Has Godot arrived in Mexico?

By Jan Dehn

Mexican data is slowly getting better, after a long wait. Turkey's GDP number shows that the economy is adjusting sharply to the rate hikes earlier this year. The US Supreme Court is set to rule early this week on the holdout case in Argentina. Santos' re-election in Colombia is good news. China's non-admission to the EM equity MSCI index is a non-event. Away from EM, Carney buys credibility by announcing early, but likely extremely modest hikes. Conditions are also being put in place for a return of expectations rather than wage-led inflation in the US, where household deleveraging resumed in Q1. Meanwhile, loss of moral authority and economic weakness continue to make themselves felt in parts of the world where Western and other interests clash – the latest example being Northern Iraq.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,035		1.94%
MSCI EM Small Cap	1,055		0.80%
MSCI FM	662		-0.43%
GBI EM GD	6.66%		0.56%
ELMI+	3.47%		0.27%
EMBI GD	5.24%	270 bps	0.48%
EMBI GD IG	4.43%	183 bps	0.61%
EMBI GD HY	7.24%	499 bps	0.22%
CEMBI BD	5.21%	305 bps	0.53%
CEMBI BD HG	4.30%	214 bps	0.53%
CEMBI BD HY	7.03%	487 bps	0.52%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1878	-0.92%
VIX Index	12.44	1.72%
5 year UST	1.55%	-12 bps
10 year UST	2.51%	-15 bps
US HY	5.29%	0.15%
European HY	4.37%	0.06%
EURUSD	1.3708	-0.36%
USDJPY	101.37	-0.74%
Brent	111.41	2.97%
Copper	323.16	0.28%
Gold	1299.95	0.19%

Additional benchmark performance data is provided at the end of this document.

Emerging Markets

- Mexico: Investors may have felt that a recovery in Mexico was to be as elusive as Beckett's Godot. Mexico has tested their patience since major reforms were undertaken by the government last year, with the expected growth dividend that usually follows reforms sorely absent. We think this impatience is somewhat misplaced. Reforms reduce the cost structure of the economy, thus raising the trend growth rate. By contrast, Mexico's recent growth performance has been sluggish mainly for cyclical reasons. The cyclical drags include weakness in the homebuilder sector, tax increases arising from fiscal measures, general uncertainty associated with the reform process, slow infrastructure investment by the new government and, importantly, very weak growth in the United States in Q1. This is why recent data gives grounds for optimism. A few weeks ago we reported on stronger than expected retail sales. Last week we then had signs of acceleration in industrial production, which rose 0.6% mom in April, up from 0.2% the previous month (seasonally adjusted). Construction picked up for the third month running. In addition, we expect tailwinds from US growth to begin supporting Mexico's growth and last week's 50bps rate cut will help too. The real benefits of Mexico's reforms will only truly be felt later. Unlike in the past, Mexico will now be able to grow faster and for longer before running into balance of payments and inflation constraints to growth as a result of the recent reforms.
- Turkey: The Turkish economy expanded much faster than expected in Q1. GDP rose 1.7% qoq, more than four times faster than anticipated. On a yoy basis, real GDP expanded at 4.3%. Exports were an important driver, rising 7.0% qoq, while domestic household spending contracted outright and investment was low. This pattern for GDP is exactly what you would expect given recent changes in Turkish macroeconomic policy, namely devaluation of the currency and the rate hikes earlier in the year. Turkey has seen extremely rapid credit growth, rendering the economy very sensitive to higher rates. The Turkish central bank hiked rates in January and now domestic demand and imports are declining (imports down 2.4% qoq in Q1). Meanwhile, the weaker TRY has made exports more competitive. Turkey's economy is responding rapidly to adjustment, as indeed do most EM countries, especially if they have the flexibility of low state involvement in the economy (as in the case of Turkey).

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Emerging Markets

- **Colombia:** Incumbent President, Juan Manuel Santos, won the presidential run-off election against former Finance Minister Oscar Ivan Zuluaga. This is good news. Both candidates advocated sound economic policies. However, Santos' campaigned on continuing peace talks with the FARC rebels, while Zuluaga favoured resumption of military action against the FARC. We think the peace process has better odds of ending the war with the FARC than a resumption of military action. Also, Santos' win means continuity. Finally, Santos is an extremely experienced politician and, in our view, one of most gifted of his generation in all of Latin America. By contrast, we believe a Zuluaga administration would be heavily influenced behind the scenes by former president Alvaro Uribe.

