VIX spiked 10 points in June – it is a good time to allocate to EM

By Jan Dehn

The Brexit vote caused a spike in the VIX index of more than 10 points in June. VIX spikes of this magnitude have in the past always been excellent entry points into EM with an average alpha of 3% in the following 12 months relative to a strategy of passively timed allocations. Moreover, flows into EM fixed income hit a new record last week. In the Global Backdrop section we explain why it does not matter so much who wins the next US presidential election – it is far more important who gets to control Congress. We outline some potential implications for EM.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	-1.16%
MSCI EM Small Cap	11.4	–	-0.38%
MSCI Frontier	9.1	–	0.07%
MSCI Asia	11.6	–	-1.09%
Shanghai Composite	12.1	–	2.54%
Hong Kong Hang Seng	6.8	–	-1.70%
MSCI EMEA	9.4	–	-1.01%
MSCI Latam	12.9	–	-1.07%
GBI-EM-GD	6.26%	–	-0.54%
ELMI+	3.77%	–	-0.53%
EM FX spot	–	–	-0.73%
EMBI GD	5.17%	379 bps	0.99%
EMBI GD IG	3.83%	239 bps	1.07%
EMBI GD HY	7.07%	579 bps	0.90%
CEMBI BD	5.12%	388 bps	0.52%
CEMBI BD IG	3.90%	267 bps	0.52%
CEMBI BD Non-IG	7.17%	591 bps	0.53%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.9	–	1.55%
1-3yr UST	0.64%	–	-0.03%
3-5yr UST	1.00%	–	0.11%
7-10yr UST	1.40%	–	0.65%
10yr+ UST	2.12%	–	2.14%
10yr+ Germany	-0.18%	–	0.77%
10yr+ Japan	-0.27%	–	0.17%
US HY	6.88%	564 bps	1.39%
European HY	4.79%	532 bps	0.18%
Barclays Ag	–	243 bps	1.24%
VIX Index*	13.19	–	-1.58%
DXY Index*	96.53	–	0.88%
EURUSD	1.1046	–	-0.98%
USDJPY	102.33	–	-0.20%
CRY Index*	187.17	–	-5.40%
Brent	46.5	–	-7.25%
Gold spot	1358	–	0.52%

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

Emerging Markets

The big global trade right now is EM. EM fixed income is already performing well and is supported by strong technicals after years of excessive selling. Asset prices moved, but EM fundamentals failed to implode over the last few years despite severe headwinds, including capital outflows, the Dollar rally, falling commodity prices and Fed monetary tightening. This has created a lot of value in EM, while there is precious little value left in developed markets.

EM is not just a value trade, however. There are also two other powerful tactical reasons for allocating to EM right now. The first reason is that Brexit – a 21 standard deviation event for the GBP – pushed VIX, the Chicago Board Options Exchange Volatility Index, up by more than 10 points relative to its 60-day moving average. In the past, all EM fixed income asset classes have generated positive alpha to investors that have deliberately allocated to the asset class during episodes of 10+ spikes in VIX. The average alpha for allocations during VIX spikes is 3% in the following twelve months. This is equivalent to a 41% higher return than the average passively timed allocation (see figure 1 below).

Fig 1: **Excess returns due to tactical timing of EM investments during +10 point VIX spikes (by theme)**

12 month returns	EMBI GD	EMBI GD IG	EMBI GD HY	CEMBI BD	CEMBI BD HG	CEMBI BD HY	GBI EM GD	ELMI+
% excess return due to active timing	27%	39%	18%	37%	28%	65%	55%	58%
Absolute excess return due to active timing	2%	3%	2%	3%	2%	6%	4%	3%
Active timing returns	12%	11%	13%	10%	9%	15%	11%	9%
Passive timing returns	9%	8%	11%	7%	7%	9%	7%	6%
Data points (months)	269	262	262	166	166	166	154	262

Source: Ashmore, Bloomberg, JP Morgan

[1] VIX is the US equity options volatility index.

