# EM's NIIP – a natural macro hedge

By Jan Dehn

Every time investors get scared and decide to sell EM, they strengthen EM's net international investment position. This provides a powerful short-term fundamental hedge, which forms part of the resilience which has enabled EM corporate and sovereign issuers to withstand multiple external shocks over the last couple of years without excessive fundamental stresses. The hedge, however, is ultimately vulnerable. EM's developed market assets offer increasingly lower return potential and increasing risks. What is a useful hedge in the short-term may turn out to be a serious liability for the longer-term.

| Emerging Markets | Next year forward PE/Yield | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| MSCI EM | 10.3 | – | -1.32% |
| MSCI EM Small Cap | 10.9 | – | -1.37% |
| MSCI Frontier | 9.0 | – | -0.14% |
| MSCI Asia | 10.8 | – | -0.50% |
| Shanghai Composite | 11.5 | – | 0.00% |
| Hong Kong Hang Seng | 6.3 | – | 0.03% |
| MSCI EMEA | 9.2 | – | -2.06% |
| MSCI Latam | 12.2 | – | -3.55% |
| GBI-EM-GD | 6.59% | – | -1.85% |
| ELMI+ | 4.37% | – | -1.06% |
| EM FX spot | – | – | -1.33% |
| EMBI GD | 5.83% | 397 bps | -0.80% |
| EMBI GD IG | 4.41% | 248 bps | -0.91% |
| EMBI GD HY | 7.82% | 606 bps | -0.67% |
| CEMBI BD | 5.61% | 391 bps | -0.29% |
| CEMBI BD IG | 4.32% | 263 bps | -0.40% |
| CEMBI BD Non-IG | 7.80% | 609 bps | -0.10% |

| Global Backdrop | Next year forward PE/Yield/Price | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| S&P 500 | 15.4 | – | 0.35% |
| 1-3yr UST | 0.88% | – | -0.26% |
| 3-5yr UST | 1.37% | – | -0.57% |
| 7-10yr UST | 1.84% | – | -1.10% |
| 10yr+ UST | 2.63% | – | -1.39% |
| 10yr+ Germany | 0.15% | – | -0.69% |
| 10yr+ Japan | -0.09% | – | 0.38% |
| US HY | 8.01% | 670 bps | 0.30% |
| European HY | 4.96% | 523 bps | 0.13% |
| Barclays Ag | – | 235 bps | -0.64% |
| VIX Index* | 15.79 | – | 1.11% |
| DXY Index* | 95.31 | – | 0.74% |
| EURUSD | 1.1204 | – | -1.03% |
| USDJPY | 109.60 | – | 0.53% |
| CRY Index* | 184.21 | – | 1.66% |
| Brent | 48.3 | – | -1.29% |
| Gold spot | 1251 | – | -1.85% |

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

## Emerging Markets

Fig 1: **EM's Net International Investment Position (NIIP)**
USD bn (unless otherwise indicated)

| | 2014 | 2015 | Change | % change yoy |
|---|---|---|---|---|
| **EM holdings of DM assets** | 26,510 | 26,452 | -58 | -0.2% |
| **DM holdings of EM assets** | 24,801 | 23,711 | -1,090 | -4.4% |
| **EM NIIP** | 1,708 | 2,741 | 1,033 | 60% |

Source: ICBC Standard Bank, Ashmore.

Emerging Markets (EM) countries have accumulated a significant positive net international investment position (NIIP) with respect to developed economies over the last couple of decades.[1] In a nutshell, they have invested a great deal more in developed economies than the other way around.

EM's positive NIIP acts as an important macroeconomic hedge during bouts of risk aversion and strong Dollar rallies. EM's NIIP increases sharply during such episodes, dulling both the financial and economic impact of irrational investor behaviour. EM's NIIP behaves in a counter-cyclical fashion for two reasons: first, developed market assets tend to rise in value during risk aversion events as investors seek to increase their exposure to Dollars and other developed markets investments; second, risk aversion often causes foreigners to withdraw funding for EM issuers, which therefore reduces overall EM liabilities.

This natural hedge is clearly very positive for EM countries, but the magnitude of the hedge is probably not fully appreciated. New data compiled by ICBC Standard Bank – see figure 1 above – shows that in the course of the market panic ahead of the start of the Fed hiking cycle in 2015 EM's NIIP increased by no less than

[1] EM's net international investment position is calculated as the sum of EM investors' holdings of direct investments, financial investments, credit and reserve assets in developed economies minus developed market investors' holdings of the same groups of securities in EM.

