Default rates again favour EM over the US

By Jan Dehn

Last week produced another good week of relative default rate performance for EM HY corporates compared to their US counterparts. In Latin America, PPK as president is good news for Peru, but the government attempts to split the opposition in Venezuela, while multiple factors appear to be conspiring against Mexico right now. In Brazil, Goldfajn replaces Tombini at the Central Bank and Colombian inflation ticks up, albeit most likely on a temporary basis. In Russia, the Central Bank starts to cut rates and South Korea uses its bank recapitalisation fund to support policy banks. However, the global market backdrop is souring as markets digest mounting evidence that the monetary authorities are running into major constraints to further easing, especially in Europe and Japan. The US outlook is also pregnant with vulnerability after the bad payroll number and the sharp decline in hiring and inflation expectations. In these circumstances, the rising odds of Brexit can do some damage, though we think the impact of Brexit per se on EM is minimal. After all, the UK is just a small European country.

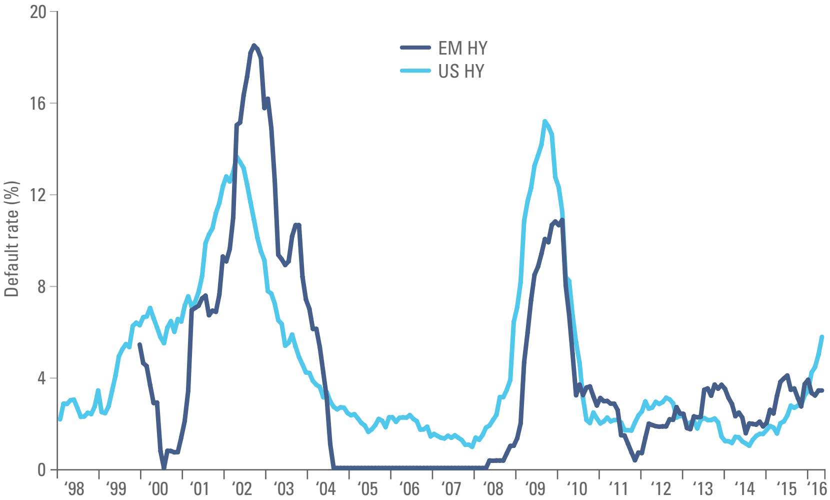
Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	1.05%
MSCI EM Small Cap	11.5	–	1.49%
MSCI Frontier	9.2	–	-0.09%
MSCI Asia	11.6	–	1.25%
Shanghai Composite	11.6	–	0.62%
Hong Kong Hang Seng	6.5	–	1.11%
MSCI EMEA	9.7	–	0.37%
MSCI Latam	12.3	–	0.29%
GBI-EM-GD	6.48%	–	1.64%
ELMI+	3.86%	–	1.11%
EM FX spot	–	–	1.23%
EMBI GD	5.59%	394 bps	0.74%
EMBI GD IG	4.22%	250 bps	0.76%
EMBI GD HY	7.50%	596 bps	0.71%
CEMBI BD	5.44%	395 bps	0.55%
CEMBI BD IG	4.18%	270 bps	0.52%
CEMBI BD Non-IG	7.55%	605 bps	0.61%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	-0.11%
1-3yr UST	0.72%	–	0.10%
3-5yr UST	1.15%	–	0.28%
7-10yr UST	1.63%	–	0.53%
10yr+ UST	2.44%	–	1.16%
10yr+ Germany	0.02%	–	2.01%
10yr+ Japan	-0.15%	–	1.04%
US HY	7.09%	564 bps	0.98%
European HY	4.65%	497 bps	0.36%
Barclays Ag	–	239 bps	0.49%
VIX Index*	17.03	–	3.56%
DXY Index*	94.54	–	0.64%
EURUSD	1.1264	–	-0.80%
USDJPY	106.06	–	-1.39%
CRY Index*	192.89	–	4.22%
Brent	49.9	–	-1.29%
Gold spot	1281	–	2.88%

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

Emerging Markets

Fig 1: **Corporate High Yield (HY) defaults**



Source: BAML.

