Issued: 3 May 2016

WEEKLY INVESTOR RESEARCH

Ashmore

All's well in EM, but the global backdrop is messy

By Jan Dehn

Economic indicators were generally solid in most Emerging Markets (EM) during the past week. There were encouraging signs of a pick-up in economic activity in Chile, Mexico and even in Brazil, while Colombia's rate hike is positive for long-term macroeconomic stability. Ecuador and Sri Lanka, two EM countries with perennial fiscal issues, turned to the IMF for support, which should support asset prices. Following its successful relaunch into the global capital markets, Argentina is now focusing on macroeconomic stabilisation at home, in particular, getting control of inflation. Russia signalled that rate cuts are on the way, China's economy looks stable, South Africa's trade balance beat expectations and Venezuela's economic and political struggles continue as the opposition submits 1.85m signatures in favour of recalling President Nicholas Maduro from office. However, the global backdrop remains challenging for many investors. Most developments so far this year – including the falling USD, the rally in EM, a rising JPY, stronger growth in the Eurozone than in the US – fly in the face of deeply entrenched consensus views and current positioning.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.7	–	-0.38%
MSCI EM Small Cap	11.4	–	-0.22%
MSCI Frontier	8.8	–	1.35%
MSCI Asia	11.1	–	-1.45%
Shanghai Composite	11.9	–	-0.70%
Hong Kong Hang Seng	6.6	–	-1.99%
MSCI EMEA	9.6	–	0.96%
MSCI Latam	12.8	–	3.35%
GBI-EM-GD	6.40%	–	1.76%
ELMI+	4.30%	–	1.18%
EM FX spot	–	–	1.54%
EMBI GD	5.72%	384 bps	0.52%
EMBI GD IG	4.29%	234 bps	0.20%
EMBI GD HY	7.71%	594 bps	0.90%
CEMBI BD	5.55%	385 bps	0.53%
CEMBI BD IG	4.29%	259 bps	0.35%
CEMBI BD Non-IG	7.70%	599 bps	0.84%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.6	–	-0.29%
1-3yr UST	0.77%	–	0.16%
3-5yr UST	1.29%	–	0.26%
7-10yr UST	1.84%	–	0.34%
10yr+ UST	2.70%	–	0.26%
10yr+ Germany	0.27%	–	0.20%
10yr+ Japan	-0.12%	–	2.26%
US HY	8.01%	674 bps	0.88%
European HY	5.24%	534 bps	-0.17%
Barclays Ag	–	235 bps	0.25%
VIX Index*	15.07	–	1.11%
DXY Index*	92.10	–	-2.48%
EURUSD	1.1588	–	2.58%
USDJPY	105.62	–	-5.11%
CRY Index*	182.53	–	3.66%
Brent	46.3	–	1.18%
Gold spot	1302	–	4.67%

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

Emerging Markets

- **Chile:** Industrial production (IP) picked up in March, rising at a rate of 3.9% yoy despite adverse calendar effects. Like other commodity producing countries, Chile has had to adjust to lower income levels. Part of this adjustment has taken place via the currency. The strong IP data suggests that the adjustment is now well advanced and that there may be better times ahead for Chile's economy.

- **Mexico:** The gradual consumption-led expansion of Mexico's economy continues. Retail sales rose at a rate of 9.6% yoy in February, nearly double the rate of increase in January (5.2% yoy). Strong retail sales are now finding a counterpart in rising private sector credit, which increased at a rate of 11.2% yoy in March compared to 6.8% yoy in the same month in 2015. Compared to previous cycles, Mexico's economy is likely to be able to sustain a faster growth rate without running into inflationary problems due to the reforms undertaken early in the administration of President Peña Nieto. Other economic indicators also improved. Unemployment declined to 3.74% in March compared to 3.86% at this time last year, while Mexico's trade balance recorded a small surplus of USD 155m (better than the USD 250m deficit expected). The monthly economic activity indicator, IGAE, also showed positive 4.1% yoy growth, beating expectations, but manufacturing indices softened somewhat. The overall better economic picture helped to improve the public finances. The fiscal deficit declined to MXN 61.6bn in Q1 2016, one third lower than at the same time last year.