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**Emerging Markets**

USD 1.03trn from USD 1.71trn at the end of 2014 to USD 2.74 by the end of 2015. This is a whopping 60% increase in a single year.[2] To put the improvement in EM's NIIP into context, consider that EM corporates and sovereigns bonds total just USD 14.8trn (as of the end of 2014) of which only USD 2.1trn are foreign currency denominated bonds.

Most of the improvement in EM's NIIP in 2015 was due to sharply falling EM liabilities, that is, developed market borrowers reducing their financing activities within EM economies. Financing to EM declined by USD 1trn in the course of 2015, much of which, of course, was due to currency valuation effects, while another large chunk was due to refinancing from USD to RMB by Chinese corporates. Still, the decline in foreign financing of EM entities was meaningful and it is testament to EM's strong underlying fundamental resilience that the withdrawal of financing from EM occurred without major deterioration in EM's credit fundamentals. Indeed, EM corporate HY default rates have actually declined from the middle of 2015 onwards. Today, EM HY default rates stand at just 3.0% compared to, say, 4.6% for US HY corporates (despite the existence of abundant financing in the US). EM sovereign defaults have been and remain very low.

Investors should obviously be comforted by these figures. Nevertheless, all is not as well as it seems. EM's investments in developed economies may offer false comfort. In 2015, these investments did not do well despite the flight of capital out of EM into developed economies. In fact, the value of EM's investments in developed economies declined in 2015 by a total of USD 57bn. This performance sends a sobering message that developed markets investments may no longer be the quality hedges they once were.

In fact, EM's NIIP with respect to developed economies may eventually turn out to be a serious liability. For the most part, developed economies have not coupled their central banks' asset purchase programs with meaningful deleveraging and structural reforms. Today more than 50% of European bonds pay negative yields, while US stock markets had negative returns last year and have not done much better so far this year. In addition to lower returns, risks are arguably rising in developed markets. For example, in the event of another economic downturn – inevitable at some point – developed market central banks have no more conventional easing options at their disposal. They will therefore be forced to adopt negative rates or Helicopter Money in order to support their economies. This means inflation and currency debasement. The effect on the purchasing power of EM's investments in developed market assets would be devastating. EM central banks whose reserves are invested almost exclusively in the four QE currencies of JPY, GBP, EUR and USD would be particularly exposed. EM FX reserves comprise one third of EM's total exposure to developed economies.

The worrying reality is that EM investors, including EM central banks, have tended to behave in almost the same way as investors in developed economies. They have simply found the enormous gravitational pull caused by QE purchases by developed market central banks irresistible and have piled into QE assets and financed these operations by reducing exposure to non-QE markets, including EM. In fairness, it has been hard to resist. After all, the combined QE asset purchases by the four QE central banks has absorbed more than 10% of all outstanding corporate and sovereign bonds in developed economies. At the same time, the QE programs did not buy a single EM bond, so the impact on relative prices has been significant.

But given current valuations, the markets are increasingly showing that the QE trades that have worked well for several years are losing steam. It is therefore time for investors in developed markets and EM alike to pay attention and considering changing their allocations.

The right thing to do now is to take profits on the QE trades and allocate to the non-QE markets, including EM. EM economies have not only survived several severe bouts of financial tightening in the last few years (Taper Tantrum, Dollar surge, commodity price collapse and the start of the Fed hiking cycle), but they have done so with low default rates and improving NIIPs. By contrast, developed market valuations have been re-inflated by policies that only provide short term relief against a backdrop of neglected reforms, rising debt levels, increasing populism and deteriorating NIIPs. EM assets today pay high yields and EM currencies are cheap following the giant portfolio shift induced by QE over the last few years. Developed market assets are extremely expensive.

The turn-around in favour of EM fixed income has already begun, but there is still time to get out of the developed market crash zone, though it is advisable to do so early before the herd starts moving. Better to leave in an orderly fashion than to get trampled in the stampede.

- Hungary: The improvement in EM's external balances – one of the dramatic consequences of the stronger Dollar over the last few years – is now finally gaining some recognition even in least likely of all places, namely the ratings agencies. Last week, Fitch Ratings upgraded Hungary's long-term foreign currency sovereign rating back to the investment grade, assigning a rating of BBB- from BB+ previously, with stable outlook. Fitch cited both lower debt levels and current account surpluses since 2010 – the year the Dollar surge against EM currencies began – as reasons for raising Hungary's rating to investment grade.

- Argentina: President Macri is likely to veto a bill passed by the Lower House that would prohibit staff layoffs within six months of hiring and double severance pay. The bill was promoted heavily by parliamentarians with close ties to Argentina's unions, but also won support from a number of Peronists. This underlines the deep structural problem in Argentina's politics, where unions operating in the greater Buenos Aires region (1/3 of

[2] David Spegel, 2016, Global EM credit ratings and fundamental forecasts and refunding risks through 2021, ICBC Standard Bank.

