/or currency weakness. To hedge against these consequences, EM investors are in the right asset class. After all, there is not a single EM country undertaking such policies. As for those investors who still have the bulk of their money in developed countries regard this as (yet another) warning; there is still time to escape the crash zone, but the clock is ticking ever louder.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.33%	3.23%	-17.72%	-4.08%	-4.84%
MSCI EM Small Cap	-0.37%	0.59%	-13.86%	-1.74%	-3.11%
MSCI Frontier	-0.45%	-1.46%	-14.28%	0.92%	0.50%
MSCI Asia	-2.09%	-0.39%	-16.81%	0.73%	-0.77%
Shanghai Composite	-0.63%	-15.65%	-24.09%	13.44%	2.17%
Hong Kong Hang Seng	-3.31%	-9.87%	-33.00%	-2.21%	-5.27%
MSCI EMEA	-1.91%	10.80%	-17.32%	-7.99%	-8.39%
MSCI Latam	-3.14%	15.46%	-17.25%	-15.14%	-12.22%
GBI EM GD	-0.78%	10.15%	-5.14%	-7.58%	-2.66%
ELMI+	-0.69%	4.72%	-2.74%	-4.35%	-3.08%
EM FX Spot	-0.96%	4.72%	-9.73%	-11.73%	-9.36%
EMBI GD	0.18%	5.23%	2.82%	2.74%	6.13%
EMBI GD IG	0.28%	5.95%	0.98%	2.18%	5.57%
EMBI GD HY	0.06%	4.24%	5.50%	3.48%	7.00%
CEMBI BD	0.21%	4.10%	2.10%	2.68%	4.90%
CEMBI BD IG	0.20%	3.52%	1.84%	3.06%	5.50%
CEMBI BD Non-IG	0.22%	5.11%	2.42%	1.80%	3.82%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.53%	0.81%	0.50%	11.72%	11.39%
1-3yr UST	0.05%	1.18%	1.10%	0.68%	0.78%
3-5yr UST	0.21%	2.76%	2.63%	1.92%	2.49%
7-10yr UST	0.49%	5.28%	4.31%	2.92%	6.20%
10yr+ UST	1.18%	9.56%	3.73%	5.58%	11.28%
10yr+ Germany	1.22%	11.49%	0.88%	9.26%	12.86%
10yr+ Japan	1.95%	11.82%	15.69%	6.72%	7.97%
US HY	0.45%	3.72%	-4.53%	1.79%	5.11%
European HY	0.21%	2.49%	-0.02%	6.31%	8.97%
Barclays Ag	0.47%	3.86%	1.08%	3.30%	5.24%
VIX Index*	10.11%	-15.65%	22.10%	25.49%	-7.41%
DXY Index*	-0.42%	-4.50%	-5.18%	14.52%	25.49%
CRY Index*	0.30%	-2.90%	-21.22%	-41.01%	-53.27%
EURUSD	0.10%	4.87%	7.80%	-13.04%	-21.09%
USDJPY	4.11%	11.18%	11.10%	-7.81%	-21.76%
Brent	5.63%	12.20%	-27.72%	-59.88%	-66.26%
Gold spot	1.38%	17.78%	4.24%	-19.96%	-14.58%

*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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