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WEEKLY INVESTOR RESEARCH

Ashmore

It is ok to allocate. Really!

By Jan Dehn

The case for allocating to EM has been building for at least a year. Performance is now catching up. We outline the case for allocating to EM, even if uncertainties linger in developed markets. The Turkish government's state of emergency should enable it to root out people with links to the recent coup attempt, but there may be a price to pay in terms of growth. Colombia looks set to hold a plebiscite on the recent peace agreement with the FARC rebels and approximately three quarters of Colombians are in favour. The global backdrop for EM deteriorated marginally as markets got depressed about the absence of further stimulus and the lack of bad news. After all, this is a world where performance in most financial assets has become more beholden to prospects of further policy support than economic data.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.4	–	0.26%
MSCI EM Small Cap	11.8	–	0.72%
MSCI Frontier	9.3	–	-0.94%
MSCI Asia	12.1	–	0.46%
Shanghai Composite	12.3	–	-1.28%
Hong Kong Hang Seng	7.1	–	-0.20%
MSCI EMEA	9.1	–	-0.85%
MSCI Latam	13.5	–	1.63%
GBI-EM-GD	6.31%	–	-1.21%
ELMI+	3.64%	–	-0.61%
EM FX spot	–	–	-0.97%
EMBI GD	5.13%	355 bps	0.01%
EMBI GD IG	3.88%	224 bps	-0.17%
EMBI GD HY	6.89%	541 bps	0.21%
CEMBI BD	5.10%	366 bps	0.08%
CEMBI BD IG	3.93%	250 bps	-0.05%
CEMBI BD Non-IG	7.03%	558 bps	0.29%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	0.64%
1-3yr UST	0.73%	–	-0.04%
3-5yr UST	1.14%	–	-0.04%
7-10yr UST	1.59%	–	-0.10%
10yr+ UST	2.30%	–	-0.24%
10yr+ Germany	-0.01%	–	0.73%
10yr+ Japan	-0.24%	–	-0.68%
US HY	6.57%	520 bps	0.28%
European HY	4.39%	483 bps	0.42%
Barclays Ag	–	243 bps	0.30%
VIX Index*	12.64	–	0.20%
DXY Index*	97.43	–	0.87%
EURUSD	1.0974	–	-0.92%
USDJPY	106.26	–	0.10%
CRY Index*	182.90	–	-5.96%
Brent	45.6	–	-3.00%
Gold spot	1317	–	-0.90%

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

Emerging Markets

Emerging Markets (EM) have performed a lot better this year than for some time. EM currencies are outperforming the Dollar and EM local bonds are up strongly year to date in Dollar terms. Despite the rally EM bonds still pay about 5-6 times higher yield than similar duration bonds in the US, while many other developed market bonds pay negative yields. The reasons for EM's better performance are many, including better valuations, stronger technicals and improving relative and absolute fundamentals. As recently as last week, the IMF revised down developed market growth again, including -0.2% revisions of US and UK growth. China's growth forecast was revised up.

Even so, it is challenging at this point in the cycle for many institutional and other investors to decide on an EM allocation. While valuations, technicals and fundamentals ought to be enough to make the decision, incentives often militate against being a first mover, because getting a bet wrong can pose career risk, while the personal reward is often small, sometimes even non-existent. But the result, if everyone waits, is herd dynamics and inefficient allocations, i.e. a classic market failure. What works for the individual hurts the population, a tragedy of the commons.

There are also deeper psychological barriers to allocating to EM at a time such as now. Nervousness is growing about core allocations to developed markets, for good reason, because valuations, fundamentals and technicals are questionable. The solution is to reduce exposure to such markets and to allocate to EM markets, but many investors are not used to allocating to EM when they are nervous. The EM asset class is, after all, still perceived by many to be 'risky'. Sure, there are risks in EM, but it is far riskier to invest in markets, where the risks are not even perceived – and hence not priced.

We think most of the fears pertaining to EM are misplaced and that it is ok to allocate to EM now, despite the uncertain outlook in developed economies. The case for EM has been building steadily for the past twelve months. Ashmore has produced a number of research reports over this period to highlight the main

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arguments. The case for EM fixed income was laid out at the start of 2016 in the *"Fixed Income Outlook 2016"* (The Emerging View, January 2016), which remains entirely relevant today. However, EM is a large universe of opportunities with many nuances upon which we have elaborated in other reports, the most important of which we list below, in the hope that this may assist asset allocators in getting a clear and comprehensive understanding why prospects are now so much better for EM than for developed markets.