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**Global backdrop**

the population) and Peronists backed by provincial governments (where the remaining 2/3 of the population lives) have historically conspired to extract rents from the central government. This type of rent seeking has historically eroded the central government's popularity and ultimately saddled it with excessive expenditures and debts and pushed it into bankruptcy and default. This political dynamic, which is clearly perverse, is the root of Argentina's legacy as a serial defaulter and we expect it to become more pronounced over the coming years. The good news, for now, however, is that President Macri is likely to veto the bill and that parliament is unlikely to muster the two thirds majority required to overturn his veto. The other silver-lining is that Argentina today has an extremely benign debt profile, which means that it will take many years before the government is pushed into default again. In fact, we expect the economy and the public finances to improve rather than deteriorate in the next couple of years. In a positive development for the local market, the central bank cut the 35-day Lebac policy rate by 75bps from 37.5% to 36.75%. Needless to say, at current levels there is still some room for rates to decline as inflation is gradually reined in.

- Turkey: Binali Yildirim, currently Turkey's transport minister, has been put forward as candidate for the job of Turkey's next Prime Minister. He has also been elected as chairman of the AK party. He is unopposed as candidate for Prime Minister. Yildirim is likely to be strongly supportive of President Erdogan's ambition to push Turkey along the path of an Asian model of development, with Erdogan himself at the helm of course. Erdogan's development model envisages Turkey investing heavily in infrastructure, wherefore Yildirim, with his transport experience, fits the bill. Unfortunately, Turkey has very low savings rates, so funding for investment will be dependent on less than reliable foreign portfolio flows rather than domestic savings. Looking ahead, one of the big questions for investors as Yildirim prepares to take office is whether Erdogan's government will seek to formally increase the institutional powers vested in the presidency – say, through a change in the constitution – or merely be content to rely on Erdogan current powerbase, whose twin pillars are the Cabinet and his popularity within the AK party. The other big question facing investors is whether market-friendly Mehmet Simsek, deputy prime minister in charge of the economy, will remain within a Yildirim cabinet.

- China: The largest and third largest banks in the world, which happen to be Chinese, have started to issue short-dated paper denominated in CNY in the United States. This development, which was picked up in an article by Carolyn Cui of the Wall Street Journal, is important. Chinese banks are obviously not issuing RMB denominated securities in the United States for funding reasons. Both banks are high quality institutions that are easily able to finance in RMB at home. The issuance should therefore be understood in a different light. First, the paper is being issued in order to meet a particular demand, most likely corporate hedging. The RMB has become more volatile as part of the process of SDR inclusion, so financial and non-financial corporates alike will have greater hedging needs. Secondly, the paper helps to fill in gaps in the short end of the offshore corporate RMB yield curve, which thus helps to complete the requirements for SDR inclusion. Conclusion: China's determination to make the RMB a global reserve currency is completely undiminished.

- Colombia: The trade deficit in March was USD 1.1bn. This took the trade deficit for Q1 2016 to USD 3.6bn, which is an improvement from USD 4.0bn in the same quarter of last year. Still, the trade deficit remains wide in comparison with many other EM countries that have seen their external balances improve sharply in recent years. Colombia, however, has until recently been reluctant to drive down domestic demand despite lower oil prices. But this may now be changing. Recent rate hikes are likely to translate into better external accounts over the next twelve months, albeit at the expense of domestic demand. Industrial production growth slowed to just 1.4% yoy in March from 8.2% yoy in February. Retail sales also decelerated.

- Brazil: After months of improvement in core inflation rates, mid-month inflation in April provided a clear setback when core inflation went up to 7.6% yoy from 7.2% yoy last month. New budget measures are due to be unveiled tomorrow. Finance Minister Henrique Meirelles last week injected realism into the government's fiscal projections when he revised the government's expectation for the primary deficit to BRL 170.5bn (2.8% of GDP) from BRL 104bn previously.

- Philippines: The economy just racked up the strongest rate of growth since 2010. At 6.9% yoy, the Q1 2016 growth rate accelerated from 6.5% yoy in Q4 2015. Philippines' growth is driving by solid domestic demand. The strong growth performance shows that the recent election did not give anyone within the Philippines much reason to worry.

- Russia: Industrial Production (IP) was 0.5% higher in April relative to the same month in 2015, and much stronger than in March (-0.5% yoy). The consensus had expected a contraction of 0.5% yoy. Real GDP contracted 1.2% yoy in Q1. This was much better than both the Bloomberg consensus (-2.0% yoy) and last quarter's growth rate (-3.8% yoy).