Continued overleaf

Emerging Markets

Default rates rose sharply for US HY corporates bonds in May, while default rates were unchanged (and are much lower) in EM HY corporates bonds. New data from Bank of America Merrill Lynch shows that US corporate HY default rates rose to 5.77% in May from 4.99% in April, while the default rate for EM corporate HY bonds was unchanged at 3.41%. EM HY default rates have averaged 2.9% since 2010, a period of a sharply rising Dollar. This is almost the same default rate as for US HY corporates over the same period (2.8%). However, the strong rally in the US dollar has had a very disproportionate and adverse effect on US HY corporate bonds compared to EM HY bonds. While EM corporate HY default rates have remained at or below their long-term average for the entire period, US HY corporate default rates have skyrocketed from just 0.98% to the current high levels starting precisely in the summer of 2014 when the Dollar rally began. Shrill warnings of FX mismatches on EM corporate balance sheets ought to have been directed at US corporates, it seems.

- Russia: The Russian Central Bank has begun to cut rates, albeit cautiously. Inflation was unchanged at 7.3% in May, dramatically down from its temporary peak at 16.9% in early 2015. The Central Bank cut the policy rates by 50bps to 10.5% and now targets real rates about 2.5-3.0%. Further cuts therefore depend on the evolution of inflation from here.

- Peru: Pedro Pablo Kuczynski (PPK) was finally elected Peru's new president after a long, but orderly vote count, where the final decision boiled down to just a few thousand votes. PPK is a former Finance Minister and will be trusted in markets. However, PPK does not have a majority in parliament. His administration is likely to run excellent macroeconomic policies and provide a benign environment for all investors, locals and foreign. However, PPK will be challenged to pass reforms. The hope is that PPK and Keiko Fujimori, vanquished contender for the presidency, will find common ground on a number of issues, since both are generally pro-market. As such, the outlook for Peru has improved compared to under the outgoing Humala administration. The Central Bank, led by Julio Velarde, one of the grand old men of Latin American central banking, kept rates unchanged at 4.25%.

- Venezuela: The government appears to be trying to split the opposition. It is trying to negotiate with different segments within the opposition, offering influence on the Supreme Court in exchange for dropping demands for a referendum to recall President Nicholas Maduro. This is a clear attempt to divide the opposition. Henri Falcon, one opposition leader out of many, said that there is no compromise possible – it is a referendum or crisis.

- Mexico: A number of factors are currently conspiring to sour sentiment about Mexico right now. The state elections last week inflicted a serious setback for President Peña Nieto, though the implications are not massively significant, because the government's main economic reform agenda was approved already. Markets are also getting worried about the effect a more protectionist United States may have on Mexico, given Mexico's extremely close trade ties with the US under the NAFTA agreement. Donald Trump has been very vocal in his dislike for Mexicans and his wish to build a wall along the Mexican border. Finally, industrial production declined 0.7% in April on the back of weaker activity in the mining and construction sectors, though industrial production was still up 1.9% yoy. Mexico's currency is also the market's favourite short during bouts of risk aversion, not least because it is large and liquid, while Mexico's policy makers are trusted to keep open capital markets. Having said all that, there is no major economic or political problem in Mexico at this time. Inflation declined -0.45% mom in May (2.6% yoy vs 2.54% in April).

- Brazil: The inflation rate rose marginally in yoy terms to 9.32% in May from 9.28% yoy in April, but the monetary policy committee kept interest rates unchanged at 14.25%. The decision to leave rates unchanged was no surprise, because this was departing Central Bank Governor Alexandre Tombini's last meeting. Tombini will now be replaced by Ilan Goldfajn, a respected economist. Goldfajn's confirmation hearing speech was well received – he said the currency will float and inflation will be brought under control using interest rates, a refreshing change from the heterodox manipulation of administrated prices exercised under the previous regime. The Central Bank also said it will not resume currency swaps. On the political front, a poll showed that only 11% of the electorate supports acting President Michel Temer; this is hardly surprising given that he was not actually elected for the job, but had to step in when President Dilma Rousseff was forced to step down. On the positive side, Temer's rejection rate is less than half of that of suspended President Dilma Rousseff, while 65% of voters support labour market reform.

- South Korea: The government has announced that USD 9.5bn will be allocated to capitalise vulnerable policy banks that have become saddled with loss-making shipbuilding and shipping sector debt (Korea produces most of the ships that transport traded goods around the world). The Bank of Korea (BoK) will not finance the bailout with Helicopter Money, i.e. buy bonds directly from the banks, but rather tap into a recapitalisation designed specifically for this purpose following the Developed Market Crisis of 2008/2009. The BoK also cut rates by 25bps to 1.25%, which was sooner than anticipated.