1. Resilience in the face of external shocks – EM countries have faced major external headwinds over the last several years, including the Taper Tantrum, the strong Dollar, a commodity price crash and the start of the Fed's hiking cycle. Many investors panicked in the face of these shocks, but EM fundamentals held up better than most expected. Default rates remain low, central banks did not lose control of inflation and balance of payments crises were few. In many instances, the tougher external conditions led to reforms. This combination of lower asset prices but resilient fundamentals has created value in the asset class. To read more about this see *"Lo que no nos mata nos hace mas fuertes ("What does not kill us makes us stronger")*, The Emerging View, March 2016 and *"EM's NIIP – a natural macro hedge"*, Weekly Investor Research, 23 May 2016.

2. Stronger external balances – There is now overwhelming evidence that EM's external balances have dramatically improved. Weaker EM currencies have helped to restore external competitiveness, while central banks have controlled inflation in the face of pass-through inflation risks. Nowhere is the improvement in external balances more evident than in EM's sharply improving current account balances. This bodes well for both reserve accumulation and growth. See *"Nothing stays the same: EM's dramatic external rebalancing"*, The Emerging View, November 2015.

3. The return of the EM growth premium – EM economies are now emerging from the cyclical slowdowns caused by capital leaving in order to chase QE sponsored rallies in the developed markets. EM's growth premium over developed market growth is now expected to rise consistently over the next five years, mainly due to net export performance. See *"EM's next growth drivers"*, The Emerging View, May 2016 and *"Global Growth: myth versus reality"*, Weekly Investor Research, 18 April 2016.

4. Latin America – Having been beaten up more than any other region during the headwinds of the last few years, Latin America now offers perhaps the most interesting investment proposition in the world. Institutions are improving, populist governments are giving way to more market friendly administrations and asset prices are cheaper than elsewhere. Latin America will also see more a more extreme turn-around in growth than other regions over the next couple of years, in our view. The case for Latin America is laid out in *"Latin America: the best investment proposition in the world today"*, The Emerging View, July 2016 and *"ANCEAM Six: small and (almost) perfectly formed"*, The Emerging View, December 2015.

5. The rise of the judiciary – The rise of middle classes is changing EM. Elected officials are facing far more careful scrutiny by judges across a number of countries. This is perhaps most evident in Brazil, but similar dynamics are evident elsewhere too. While the judiciary is not winning in all EM countries the trend towards greater accountability at the hands of increasingly powerful judges is nevertheless likely to strengthen as living standards continue to rise. For more detail see *"The Rise of the Judiciary"*, Weekly Investor Research, 14 September 2015 and *"The Institutional Avenues of political accountability"*, Weekly Investor Research, 21 March 2016.

6. Attractive valuations in a number of EM asset classes – The relative and absolute valuations in EM are compelling after years of selling by asset allocators as they have chased QE sponsored developed market assets. EM IG corporates now offer superior returns and lower risk than US IG corporates across time periods, maturity and ratings buckets. The risk return profile for EUR denominated EM bonds also strongly favours EM over Eurozone sovereign bonds. EM corporate high yield bonds have lower default rates than US high yield bonds and a number of arbitrage opportunities now exist in external debt, including about 100bps of free spread due to the greater diversification of the index following the doubling of the number of issuers over the past decade. These arguments are elaborated in *"Free Money: Arbitrage Opportunities in EM external debt"*, Market Commentary, June 2016, *"Switch from Eurozone IG bonds to EM IG EUR-denominated bonds"*, Market Commentary, July 2016, *"Switch to EM corporates from US corporates"*, The Emerging View, February 2016 and *"Superior returns and lower risk in EM IG Corporate bonds"*, The Emerging View, July 2016.

7. Excellent technicals – Positioning in EM is light. The bulk of retail, fast money, banks, hedge funds and other momentum investors are out of the asset class or very lightly positioned. Institutional investors have in many cases not allocated in line with the growth of their AUM over the last few years. The resulting strong technical position has made the EM asset class more resilient in the face of several confidence shocks this year, including the pricing of future Fed hikes and Brexit. This suggests that the EM rally has legs, even though, of course, markets never move in a straight line. A number of publications explain why the switch out of QE markets into the previously unloved non-QE markets, including EM is now the right trade, including *"The Mars Bar effect"*, Weekly Investor Research, 14 December 2015, *"EM Traffic Light: Red, Amber, Green"*, The Emerging View, July 2015 and *"The Failure of QE"*, The Emerging View, April 2015.

Note: All referenced Ashmore publications can be found by following the hyperlinks in the text or at: www.ashmoregroup.com/insights/research

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8. **Diminishing sensitivity to Fed tightening** – Fed hikes are still perceived by many to be the greatest threat to EM. Yet, correlations between EM rates and FX and the short end of the US Treasury curve have been declining steadily and are now very low. EM pullbacks in response to Fed tightening have become steadily shallower, while recoveries after Fed events have become stronger. EM bond yields are already hovering close to levels last seen when the Fed had policy rates above 5%, so the likely gentle trajectory for Fed hikes should not hurt EM. By contrast, there is clearly vulnerability in developed fixed income markets, where debt burdens are higher and bond yields far lower. Indeed, developed market bonds are showing increasing sensitivity to Fed tightening. See *"EM and the Fed: smaller pullbacks and greater recoveries"*, The Emerging View, June 2016.

9. **Good tactical entry point** – Spikes in risk aversion in developed economies have usually been good entry points for EM allocations. Brexit caused a 10 point spike in VIX. In the past, VIX spikes of 10 points or more have produced on average 3% alpha over the subsequent twelve months compared to passively timed investments. Investors should use such events to add to EM positions. See *"VIX spiked 10 points in June – it is a good time to allocate to EM"*, Weekly Investor Research, 11 July 2016.

10. **Less attractive alternatives** – The opportunity cost of investing in EM is declining sharply, because yields in developed markets are going negative almost across the entire term structure. Investments in developed economies are also becoming more risky, because reforms are being neglected and the ability of developed countries to stimulate their economies in conventional fashion is diminishing. The next generation of easing measures could be painful for investors. See *"Beyond 'conventional unconventional' policies"*, The Emerging View, April 2016.

11. **Rising political risks in developed economies** – Investors were recently reminded that investments in developed economies can be far from risk free. The GBP, a global reserve currency, experienced a 21 standard deviation shock in the immediate aftermath of the UK Brexit vote. But Brexit is merely one manifestation in a broader shift towards more populism in developed economies and there are likely to be many more. Populism will lead to policies that directly hurt economies, while the crucial ingredients that could engender a genuine economic recovery, such as deleveraging and aggressive economic reforms, get set aside. This means that risks are increasing, boding poorly for return prospects. For more details see *"All is well in EM, but the global backdrop is messy"*, Weekly Investor Research, 3 May 2016, *"The Politics of Denial"*, Weekly Investor Research, 1 July 2016 and *"The Coming Trump Pitch"*, Weekly Investor Research, 16 May 2016.

12. **A lot of alpha opportunities** – The universe of sovereign issuers in EM will reach 67 or higher this year. There are more than 3,000 corporates in the BAML EM corporate bond index. Ashmore continues to produce numerous reports, on a weekly and monthly basis, covering country-specific developments in the growing EM universe. Right now, the 'live' opportunities include Venezuela, Brazil, China, Russia, Turkey, Malaysia, Argentina, Ecuador, Indonesia, India, Mexico and others.

- **Turkey:** The government's three-month state of emergency is geared at purging all elements associated with the recent attempted coup against the government. This purge is likely to lead to a slowdown in growth due to the associated disruptions and could have longer-term negative growth implications if the government cannot find qualified people to replace those that are being removed from office. Having said that, President Erdogan should emerge stronger as a result of the purges, which could ultimately result in less future political uncertainty. In other developments, S&P downgraded Turkey's local currency long-term debt rating to BB+ from BBB- with negative outlook. This means that Turkey will be excluded from the GBI EM GD Investment Grade sub-index, although the country will continue to be included in the broader and far more widely used GBI EM GD index. Moody's also put Turkey on review for downgrade in external debt. The central bank cut rates by 25bps. Finally, Russia lifted restrictions on flights to Turkey.

- **Colombia:** The High Court approved a plebiscite on President Juan Manuel Santos' proposed peace deal with the FARC rebel movement. The deal has the potential to end five decades of war. A recent poll shows that 74% of Colombians support the plebiscite. The government has not yet formally set a date for the plebiscite, but it is expected to be held sometime in Q3 2016. The trade deficit narrowed sharply to USD 740m in May from USD 1.0bn in April.

Note: All referenced Ashmore publications can be found by following the hyperlinks in the text or at: www.ashmoregroup.com/insights/research

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Snippets:

- **Argentina:** The central bank left the policy rate unchanged again at 30.25%.
- **Brazil:** Mid-month CPI inflation was higher than expected in July at 0.54% mom versus 0.45% expected. The higher than expected inflation was due to food prices, but given the momentum in producer prices, which is soft there is reason to believe in lower inflation going forward. The central bank's monetary policy committee kept rates unchanged at 14.25%.
- **Indonesia:** The central bank left rates unchanged at 6.50%.
- **Malaysia:** CPI inflation was lower than expected at 0.2% mom (1.6% yoy) in June.
- **Russia:** The credit impulse – the change in credit growth – turned positive in H1 2016, according to new Russian lending data. Industrial production rose 1.7% yoy in June, up from 0.7% yoy in May. Real wages, unemployment and retail sales were also better than expected, but construction was weak.
- **Ukraine:** The finance ministry said that they expect to reach agreement on the next tranche of IMF support by August rather than July.

Global backdrop

The European Central Bank, the Bank of England and the Bank of Japan all remained on the side-lines as they await the economic fallout from the UK Brexit vote. The G20 highlighted the same risk. So far only one piece of major macroeconomic data has been released following the Brexit vote, namely UK services PMI, which declined sharply from 52.3 in June to 47.4 in July. US data is getting stronger and the fears of less policy easing is weighing a bit on markets that have become far more sensitive to policy stimulus than actual economic data. A USD bid tone continued most of the week, aided by a minor repricing of Fed hikes following an article by Fed mouthpiece Jon Hilsenrath of the Wall Street Journal. Hilsenrath floated the idea of a September Fed hike, but the market is pricing in a 26% probability of a September hike. No one really knows what the economic fallout will be from Europe's problems and America's upcoming election, so odds strongly favour 'no change' at this week's Fed meeting.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.55%	11.37%	-3.97%	-0.33%	-2.77%
MSCI EM Small Cap	3.77%	5.24%	-5.84%	0.67%	-1.75%
MSCI Frontier	0.47%	-0.03%	-10.60%	-0.78%	1.60%
MSCI Asia	4.59%	6.92%	-4.38%	3.34%	0.78%
Shanghai Composite	3.80%	-13.33%	-23.65%	17.28%	4.26%
Hong Kong Hang Seng	4.03%	-2.69%	-19.65%	2.52%	-2.68%
MSCI EMEA	3.97%	16.17%	-8.31%	-5.70%	-6.22%
MSCI Latam	5.56%	32.65%	3.28%	-6.66%	-8.55%
GBI EM GD	-0.32%	13.65%	2.53%	-4.30%	-2.47%
ELMI+	-0.13%	5.68%	0.12%	-3.38%	-2.92%
EM FX Spot	-0.81%	4.40%	-5.81%	-10.43%	-9.28%
EMBI GD	2.03%	12.55%	11.56%	6.85%	6.70%
EMBI GD IG	1.45%	11.82%	9.72%	6.13%	5.80%
EMBI GD HY	2.69%	13.21%	13.78%	7.68%	7.99%
CEMBI BD	1.40%	9.31%	6.47%	5.63%	5.44%
CEMBI BD IG	1.00%	7.42%	6.14%	5.59%	5.56%
CEMBI BD Non-IG	2.07%	12.57%	6.68%	5.45%	5.22%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	3.74%	7.72%	5.17%	10.95%	12.47%
1-3yr UST	-0.22%	1.42%	1.37%	0.74%	0.69%
3-5yr UST	-0.43%	3.34%	3.78%	2.50%	1.91%
7-10yr UST	-0.73%	6.92%	8.59%	5.05%	5.18%
10yr+ UST	-0.05%	15.56%	18.31%	11.23%	10.77%
10yr+ Germany	-1.36%	16.34%	17.46%	12.06%	12.13%
10yr+ Japan	-1.60%	14.86%	19.08%	9.93%	7.72%
US HY	3.06%	12.39%	5.61%	4.30%	6.22%
European HY	2.24%	6.05%	3.65%	6.87%	9.39%
Barclays Ag	1.14%	7.74%	7.87%	5.23%	5.44%
VIX Index*	-19.13%	-30.59%	-8.01%	-2.54%	-34.68%
DXY Index*	1.34%	-1.22%	0.19%	18.86%	31.55%
CRY Index*	-5.02%	3.84%	-10.80%	-36.25%	-47.12%
EURUSD	-1.16%	1.09%	-1.02%	-17.35%	-23.67%
USDJPY	2.97%	-11.49%	-13.79%	7.03%	35.74%
Brent	-8.31%	22.18%	-16.61%	-57.69%	-61.38%
Gold spot	-0.40%	24.07%	20.38%	-1.27%	-18.41%

*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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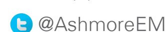
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