- Chile: The real economy expanded by a full 1.3% in Q1 2016 compared to Q4 2015. This is the strongest rate of growth for three years. Growth was broad-based. Chile's current account was also in surplus in Q1, while FDI inflows in the 12 months to March totalled 3.6% of GDP.

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**Emerging Markets**

Snippets:

- Egypt: Real GDP growth accelerated in Q4 2015 to 3.9% yoy from 3.1% yoy in Q3 2015.
- Indonesia: Bank Indonesia left the new 7-day repo policy rate unchanged at 5.5%. Government officials said that the government is considering reducing withholding taxes on bonds to zero.
- Malaysia: Bank Negara left the overnight policy rate unchanged at 3.25%.
- Mexico: GDP growth accelerated in Q1 2016 to 3.3% yoy from 2.2% yoy in Q4 2015.
- Peru: Real GDP expanded 3.7% you in March, according to the monthly GDP proxy. This means that Q1 GDP was up 4.4% yoy.
- Singapore: Inflation in April was -0.5% yoy versus -0.7% yoy expected. Inflation in March was -1.0% yoy.
- South Africa: The central bank left rates unchanged at 7%. Consumer prices inflation slowed to 6.2% yoy in April from 6.3% yoy in March and 7.0% yoy in February.
- South Korea: Exports returned to positive territory in yoy terms after ten straight months of contraction. Exports in the first 20 days of May were up 2.1% yoy versus -13.4% yoy in April.

**Global backdrop**

The main change in the global backdrop was a sharp repricing of the probabilities of a Fed rate hike in either June or July of this year. This followed FOMC minutes that were perceived to be hawkish. All EM dollar denominated bonds gave up some of their return though not as much as, say, US bonds, which means that EM dollar bonds outperformed the US over the week. EM currencies remain up 2% against the US dollar year-to-date and EM local currency bonds are outperforming similar duration US Treasury bonds by a factor of nearly four in dollar terms.

Despite the habitual knee-jerk Fed fears in the market, towards the end of last week the price action began to swing back in favour of EM local markets. This may be telling. If the Fed does hike in June or in July we expect the impact on EM market to be much milder than the impact from the December 2015 Fed hike, which in turn produced a much milder sell-off than tapering (the Fed's first move towards tightening). There is a pattern here; not only are the pullbacks in EM getting smaller, but the bounce-backs are getting stronger. In net terms, returns are turning positive around Fed tightening events.

There are several reasons for this change. Most importantly, EM bond yields have become vastly more attractive than bond yields in developed markets over the last couple of years. Secondly, the USD has become a bit of a victim of its own success – it rallied in anticipation of higher growth and higher rates, but it is now so strong that it is difficult for the economy to grow and therefore difficult for the Fed to hike. In addition, US stocks are not delivering much in the way of return and due to their negative yields European core government bonds should now be thought of as a tax, not an investment.

We think the most likely scenario for the Dollar in 2016 is simply that it flatlines. Barring a recession or inflation – neither of which we expect as a base case for 2016 – there is little to push the Dollar away from current ranges. A flat Dollar would be a far cry from the go-go days of QE from 2010-2015, where the Dollar powered higher at a pace of 10% per year against most EM currencies. Without strong Dollar appreciation, EM local bond yields become very attractive – they simply beat developed market bond yields hands down. As such, there is absolutely no excuse for not having decent yielding assets in fixed income portfolios in 2016. EM – 57% of GDP – offers government and corporate bonds that in many cases pay more than when the Fed had interest rates above 5%.

In other global news, the US has imposed duties of more than 500% on Chinese steel imports in a bid to protect unproductive rent-seeking US steel producers. This is nothing new. In George Bush's first term, the government also took steps to protect the weak US steel industry. The economic implications are clear; consumers of US steel will now pay more than the fair market price and be given less choice of suppliers. The policy sends a clear signal that rent-seekers can gain at the expense of the overall health of the economy. Protectionism may well become more pronounced in the coming years.