- **Brazil:** As noted last week, recent data releases have shown that economic activity may be bottoming out in Brazil, while inflation and external balances have already been improving for some time. Consistent with these observations, business confidence surged last week due to improved expectations for the future. The more positive sentiment is undoubtedly linked to the ongoing impeachment process, which could mark the end to a

Continued overleaf

Emerging Markets

protracted period of ineffective government in Brazil. A Senate Committee will vote on 11 May whether to adopt the impeachment trial against Dilma Rousseff. If the committee votes in favour – which we expect – then Dilma will have to step down from the presidency for 180 days and Vice-President Michel Temer will take over pending a final vote on the floor of the Senate. Meanwhile, back to the economy: The YTD trade surplus in Brazil reached USD 13.3bn following a better than anticipated trade balance in April (USD 4.9bn vs USD 4.7bn expected). This is actually the largest YTD trade surplus ever recorded since the start of the current data series (1989). The fiscal numbers in Brazil are still worsening, but last week's budget numbers, while poor, now also show signs of stabilisation. The primary deficit in March was BRL 7.9bn, which was far better than the consensus expectation of a deficit of BRL 9.9bn. In particular, it is encouraging that the yoy pace of decline in fiscal revenues is slowing. The pace of decline abated to -6% yoy in March from -13% yoy in February. The main problem is on the expenditures, where statutory obligations continue to put upwards pressure on spending, albeit at a declining pace. Spending thus increased 4% yoy in March compared to 8% yoy in February. Employment data, typically lagging the broader economy cycle, worsened as the number of unemployed reached 10.9% of the labour force. Against this backdrop, COPOM, Brazil's central bank's monetary policy committee, prudently left rates unchanged at 14.25%, but we expect rates to come down later in the course of 2016.

- Colombia: The Central Bank of Colombia (BANREP) hiked the policy rate by 50bps to 7%. This is good news. Colombia's national income has declined sharply due to falling oil prices, but the government has so far been reluctant to face the inevitable consequence: that domestic spending must also moderate. The recognition on the part of BANREP that domestic demand must now be adjusted in order to keep both inflation and external balances within acceptable bounds is encouraging news for long-term investors in Colombia. Officials indicated that the hiking cycle is not yet over.

- IMF: Sri Lanka, a country perennially challenged by its proclivity to fiscal profligacy last week struck an agreement with the IMF that could unleash some USD 1.5bn in financial support over the next three years. In exchange for IMF concessional funding, Sri Lanka must improve fiscal revenues, reform state-owned enterprises and move the currency to an inflation targeting regime. The IMF program should be supportive for bonds, in our view. Another fiscally challenged economy, Ecuador, also requested IMF support following a recent devastating earthquake. The Ecuador program is also likely to be accompanied by reforms.

- Argentina: Argentina has successfully resolved the holdout issue, the Argentinian government is moving on to the next phase in a broader program designed to resuscitate the economy from years of mismanagement under the previous Kirchner administrations. Central Bank Governor Federico Sturzenegger announced last week that an official inflation targeting regime will come into effect in September under which the central bank will aim to bring inflation – currently about 35% in the Buenos Aires area – down to about 5% by 2019. Inflation targeting regimes have been extremely successful across the bulk of EM countries. It is essential for the government to increase the credibility of the peso in order to re-open the domestic bond market, which is destined to become the cornerstone of the financing policies of the government. This will involve the curtailment and eventual elimination of direct financing of the government by the central bank (Helicopter Money), which is Argentina's principal cause of high inflation. The restoration of access to external debt markets has given the government other means of financing while the monetary excesses of the past are reversed. In addition to new financing sources for the government, the central bank will hope for an improved supply of Dollars due to better conditions for exporters. It is therefore a positive development that the Argentinean Chamber of the Oil Industry (Ciara) and the Cereals Exporters Center (CEC) reported that revenues from grain exports rose 15.4% to USD 681m last week. Argentina's soy exporters, it seems, have begun to sell their harvest on global markets. The trade deficit in Q1 was USD 381m, down 68% compared to the trade deficit in Q1 2015.

- Russia: The Central Bank of Russia (CBR) signalled last week that if inflation continues to fall at the current pace, then it will be willing to resume rate cuts. CBR nevertheless kept the policy rate unchanged at 11%. Inflation has been falling sharply recently, while the RUB has found support on the back of stabilising oil prices. Russia's central bank has managed the oil shock better than most central banks in oil exporting EM countries. Despite austere policies, one poll last week showed President Vladimir Putin's approval rating at 82%.