- **Argentina:** The US Supreme Court is likely to decide this week whether to reject, accept or seek further information before making a final decision on Argentina's appeal of a New York Second District Court ruling in favour of holdout investors. The decision could have far-reaching effects as it may impact the payment stream to holders of performing bonds.

- **China:** MSCI, the equity index provider, announced last week that the China-A shares inclusion in the main EM index will be delayed until 2015. MSCI needs to weigh up the growing interest and accessibility of the local market with the actual ability of its clients (namely institutional investors, large index funds, etc.) to invest. Access is still restricted to accounts with QFII and RQFII systems in place, although this is likely to continue to evolve over time – MSCI's decision was therefore not surprising and does not change the status quo.

Global backdrop

Bank of England Governor, Mark Carney, did not take long to respond to better UK data. Last week he signalled his intention to raise rates as early as this year. The UK business cycle is well ahead of that of the US and given the similarities between the two countries (plus the fact that both countries can inflate and devalue) makes the UK experience highly relevant to the US.[1] House price appreciation has been rapid in London, raising the risk that consumer inflation expectations are affected. We think the BOE is likely to hike at an extremely modest pace on account of the enormous UK debt stock. For this reason, it makes sense for Carney to build credibility by acting early, so that he has to do fewer actual hikes later on.

The pre-conditions for higher US inflation are in place, despite labour market slack. Inflation has already pushed financial asset prices to all-time highs and is now spilling into the prices of real assets such as housing. This week the IMF warned against rising house prices. House prices matter for inflation expectations, because most people pay much more attention to the prices of their homes than financial asset prices. Add in super low policy rates, a dovish Fed committed to keeping them low, an indebted economy unable to stomach major real rate hikes and huge volumes of outstanding liquidity that cannot be soaked up readily. It all adds up to rising risks of higher inflation via the expectations channel; inflation can rise via this channel even when there is still slack in the labour market.

US Q1 growth was revised even lower this week by most analysts on the back of lower than anticipated health services spending. Recall that one of the few positives supporting Q1 growth was higher anticipated health care spending due to the roll-out of Obamacare. That expectation has now been dashed and many now expect the eventual number for Q1 to be around -1.5% to -2.0% qoq. Considering last year's overwhelming consensus that US growth would be higher in Q1 2014, this outturn must surely constitute one of the largest shocks to consensus expectations ever recorded without a meaningful shock (and citing weather effects is hardly credible). We can only be grateful that this disappointment befell the US, because if the same thing had happened to an EM country then it is likely that there would be no limit to the cacophony of Doomsday merchants predicting 'the end of EM'. Be that as it may, the real importance of the weak start to US growth in 2014 is simply this: even if quarterly growth returns to 3% in Q2 and the rest of 2014, the low base in Q1 effectively ensures that the year is 'gone'. In other words, this will be yet another lacklustre 2% year for the US economy.

Federal Reserve data shows that US household deleveraging re-accelerated in Q1 2014 following a hiatus in 2013. In Q1 2014, the ratio of household debt to income fell to 103% from 104% in Q4 2013 and 106% at the same time last year. US households reduced the ratio of debt to disposable income at a pace of roughly 1.1% per quarter since 2010. The ratio peaked at 130% in September 2007. At the current pace, the ratio will return to pre-Greenspan bubble levels by Q1 2017. This is somewhat later than our previous projections, due in large part to the slower pace of deleveraging in 2013. All else even, this will push rate hikes further into the future, although this variable is of course not the sole determinant of Fed policy.