- Colombia: Core inflation rose to 8.2% yoy in May from 7.9% yoy in April, making a hike likely at the next policy meeting this month. Colombia has not adjusted domestic demand strongly in response to lower oil prices, although the currency has weakened a lot. The weaker currency has produced some inflation pass-through. We expect inflation to come down since the central bank has now embarked on hiking policy rates.

- India: The Senate election outcome was better for the ruling BJP than expected. This is leading to growing speculation in local media that the government will push ahead with Goods and Services Tax (GST), an important tax reform that would significantly increase efficiency in the Indian economy. Whether the bill survives the Senate

Continued overleaf

Emerging Markets

depends not just on BJP but also the willingness of potential coalition partners to support the bill. In other news, industrial production moderated sharply in April, though the three month moving average of what is a volatile series rose from 0.3% mom in March to 0.5% mom in April. The Central Bank left rates unchanged at 6.5%.

- China: Inflation slowed from 2.3% yoy in April to 2.0% yoy in May. This was below the consensus expectation of 2.2% yoy. The trade surplus increased to USD 50bn in May from USD 46bn in April, while industrial production rose sequentially by more than expected in May (7.6% mom vs 6.2% mom in April). Fixed asset investment, however, was weaker than expected, while retail sales were in line with expectations. China's ongoing reforms can be expected to result in postponement of investment decisions for the foreseeable future, in our view.

Snippets:

- Argentina: The central bank cut rates on the Badlar (t-bills) by another 100bps to 33.25% from 34.25%.
- Bahrain: S&P affirmed Bahrain's BB rating with a stable outlook.
- Bolivia: Moody's moved Bolivia's sovereign credit rating outlook to negative from stable over fiscal concerns.
- Malaysia: Manufacturing rose 3.0% yoy, up from 2.8% yoy in March.
- Philippines: Exports declined at a pace of -4.1% yoy versus -15.1% yoy in March. Core inflation was 1.6% yoy in May.
- South Africa: Manufacturing up 2.9% yoy in April versus -2.4% yoy in March and 1.5% yoy expected. Fitch left the country's sovereign credit rating unchanged at BBB-, with stable outlook.
- Turkey: At 4.8% yoy Q1 GDP was stronger than expected (4.4% yoy). This was a slowdown from Q4 2015 (5.7% yoy).
- Uruguay: S&P moved Uruguay's outlook from stable to negative, but the country's BBB investment grade rating was left unchanged.

Global backdrop

Global market sentiment soured last week due to mounting concerns about developments in the lowest yielding markets of Europe and Japan. While the economic outlook looks weak overall, the concern focuses on the banking sector. The Group Chief Economist for Deutsche Bank (DB) last week sent a message to European Central Bank (ECB) President Mario Draghi accusing the ECB of placing the entire European project in jeopardy by pursuing negative interest rates. The policy obviously threatens DB's funding base and DB is undoubtedly aware that it is a systemically important bank. The message is therefore a thinly veiled threat aimed right at the highest level of policy-making in the Eurozone. Commerzbank, another European bank, also announced that it may store excess cash in its own vaults rather than placing it with the ECB. To add insult to injury, in Japan, Mitsubishi Bank relinquished its role as primary dealer. The problem facing Mitsubishi Bank is that negative yielding bonds are costly to hold for market-making purposes, so, not having the ability to bring its vast liabilities (customer's deposits) to negative rates, the bank deems it wiser simply not to be in the market anymore. Credit Suisse, the Swiss bank, made a similar decision to exit the European bond market last year. All of this is happening as ECB embarked on direct purchases of corporate bonds in Europe last week and thus pushed yields even further into negative territory. Some 15% of European corporate bonds now pay negative yields. This is twisted, because investors are paid no compensation whatsoever for credit, duration and liquidity risks. While naïve investors may conceivably be lured into believing the nonsense that government bonds are risk free surely no one will believe that corporate bonds are risk-free too? To us, negative corporate bond yields are prima facie evidence of bubble valuations in European fixed income markets.

The big problem, of course, is that central banks are running out of easing options. What will they do when the next recession hits? It is not as if there are no risks out there. The most immediate risk pertains to the vote on EU membership in the UK on 23 June. The polls continue to show gains for the 'Leave' campaign. A vote by the British people in favour of Brexit would raise major question marks about economic growth in the UK and concerns about further unravelling of the EU, which would surely weigh on European growth. This is why the ECB's shrinking arsenal of policy options is such a worry.