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Emerging Markets

The other tactical reason for considering an EM allocation now is flow-related. Last week saw EM bond funds post the largest weekly inflow on record, despite a week shortened by holidays in the US and elsewhere, according to new data from JP Morgan. The flows were broad-based and the bulk went to actively managed funds. This increase in flows comes on the back of strong performance year to date and proven resilience in the face of expectations of several rate hikes from the Fed this year and the volatility caused by the UK's Brexit vote. It is possible that EM allocations may soon become the subject of a broader momentum trade, having been out of favour for some time.

While keeping an eye on these tactical arguments for allocating to the asset class, we think investors should also carefully examine the value argument for EM. Recent research shows that investors can increase returns and reduce risks by expanding their EM exposure at the expense of their exposure to overvalued developed markets.[2]

The bigger picture is clear: global financial markets have largely been driven by highly discriminate buying of developed market assets on the back of strong QE bids from central banks in developed economies. But these big QE trades are nearing their end. While central banks are still pursuing very loose economic policies in developed economies, asset prices in those economies offer an increasingly unattractive risk-return propositions. The Brexit event was a powerful reminder that there are no risk-free markets. All markets are risky. Investors should avoid, as far as possible, excessively exposing themselves to a narrow range of very overbought and risky securities in developed markets. As this becomes clearer we expect the QE momentum bandwagon to give way to more value-oriented strategies that give greater confidence to investors that they are adequately compensated for the risk they are taking. And that means EM.

- Brazil: Finance Minister Henrique Meirelles announced the 2017 primary fiscal deficit target of 2.1% of GDP. We think this target is realistic. What is far more important than the fiscal deficit target, however, is that Meirelles' fiscal reform, which caps public spending for 20 years and ensures a sustainable trajectory for public debt, is implemented. The 2017 fiscal deficit is wide because the Temer administration has accepted several upfront commitments to States and Municipalities in exchange for support for the fiscal reform. This means that the main risk going forward is that the fiscal reform is not passed. This is not out base case, however.

Snippets:

- Argentina: The central bank allowed the 35-day Lebac rate to drop by another 50bps to 30.25%. Rates are coming down as inflation is brought down. The government is cushioning the growth shock by borrowing extensively in external markets.
- Chile: GDP picked up to 1.8% yoy in May from 0.7% yoy in April. The market consensus was a pick-up of 1.5% yoy. Fitch affirmed Chile's sovereign rating of A+.
- China: FX reserves rose again in June to USD 3,205bn. The market had expected a decline of USD 25bn. The Caixin Services PMI rose to 52.7 in June from 51.2 in May. Chinese inflation declined marginally from 2.0% yoy in May to 1.9% yoy in June.
- Colombia: Inflation was higher than expected in June. Headline was 0.48% mom versus 0.26% and core was 0.47% mom vs 0.30% mom. This puts the central bank on the path to another hike, in our view.
- Croatia: The trade deficit declined 9.1% yoy.
- Hungary: Inflation was -0.2% yoy in June versus -0.1% yoy expected. The trade surplus rose by a substantial 60% yoy to EUR 755m in May.
- Mexico: Inflation was 0.11% mom in June versus 0.16% mom expected. Gross fixed investment was slower than expected (1.6% yoy in April versus 2.1% yoy expected).
- Peru: President-elect Kuczynski will appoint Fernando Zavala as cabinet chief. Zavala is currently CEO of SABMiller in Peru.
- Philippines: Inflation rose to 1.9% yoy in June for both core and headline. This was exactly as expected. Gross international reserves reached a new high of USD 84bn at the end of June.
- Russia: Manufacturing and services both picked up strongly in June. The Composite PMI rose to 53.5 from 51.2. This is the highest level in three years. Inflation was 7.5% in June versus 7.3% yoy in May.
- Saudi Arabia: The economy expanded just 1.5% yoy in Q1 2016 due to contraction in government spending under the government's fiscal austerity programme.
- Turkey: Inflation was 7.6% yoy in June versus 6.9% expected. The culprit was volatile food prices. Core inflation was 8.7% yoy, which was lower than expected (8.9% yoy).