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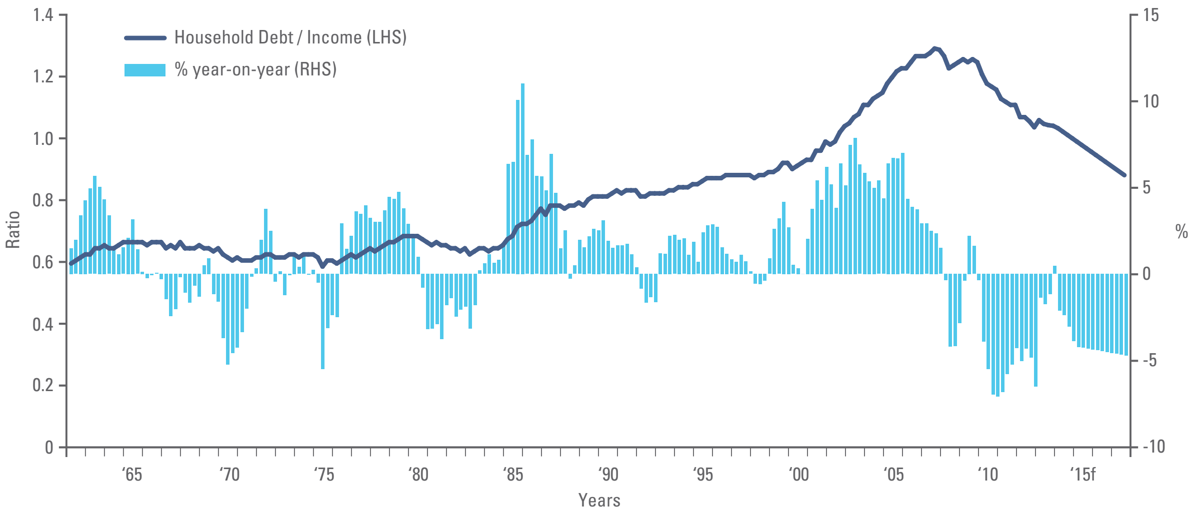
[1] *'Watch the UK'* in *"Poroshenko wins big in Ukraine"*. Weekly Investor Research, 27 May 2014.

Global backdrop

We think US household deleveraging is central to the outlook for US inflation, growth and interest rates. US banks are ready to lend and companies are cashed up to invest, but consumers will only get back to 'credit fuelled consumption mode' once debts have returned to pre-Greenspan bubble levels, in our view. Once this happens, however, activity is likely to rise sharply and inflation will be back.

Fig 1: **US household deleveraging (Ashmore projections beyond Q1 2014)**



Source: Federal Reserve, Ashmore.

Middle East tensions continue to slowly ramp higher last week with the outbreak of open three-way fighting in Northern Iraq. Oil prices are now trading at the highest level for a year. Iraq has become vulnerable to destabilisation following the recent withdrawal of US military support, an important source of the government's ability to hold on to power in a country deeply divided along sectarian lines. Indeed, the Baghdad government's legitimacy is disputed in large parts of Iraq. Bashar Hafez Al-Assad's victory in the Syrian civil war earlier this year has caused an influx of fighters into Northern Iraq. Western powers now face a tough dilemma: to provide military support for the Iraqi government to help preserve Western influence in what is still a strategically important country, but in doing so, incur the ire of Western voters with no appetite for another Middle East intervention. The West's loss of moral authority to act has already inflicted diplomatic defeats on Western powers in the Syrian conflict and over Crimea and in Georgia, though Western interests were well-served by the coup in Egypt. We see very little chance that the West will be able to significantly ramp up its influence in the region from current levels, which means that the West's most important allies increasingly have to rely on their own financial and military means to see off the threat to their rule from militants.

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.1%	3.6%	1.3%	-0.4%	10.8%
MSCI EM Small Cap	1.5%	5.0%	-1.2%	-0.9%	13.3%
MSCI FM	0.5%	15.0%	25.6%	9.9%	12.0%
S&P 500	-0.15%	2.40%	16.17%	14.67%	18.76%
GBI EM GD	2.00%	4.86%	-6.82%	1.44%	8.15%
ELMI+	1.02%	1.78%	-0.82%	-0.77%	3.28%
EMBI GD	1.82%	6.93%	1.26%	7.26%	10.61%
EMBI GD IG	2.04%	7.13%	-0.27%	6.01%	8.55%
EMBI GD HY	1.39%	6.57%	4.25%	9.48%	13.54%
5 year UST	0.67%	2.07%	-0.93%	2.68%	3.31%
7 year UST	0.92%	3.94%	-2.05%	4.09%	4.50%
10 year UST	1.24%	6.77%	-1.62%	6.22%	5.15%
CEMBI BD	1.18%	4.82%	2.07%	5.85%	10.43%
CEMBI BD HG	1.19%	5.14%	2.19%	6.23%	9.23%
CEMBI BD HY	1.16%	4.14%	1.82%	5.43%	14.45%
US HY	0.55%	4.52%	7.22%	9.53%	15.97%
European HY	0.64%	5.10%	11.73%	12.99%	19.11%
Barclays Ag	0.51%	4.09%	4.39%	2.55%	4.82%

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