In politics, a Rasmussen poll last week placed voting intensions for Donald Trump at 42% compared to 37% for Hillary Clinton. A NBC News/Wall Street Journal poll showed Hillary Clinton's poll lead shrink to 3% from 11% in April. Investment banks are increasingly paying attention to the US election. In our view, the eventual choice of candidate may be less important than at first meets the eye. After all, both candidates would have very limited choices when it comes to economic policy. Newly elected presidents in the United States always face the same challenge: how to design an economic program that allows him or her to win a second term. In this year's election, given the starting point of over-inflated asset prices, an over-valued US dollar, sky-high debt levels, manufacturing teetering on the edge of recession, low productivity and an energy sector in free-fall – it is by no means an easy task to design an economic program that can restore a sense of optimism in America today. The lowest hanging fruit, in our view, is to embark on a massive fiscal spending binge targeting infrastructure investment. Such a strategy would take advantage of low government bond yields,

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Ashmore

## Global backdrop

would create jobs and might even increase productivity a bit. The only question is who will buy the hundreds of billions of Dollars required to finance the program. The answer may be the Fed via Helicopter Money. We think Donald Trump and Hillary Clinton may both be forced down this road. The important question is therefore not who wins, but rather who can get a big spending program through Congress?

Finally, we note with some delight that the World Bank has decided to drop the distinction between developed and developing countries in its official data releases. Call us cynical, but somehow we do not expect the global financial market to display the same degree of equanimity. After all, markets are addicted to simple rule of thumb trading when it comes to EM. Developing countries are likely to continue to trade with greater volatility relative to their actual riskiness, while the opposite is likely to remain the case for developed economies. Hence, we expect specialist EM management skills will be required for the foreseeable future.

## Benchmark performance

| Emerging Markets | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| MSCI EM | -6.42% | -0.54% | -22.08% | -6.69% | -4.59% |
| MSCI EM Small Cap | -5.33% | -2.97% | -20.96% | -4.87% | -3.02% |
| MSCI Frontier | 1.02% | 3.05% | -10.60% | 0.48% | 1.70% |
| MSCI Asia | -5.04% | -4.26% | -21.61% | -2.91% | -1.15% |
| Shanghai Composite | -3.76% | -20.07% | -35.42% | 9.95% | 2.25% |
| Hong Kong Hang Seng | -7.11% | -14.03% | -39.93% | -5.99% | -5.28% |
| MSCI EMEA | -9.56% | 6.09% | -22.64% | -9.96% | -7.38% |
| MSCI Latam | -9.01% | 14.97% | -19.25% | -15.10% | -10.90% |
| GBI EM GD | -5.25% | 7.90% | -6.75% | -8.13% | -3.03% |
| ELMI+ | -3.09% | 3.10% | -5.40% | -4.70% | -3.21% |
| EM FX Spot | -4.60% | 2.05% | -12.24% | -12.06% | -9.56% |
| EMBI GD | -0.44% | 6.43% | 4.40% | 3.12% | 5.87% |
| EMBI GD IG | -0.71% | 6.26% | 2.79% | 2.53% | 5.03% |
| EMBI GD HY | -0.14% | 6.46% | 6.45% | 3.86% | 7.08% |
| CEMBI BD | 0.01% | 5.69% | 2.50% | 3.08% | 4.86% |
| CEMBI BD IG | 0.03% | 4.38% | 2.79% | 3.31% | 5.20% |
| CEMBI BD Non-IG | -0.02% | 7.97% | 1.68% | 2.38% | 4.25% |

| Global Backdrop | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| S&P 500 | -0.42% | 1.31% | -1.32% | 9.46% | 11.36% |
| 1-3yr UST | -0.14% | 0.91% | 0.85% | 0.58% | 0.63% |
| 3-5yr UST | -0.19% | 2.12% | 2.49% | 1.78% | 1.93% |
| 7-10yr UST | -0.09% | 4.34% | 5.66% | 3.02% | 5.13% |
| 10yr+ UST | 1.00% | 8.43% | 12.27% | 6.65% | 9.69% |
| 10yr+ Germany | 2.05% | 9.83% | 8.35% | 9.67% | 11.25% |
| 10yr+ Japan | 0.59% | 13.22% | 17.89% | 9.60% | 7.62% |
| US HY | 0.02% | 7.22% | -1.96% | 2.18% | 5.52% |
| European HY | -0.47% | 3.49% | 0.89% | 5.77% | 8.72% |
| Barclays Ag | -0.25% | 4.18% | 3.55% | 3.34% | 4.84% |
| VIX Index* | 0.57% | -13.29% | 30.17% | 12.22% | -13.57% |
| DXY Index* | 2.40% | -3.37% | -0.73% | 13.74% | 25.24% |
| CRY Index* | -0.22% | 4.58% | -18.33% | -35.60% | -45.32% |
| EURUSD | -2.11% | 3.21% | 2.06% | -13.38% | -20.24% |
| USDJPY | 2.98% | -8.71% | -9.84% | 7.43% | 33.64% |
| Brent | 0.44% | 29.67% | -26.05% | -52.81% | -56.09% |
| Gold spot | -3.27% | 17.83% | 3.98% | -10.09% | -17.56% |

*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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