- China: Both services and manufacturing PMIs softened mildly in April, but remained above the 50 level, which separates expansion from contraction. The Caixin manufacturing PMI number softened to 49.4 in April, however. This compares to 49.7 in March. The Caixin PMI mainly captures SMEs rather than the large companies that dominate the official PMI. Despite the mixed picture in manufacturing, industrial profits rose 11.1% yoy in March, up from 4.8% yoy in the January-February period. The broadly solid numbers should lead to the conclusion that policy makers are comfortable with the pace of growth. This suggests that reforms to transform China's economy from an export to a domestic demand led economy will continue.

- South Africa: The trade data in March was far better than expected. Instead of a deficit of ZAR 1.9bn, which was expected by the consensus, South Africa clocked up a trade surplus of ZAR 2.9bn, led by a strong 6.3% mom surge in exports. In other news, a South African court has criticised a decision by prosecutors to drop charges of corruption against President Zuma back in 2009 and now urges that the charges be reinstated.

Continued overleaf

Emerging Markets

- **Venezuela:** Opposition politicians have submitted 1.85 million signatures to the National Electoral Council (CNE) calling for the commencement of a process of recalling President Nicholas Maduro from office. A similar recall referendum took place against former President Hugo Chavez more than a decade ago. Chavez easily survived, but President Maduro lacks his predecessor's charisma and presides over a much weaker economy. Maduro may therefore find it harder to survive politically. For that reason, he is likely to lean even more heavily on institutional support from his allies in the Supreme Court and at the CNE. Jorge Rodriguez, mayor of Caracas, has been put in charge of verification of the signatures. Rodriguez was also in charge of the Chavez recall referendum, where he proved adept at manipulating the process. The Supreme Court last week ruled an attempt by the National Assembly to shorten Maduro's term unconstitutional. Meanwhile, in a sign of the severe ineptitude of the government in terms of delivering basic services, the working week for civil servants was reduced to just two days last week in response to electricity shortages.
- **Peru:** The latest polls place Keiko Fujimori and Pedro Pablo Kyczynski neck and neck with 43% of voting intentions each ahead of the 5 June run-off presidential election. Both candidates are market friendly. Inflation was non-existent in April. The market had expected prices to rise 0.17% during the month.
- **Dominican Republic:** As the 15 May presidential election draws nearer, the latest polls show a strong margin in favour of incumbent President Danilo Medina (63%) over his main rival Luis Abinader (29%). Medina has presided over a strong economic expansion, which continued in Q1 2016 when the economy expanded 6.1% yoy.

Snippets:

- **El Salvador:** Trend growth accelerated marginally from 1.1% yoy in January to 1.2% yoy in February.
- **Hungary:** The central bank cut rates by 15bps to 1.05%.
- **Indonesia:** Inflation was 3.6% yoy in April versus 3.8% yoy expected. Core inflation is running at a comfortable 3.4% yoy.
- **Panama:** Trend growth accelerated to 4.5% yoy in February from 4.4% in January.
- **Singapore:** Industrial production declined -0.5% yoy in March compared to -2.6% yoy expected.
- **South Korea:** Industrial production declined 2.2% mom. Real GDP growth slowed to 2.7% yoy in Q1 2016. Inflation is running at 1% yoy in April, unchanged from March.
- **Taiwan:** The economy's rate of expansion slowed to just 0.2% qoq (sa) in Q1 from 0.5% qoq (sa) in Q4 2015. The main PMI manufacturing index dropped from 51.1 in March to 49.7 in April.
- **Thailand:** The trade surplus was 4.7% larger in March than at this time in 2015. This meant that the overall balance of payments was in surplus to the tune of USD 3.2bn. On the inflation front, Thailand finally escaped more than a year of outright deflation when headline CPI popped up to a modest 0.1% yoy.

Global backdrop

Alongside the Chinese RMB's appreciation versus the USD last week, Japan's central bank's reluctance to countenance further measures to weaken the JPY despite lower than expected inflation fits neatly into the hypothesis – so far not formally acknowledged in government circles – that an informal Dollar Accord has been struck among G20 countries.

The alleged purpose of a Dollar Accord is to limit the rise of the Dollar, which has become a threat to global growth. The rising Dollar has damaged EM growth for several years, albeit without causing major crises (except perhaps among investors) and in the last twelve months the rising Dollar has also started to hurt the American economy.

In the first few years following the Developed Market Crisis (DMC) of 2008/2009, the US was happy to see the Dollar rise. The US did not pay much attention to the adverse consequences of the rising Dollar for other countries and was happy to see capital stream back into its economy.