But what does Brexit mean for EM? Very little, in our view. The UK is a small European country, so a recession would have virtually no impact on most EM countries. So far, EM countries have also performed well despite rising odds of Brexit and indeed the rise of Trump and other nationalist politicians across the developed world. If the lurch into populism in developed countries continues we think investors should place their money elsewhere, including EM, which day by day looks the safer place to be invested.

Concerns are also mounting in the US, albeit less acutely. The shockingly weak payroll number has left US markets with an air of vulnerability. Hiring dropped sharply in the latest JOLTS data too and on Friday inflation expectations plunged in the latest Michigan consumer confidence survey. Productivity also declined yet again (-0.6% qoq ar), but there are silver-linings. Other economic indicators still point to stability and it is difficult to

Continued overleaf

Ashmore

Global backdrop

identify a specific fundamental trigger for a major economic disaster in the near-term. Even so, Fed Chairwoman Janet Yellen was quick to step back from pointing to a specific data for the next rate hikes and the market promptly went on to price out entirely a June hike and to push the odds of a July hike to below 18%. Indeed, the odds of any hike at all this year is now down to just 50%. In our view, the risk of a major market correction is far greater than the risk of an economic crisis in the near-term. This is because global investors are so massively positioned in the developed markets following the QE-driven momentum trade of the last few years. The best way to avoid getting soaked in a violent correction in the US stock or European bond markets would be to reduce exposure to these overvalued markets early and gradually to shift some funds into those markets that offer genuine value. After all, the main lesson for 2016 is already clear: this is the year when momentum trades give way to value trades.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.19%	4.58%	-13.38%	-2.84%	-3.47%
MSCI EM Small Cap	2.40%	1.26%	-13.63%	-1.69%	-1.95%
MSCI Frontier	1.06%	4.14%	-9.42%	0.51%	2.12%
MSCI Asia	1.84%	1.33%	-12.73%	1.08%	0.46%
Shanghai Composite	0.52%	-17.02%	-41.99%	12.62%	3.76%
Hong Kong Hang Seng	1.73%	-8.07%	-33.15%	-1.13%	-3.37%
MSCI EMEA	2.86%	11.10%	-12.66%	-5.94%	-7.06%
MSCI Latam	3.54%	16.73%	-15.08%	-11.84%	-10.64%
GBI EM GD	3.31%	11.24%	-0.71%	-4.95%	-2.70%
ELMI+	1.77%	5.03%	-2.23%	-3.51%	-3.00%
EM FX Spot	2.30%	4.07%	-8.56%	-10.46%	-9.33%
EMBI GD	1.66%	8.49%	8.52%	5.47%	6.14%
EMBI GD IG	1.69%	8.24%	7.40%	4.77%	5.25%
EMBI GD HY	1.63%	8.61%	9.83%	6.37%	7.43%
CEMBI BD	0.97%	6.94%	4.66%	4.66%	5.11%
CEMBI BD IG	0.89%	5.42%	4.87%	4.79%	5.30%
CEMBI BD Non-IG	1.11%	9.56%	3.95%	4.16%	4.77%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.02%	3.59%	1.76%	10.75%	12.91%
1-3yr UST	0.32%	1.28%	1.41%	0.72%	0.67%
3-5yr UST	0.85%	2.96%	4.15%	2.31%	1.92%
7-10yr UST	1.74%	6.19%	9.44%	4.30%	5.11%
10yr+ UST	3.74%	12.26%	19.33%	9.18%	9.97%
10yr+ Germany	3.61%	14.31%	20.16%	11.74%	11.91%
10yr+ Japan	0.93%	14.39%	20.48%	9.77%	7.82%
US HY	1.01%	9.15%	1.21%	3.58%	5.81%
European HY	0.60%	4.95%	3.23%	6.76%	9.10%
Barclays Ag	1.16%	5.82%	6.72%	4.51%	5.12%
VIX Index*	20.01%	-6.48%	23.58%	3.78%	-13.16%
DXY Index*	-1.41%	-4.15%	-0.46%	17.07%	26.88%
CRY Index*	3.62%	9.51%	-13.71%	-32.39%	-44.02%
EURUSD	1.30%	3.76%	-0.17%	-15.79%	-21.85%
USDJPY	-4.21%	-11.66%	-14.06%	11.21%	32.18%
Brent	0.42%	33.85%	-21.87%	-52.13%	-58.10%
Gold spot	5.42%	20.70%	7.99%	-7.57%	-15.50%

*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