[2] See *"Superior returns and lower risk in EM IG corporate bonds"*, The Emerging View, July 2016.

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Global backdrop

Global financial markets are still trying to come to grips with the implications of the UK Brexit vote. Our view is that Brexit is overwhelmingly a UK tragedy, but analysts have wasted little time extrapolating potential implications for the wider European arena, even for EM.

As far as the EM extrapolation is concerned, it has largely failed. After all, the UK accounts for less than 2% of global GDP, so the country's demise will barely register in most EM countries. EM technicals are also strong, which means that there have been very few sellers. Without pregnant positions to help create momentum interest is fading in the press and among analysts.

Europe looks more vulnerable to contagion from the UK. Brexit will, so the narrative goes, cause a significant slowdown in the UK, which in turn will push Europe into recession. The slowdown in European growth will force the ECB to push interest rates even further into negative territory, which is bad for the banks. This is why the global markets are focussing on Italian banks, Deutsche Bank and attempting to revamp the old Periphery sovereign trades. It would be wrong to underestimate the risks of a contagion into Europe. Brexit dovetails beautifully with the very broadly held consensus view that Europe is in deep trouble.

Our view, however, is that the scope for a big 'sell Europe' trade is currently limited. One reason is that valuations in the US markets are very high. Shifting exposure from Europe to the US right now would therefore require buying very expensive assets. The strong Dollar is already hurting the American economy. Similarly, defensive European trades, such as buying government bonds in core Eurozone economies, are also unattractive due to negative yields. Indeed, at the current low yields an investor would have to hold a 30-year German government bond for 82 years in order to make up for the loss associated with just a 150bps move in the yield curve. Note that, the yield on the German 30-year bond would have to by far more – 410bps – in order to return to its long-term average of 4.4%.

There is also some validity to the argument that the European economy may not be nearly as vulnerable as many analysts and reporters would have us think. The UK is in trouble, no doubt. Consumer confidence dropped to the lowest level in 21 years. But the European economy is not only the largest in the world, it is also highly diversified. European populations have, according to the most recent polls, become more, not less, enamoured of the European Union after the UK's decision to exit. Many Europeans simply think it was stupid of the UK to leave and Brexit has reminded them of the many benefits of EU membership.

In the US, the strong payroll number was positive news, which reduces the odds of a near-term recession. EM markets responded positively to the news. As attention to Brexit slowly begins to fade we think the US election will become one of the next important drivers of market sentiment. At first sight, Hillary Clinton and Donald Trump appear to be very different candidates, but contrary to mainstream perceptions we do not think it matters all that much whether Hillary Clinton or Donald Trump wins the upcoming US presidential election – at least not from a macroeconomic perspective.

To see why, consider that there are basically only two types of US presidents – loser presidents and winner presidents. The difference between loser presidents, such as George Bush Senior and Jimmy Carter, and winner presidents, such as George W Bush, Bill Clinton and Barack Obama, is that loser presidents only win one term in office.[3]

Obviously, no newly elected US president wants to do go down in history as a loser president, so the single most important consideration at the start of a new presidential term is how to get re-elected for a second term.

This is so important, in fact, that newly elected presidents carefully design their economic and legislative programmes in order to maximise the odds of re-election for years hence. This means, above all, that their programmes must ensure that Americans are left feeling better about themselves and their country at the end of the term than they felt at its start.

Unfortunately, it is already quite clear that America's next president will face an uphill battle in making Americans feel better about themselves and their country over the next four years. The economy is at the very tail-end of a massive stimulus-induced financial sector boom and stock and bond prices are already at all-time highs. The Dollar is significantly overvalued, according to the IMF. The economy is labouring under excessive debts, eye-watering unfunded future health and pension liabilities, rising inequality and declining rates of productivity growth. Economic growth is sluggish – barely 2% real GDP growth per year for the past seven years despite record stimulus. How, then, will the economy perform when the Fed raises rates? In fact, markets are expecting a recession to kick in sometime within the next year or two. In short, this is not exactly the stuff of re-elections.

What, then, can the next US president do to make America feel great again? Actually, the answer is fairly obvious. Since markets continue to insist that US debt is risk free, as evidenced by record low US treasury yields, the big opportunity is to take advantage of the low yields by issuing a lot more debt and spending the proceeds on infrastructure investment. A trillion Dollar infrastructure investment programme implemented at state level across the whole of America, funded by bond issuance, would revamp America's infrastructure, create jobs and push up stock markets. Economists would be able to claim that productivity is going up and hence boost America's long-term growth rate.

[3] In reality there are three types of presidents. President Nixon was impeached.

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Global backdrop

The alternatives are far less appealing. Reforms and deleveraging would be hugely politically unpopular and further monetary policy easing has largely run its course. Doing nothing would also not be popular as growing sections of the population view the current policy stance as contributing outright to inequality and stagnation.

Faced with these economic and political realities, we think it matters very little who becomes president. Hillary Clinton and Donald Trump are both likely to go down the road of greater fiscal spending, given the unattractiveness of the alternatives.

Suppose, then, that the next US president, whether Hillary Clinton and Donald Trump, decide to go down the road of the 'Trillion Dollar Infrastructure' programme. How will such a programme be funded? The answer is likely to be Helicopter Money, i.e. direct placement of debt with the Fed. Under current laws, States can issue debt directly to the Fed, but only very short-dated paper, which would not be suitable for infrastructure investments, which tend to have very long duration. Hence, a more feasible solution would be for the Federal Government to issue the long-term bonds to the Fed and then on-lending the proceeds to States.

This, in turn, means that the balance of power in Congress will be important, arguably more important than the presidential election. The House currently looks likely to remain under Republican control, but the Senate, also under Republican control, could possibly change hands.

In the scenario where the composition of Congress does not change, the odds of enacting 'Trillion Dollar Infrastructure' are good if Donald Trump wins. One could easily imagine, for example, a deal between House Speaker Paul Ryan and Donald Trump to downsize Washington – a popular move in Tea Party country – in exchange for increasing hiring at State level under the big infrastructure programmes. The alternative scenario where the Senate falls to the Democrats with Trump as president would certainly pose challenges for a nation-wide infrastructure push, but Washington could still favour States that are open to participation. The incentive not to participate would be weak.

The most difficult situation would be a Hillary Clinton win, provided Congress remains in Republican hands. Another lame duck Democrat presidency with a staunchly Republican Congress would virtually guarantee that nothing gets done. Even Budgets, debt ceilings, Supreme Court appointments, etc. could be difficult to pass. Infrastructure programmes would be stuck as they have been under Obama. Hence: no new roads, no new bridges, no new ports and no new airports. Hillary Clinton would be well on her way to becoming America's next loser president. The decline of mainstream politics in favour of populism would continue. Monetary policies would have to be used well beyond their 'sell by' date. Risk aversion would remain elevated and growth rates would continue to structurally decline. Without inflation and a weaker Dollar to help reduce the debt stock and stimulate exports capital would remain locked up in very unproductive assets, such as government bonds.

Clearly, the US election is not an insignificant event, even for EM countries. In the benign scenario of 'Trillion Dollar Infrastructure' financed by Helicopter Money inflation would rise and the Dollar would weaken neither of which would be bad for EM. A little inflation would help to reduce the US debt stock and hence support growth, while a lower Dollar would help the US energy sector, exporters and manufacturing. The global economy would welcome a weaker Dollar, because capital would flow back to finance-starved EM economies. Investment, consumption and growth would pick up in its wake.

From a country-specific perspective, however, a Trump presidency could present challenges for some EM countries. Trump is not particularly popular in Mexico on account of his public statements about Mexicans and NAFTA. Here, the contrast with Hillary Clinton is quite extreme. After all, it was Bill Clinton who introduced NAFTA. Muslims may also have some reservations about Trump's proposal to introduce travel restrictions for what is 23% of the world's population. But these types of policies would ultimately hurt the US economy the most. EM countries have already shown considerable resilience in the face of the very dramatic slowdown in developed market growth – developed economies are today growing 40% slower than they did prior to the crisis in 2008/2009.

A lame duck Hillary Clinton presidency would not be fatal for EM either. It would merely be a continuation of the situation that prevails today. EM assets are outperforming and EM's growth premium over developed economies looks set to widen this year. Current valuations suggest far more upside than for developed market assets.

In conclusion, the US election is likely to be a net positive for EM. Once the uncertainty of the outcome is over, the next US president is likely to engage in major fiscal stimulus. The ability to go down the road of 'Trillion Dollar Infrastructure' will depend more on the composition of Congress than on the choice of president. An alignment of interests between the President, the House and the Senate would enable a far more meaningful programme of infrastructure investment at State level, funded by Helicopter Money. Higher growth, more US inflation and a lower Dollar would be good for EM, even if Mexicans and Muslims rightly would have some reservations about a Trump victory in November. The alternative scenario of another lame duck Democrat administration would be less bullish, but EM would, in our view, still outperform given the current base case scenario for growth and relative valuations between developed and EM assets.

Ashmore

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.54%	5.94%	-5.75%	-0.23%	-3.88%
MSCI EM Small Cap	0.18%	1.60%	-3.50%	1.11%	-2.40%
MSCI Frontier	0.26%	-0.24%	-10.45%	0.59%	1.25%
MSCI Asia	-0.54%	1.68%	-5.36%	3.19%	-0.31%
Shanghai Composite	2.68%	-14.27%	-12.99%	17.87%	3.85%
Hong Kong Hang Seng	-1.70%	-8.06%	-19.79%	1.89%	-4.02%
MSCI EMEA	-0.57%	11.09%	-8.64%	-4.90%	-7.21%
MSCI Latam	-0.41%	25.15%	-3.32%	-6.78%	-9.83%
GBI EM GD	-0.20%	13.80%	3.09%	-3.23%	-2.42%
ELMI+	-0.41%	5.38%	-0.42%	-2.91%	-3.00%
EM FX Spot	-0.67%	4.54%	-5.93%	-9.77%	-9.30%
EMBI GD	1.54%	12.01%	11.33%	7.84%	6.71%
EMBI GD IG	1.68%	12.08%	9.90%	7.43%	5.94%
EMBI GD HY	1.38%	11.76%	13.17%	8.26%	7.84%
CEMBI BD	0.93%	8.80%	6.19%	6.17%	5.43%
CEMBI BD IG	0.92%	7.34%	6.06%	6.28%	5.65%
CEMBI BD Non-IG	0.94%	11.33%	6.12%	5.73%	5.03%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.55%	5.45%	6.38%	11.40%	12.02%
1-3yr UST	-0.04%	1.61%	1.27%	0.83%	0.72%
3-5yr UST	0.10%	3.90%	3.63%	2.92%	2.06%
7-10yr UST	0.79%	8.56%	9.23%	6.13%	5.62%
10yr+ UST	3.21%	19.33%	21.31%	13.06%	11.62%
10yr+ Germany	0.53%	18.57%	19.03%	13.56%	12.43%
10yr+ Japan	0.70%	17.54%	21.93%	11.17%	8.48%
US HY	1.39%	10.57%	3.35%	4.69%	5.96%
European HY	0.57%	4.32%	3.69%	6.78%	8.99%
Barclays Ag	1.24%	7.85%	7.69%	5.76%	5.49%
VIX Index*	-15.61%	-27.57%	-21.63%	-5.85%	-28.28%
DXY Index*	0.41%	-2.13%	0.53%	16.66%	27.04%
CRY Index*	-2.80%	6.26%	-14.24%	-34.71%	-45.05%
EURUSD	-0.51%	1.75%	0.40%	-15.66%	-21.26%
USDJPY	-0.84%	-14.77%	-17.09%	3.41%	27.50%
Brent	-6.46%	24.65%	-20.88%	-56.86%	-60.36%
Gold spot	2.72%	27.96%	17.29%	5.59%	-12.57%

*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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