By 2015, however, the USD had become a victim of its own success. The Dollar's impact on commodity prices, US trade and manufacturing competitiveness began to hurt the US economy. US interests now became aligned with those of other countries in favour of limiting Dollar appreciation.

The USD has fallen against most other currencies since the 26-27 February G20 Summit in Shanghai. Ashmore argued ahead of the summit that the time has arrived for a US Dollar accord (see the Market Commentary of 10 February 2016).[1]

Unfortunately, investors did not catch on to this important change. This has left global markets extremely unsettled. Emerging Markets are outperforming developed markets; the US Dollar is falling against most other developed market currencies, notably against JPY. EM FX is up against the Dollar year to date. The Eurozone

[1] *"The time for a Dollar Accord has arrived"*, Market Commentary, 10 February 2016.

Continued overleaf

Global backdrop

is growing faster than the US economy. None of these developments are consistent with the consensus views of global investors, who remain long the Dollar, short EURs, short JPY and of course short EM. Large positions have been established in all these trades, so the technicals remain challenging for the consensus. This means that current conditions could continue for longer than many expect. The FOMC certainly did not do anything last week to change sentiment; the committee explicitly failed to commit to a hike in June following weak durables and ISM, rising inventory ratios, weakening imports and softer consumer confidence.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.53%	5.73%	-17.87%	-4.37%	-4.44%
MSCI EM Small Cap	-0.45%	2.03%	-15.62%	-2.74%	-2.98%
MSCI Frontier	-0.20%	1.80%	-13.26%	1.27%	0.86%
MSCI Asia	-0.22%	0.60%	-18.47%	-0.55%	-0.81%
Shanghai Composite	-2.16%	-16.95%	-32.80%	13.39%	2.67%
Hong Kong Hang Seng	-0.71%	-7.44%	-36.13%	-2.83%	-4.25%
MSCI EMEA	-0.80%	16.36%	-15.13%	-7.10%	-7.49%
MSCI Latam	-1.39%	24.59%	-13.21%	-12.96%	-10.53%
GBI EM GD	-0.27%	13.56%	-1.84%	-7.07%	-2.50%
ELMI+	-0.08%	6.31%	-2.41%	-4.06%	-3.17%
EM FX Spot	-0.25%	6.71%	-8.30%	-11.15%	-9.31%
EMBI GD	-0.03%	6.87%	4.44%	2.84%	6.26%
EMBI GD IG	-0.05%	6.97%	2.91%	2.06%	5.56%
EMBI GD HY	-0.02%	6.59%	6.46%	3.85%	7.31%
CEMBI BD	0.06%	5.74%	2.93%	2.97%	5.03%
CEMBI BD IG	0.06%	4.41%	2.61%	3.09%	5.43%
CEMBI BD Non-IG	0.05%	8.05%	3.22%	2.54%	4.29%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.78%	2.54%	0.89%	11.52%	11.21%
1-3yr UST	-0.01%	1.05%	1.03%	0.61%	0.69%
3-5yr UST	-0.08%	2.23%	2.53%	1.65%	2.08%
7-10yr UST	-0.30%	4.11%	4.58%	2.23%	5.41%
10yr+ UST	-0.82%	6.48%	6.07%	3.91%	9.66%
10yr+ Germany	0.37%	8.02%	1.01%	7.87%	11.32%
10yr+ Japan	1.09%	13.78%	17.65%	8.44%	8.03%
US HY	0.00%	7.19%	-1.93%	2.21%	5.62%
European HY	-0.07%	3.90%	1.30%	6.14%	9.05%
Barclays Ag	-0.18%	4.25%	2.82%	3.05%	5.00%
VIX Index*	-4.01%	-17.24%	18.66%	17.28%	-9.76%
DXY Index*	-1.06%	-6.63%	-3.36%	12.14%	25.92%
CRY Index*	-1.13%	3.62%	-19.93%	-37.10%	-50.00%
EURUSD	1.24%	6.74%	3.97%	-11.64%	-21.84%
USDJPY	-0.76%	-12.03%	-12.08%	6.69%	30.49%
Brent	-3.84%	24.14%	-30.36%	-55.58%	-62.20%
Gold spot	0.66%	22.62%	9.52%	-11.51%	-15.27%

*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.

Continued overleaf

Ashmore

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

Other locations
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2016.

Important information: This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised and regulated by the Financial Conduct Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. Past performance is not a reliable indicator of future results. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment.