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WEEKLY INVESTOR RESEARCH

Ashmore

Balance of risks

By Jan Dehn

The case for Emerging Markets (EM) rests not just on valuations, fundamentals and the positive outlook for EM currencies, but also, importantly, on current positioning. Light positioning in EM assets means that there are fewer sellers to respond to negative global risk events and more potential upside if institutional investors allocate when they come back from summer holidays. Hence, risks are on balance skewed favourably in EM even after this strong performance year to date. Turning to developments of relevance to investors in individual EM countries, the trial of President Dilma Rousseff has begun in Brazil, while Mongolia is showing signs of wanting to put things right. In China, the data disappoints, but without surprising a great deal. Egypt accepts help from the IMF, Eastern European countries grow strongly, Russia gets into another tiff with Ukraine and speculation mounts that Sukuks will soon be included in JP Morgan's fixed income benchmark indices. The global backdrop section discusses the huge shifts in the FOMC's projections for the steady state variables against which it defines policy. What do these shifts mean for you?

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	2.81%
MSCI EM Small Cap	12.3	–	1.68%
MSCI Frontier	9.5	–	0.86%
MSCI Asia	12.5	–	2.39%
Shanghai Composite	12.9	–	2.53%
Hong Kong Hang Seng	7.6	–	4.64%
MSCI EMEA	10.1	–	3.43%
MSCI Latam	14.1	–	3.40%
GBI-EM-GD	6.15%	–	2.13%
ELMI+	3.31%	–	1.00%
EM FX spot	–	–	1.59%
EMBI GD	4.98%	346 bps	0.98%
EMBI GD IG	3.76%	217 bps	1.01%
EMBI GD HY	6.75%	531 bps	0.94%
CEMBI BD	4.94%	354 bps	0.66%
CEMBI BD IG	3.80%	241 bps	0.53%
CEMBI BD Non-IG	6.83%	542 bps	0.87%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	0.12%
1-3yr UST	0.69%	–	0.05%
3-5yr UST	1.09%	–	0.14%
7-10yr UST	1.51%	–	0.41%
10yr+ UST	2.23%	–	1.36%
10yr+ Germany	-0.10%	–	0.43%
10yr+ Japan	-0.05%	–	0.60%
US HY	6.46%	512 bps	0.88%
European HY	4.11%	459 bps	0.70%
Barclays Ag	–	245 bps	0.65%
VIX Index*	11.55	–	0.16%
DXY Index*	95.72	–	-0.68%
EURUSD	1.1162	–	0.67%
USDJPY	101.17	–	-1.25%
CRY Index*	182.68	–	0.88%
Brent	47.3	–	4.23%
Gold spot	1340	–	0.36%

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

Emerging Markets

The statistics that purport to capture flows in EM bond and equity funds are highly imperfect, but for what they are worth they have been showing a decent pickup in allocations in recent weeks. EPFR, a flow data provider, shows for example that there have been inflows into EM for six consecutive weeks now. However, EPFR and other readily available sources only capture a small part of the overall flow story. Large swathes of the institutional investor base, for example, do not report flows to EPFR.

Regardless of their inadequacies, these positive flow indicators undoubtedly reflect the pick-up in EM performance this year. The strong performance reaches across EM asset classes. Year to date, for example, EM currencies are up 7.7% versus the Dollar and EM equities are up twice as much as US equities (16.8% and 8.3%, respectively), with Latin American equities up more than four times as much as US stocks (38.9%). In addition, local currency bond returns are five times higher year to date, in Dollar terms, than US bonds of the same duration (17.6% and 3.5%, respectively). EM sovereign and corporate Dollar bonds are both up 14% ytd.

Given the positive flow dynamics and after some good performance many will likely be asking themselves whether the trade is over. Performance is obviously never a straight-line. This year has already had both up and down months. Even so, we think the case for EM remains solid even after the rally so far. The case for EM hinges on four basic arguments:

First, valuations are still very attractive. EM local bonds pay yields that are some six times higher than US yields of the same duration. In fact, until very recently EM bond yields were higher than they were when the Fed had rates above 5%! Relative yields when compared to Europe and Japan are even more compelling.

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Emerging Markets

Equities are also cheap. They trade significantly below their historical price to book, which looks increasingly odd taking into account that EM stocks now have a larger tech share than the S&P500 (23% versus 21%), while the commodity share is now down to just 14%. Or to put it differently, EM stocks are today, a structural growth story. It follows that they should trade above, not below, their historical price to book.

Secondly, the fundamental outlook for EM is clearly brightening. 2016 is the first year since 2011 when EM's growth premium – that is, its growth rate in excess of growth rates in developed economies – increases. Moreover, this growth premium is set to increase further in the next five years, according to the IMF. Headwinds are turning to tailwinds.

Thirdly, EM currencies have stopped falling versus the USD. In fact, they are rising versus the Dollar. This matters, because investors like to have money invested in currencies that go up. As capital begins to flow back into EM there will be a pick-up in both consumption and investment too, because financial conditions will ease.

Finally, positioning remains extremely benign. Flows so far this year have mainly been due to re-allocations towards EM within existing portfolios of cross-over investors. The bulk of cross-over, retail, bank and hedge fund investors, however, left the asset class years ago and are not currently invested. The fact that EM assets are now mainly held by institutional/dedicated EM funds matters for performance, because these are solid hands that usually buy on bouts of risk aversion, thus limiting the scope for downside risks. This is very evident in the asset class performance this year. Risk events such as Brexit, prospects of Fed hikes, the Turkish coup and even weaker Chinese data, have not been able to dent EM performance this year. If the same events had happened four or five years ago it would have been a very different story. This is the power of positioning. Moreover, if performance continues, which seems likely, then institutional investors will come back and then there will be far more upside. In short, current positioning means that the risk rewards is skewed strongly toward the upside.

Beyond these four basic arguments, we would also encourage investors to take a broader perspective. For the past half a decade institutional investors have been chasing returns in developed markets that have been generated almost exclusively due to the enormous asset purchase programmes of central banks (they did not buy a single EM bond). Today, there is not a lot of value left in the QE markets. The lack of juice is particularly evident in fixed income markets, where some USD 11.7trn of bonds now trade with negative yield (up by USD 200bn in the past two weeks). Thinking about this from a long-term investment perspective, we find it mindboggling that anyone even looks at developed market bonds these days. It seems to us that investors, for all their sophistication, really have a hard time distinguishing between an investment and a tax. As a general rule, in an investment someone pays you to give them or lend them money. One can then debate whether the compensation is or is not commensurate with the risk, but surely being paid for taking risk is a basic criterion for any investment. Today, however, the bulk of developed market bonds pay negative real yields. As such, they are best thought of as taxes; you are paying to lend money. There are far better alternatives available.

- Brazil: The Lower House concluded its renegotiation of a moratorium on state debts. The result was a concession to the states which allows them not to freeze public sector salaries. However, in exchange the government won support for a threshold that limits the maximum increase in total public sector expenditure to the previous year's inflation rate. This means that states will have to find cuts elsewhere in their budget if they choose to spend more on salaries. The support for the spending cap, in our view, is critical, so this is good news. In other news, the appreciation of the currency has allowed the Brazilian central bank to step up Dollar purchases. It has done so by expanding the volume of reverse repos to 15,000 contracts per day – equivalent to USD 750m. This may weigh on the pace of BRL appreciation in the near-term. If the programme continues at this pace the central bank will have entirely eliminated its forward book of USD 48.6bn by the middle of November. Year to date, Brazil's FX reserves have increased by nearly USD 8.3bn to USD 377bn. Meanwhile, the monthly GDP indicator continues to improve. Having bottomed out at -1% in March 2015, the mom prints have steadily improved until they broke into positive territory in June (+0.23% mom)

- Mongolia: The country's finance minister said that Mongolia is in crisis and that a plan must be implemented to avoid default. This is good news, but Mongolia faces a major uphill struggle to bring the economy onto a sound footing. Mongolia has been hit by three shocks, two of which are self-inflicted. Commodity prices declined, which, for a country like Mongolia, whose main industry is mining, means trouble. However, in addition the government has been unable to define an attractive and stable business environment for foreign investment, which means that they have not been able to increase output to offset falling prices. Finally, after a prudent entry into global financial markets a decade ago the Mongolians quickly got well ahead of themselves debt wise. If the government follows through with the adjustment programme announced by the finance ministry, then this should be seen as good news, even if Mongolia will be walking across plains of macroeconomic pain for a while.

- China: Most economic indicators weakened in July, particularly fixed asset investment and loan growth. Retail sales and industrial production rose, but more slowly than anticipated. There are two broad sets of reasons for the softer data. First, there were some temporary technical factors. For example, there were fewer working days in July this year than last year and major floods across large swathes of China will also

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Emerging Markets

have had an impact. In addition, slower than anticipated rate of growth of fixed asset investment (8.1% yoy versus 8.9% expected, year to date) may be due in part to the lumpy nature of infrastructure investment. Secondly, the overall slowdown in growth and the tendency for investment related data to be weaker than consumption related data is precisely what markets should be expecting. After all, no one should be surprised by now that China is rotating spending away from investment related activities towards consumption. This is why retail sales are running at a healthy clip of 10.2% yoy – higher than the expected real GDP growth rate – while investment related activity is growing more slowly. This is also why mortgage related lending is strong, while private sector capex is weaker. As we have argued for years, China's transition from an investment/export-led economy to a consumption-led economy will take time during which the economy will slow, wherefore the main investment proposition continues to be fixed income, while equity opportunities are likely to be more opportunistic.[1] Eventually, of course, when China's reforms have been completed the equity markets will once again be the place to be. China's 5-year government bond yield has dropped from 4.50% at the start of 2014 to 2.47% last week. Ten year yields also dropped to record lows. Yet, China's bonds continue to yield much more than any of the other countries that form part of the global reserve currency system, in nominal as well as real terms.

- Egypt: The government signed a preliminary IMF agreement for three years that can provide about USD 12bn in fresh funding. Egypt needs external rebalancing following declines in tourism receipts. This implies less domestic demand and a weaker Egyptian pound. These measures will depress growth for a time, but should, if implemented, bring investor confidence back.

- Eastern European growth: Hungary, Poland and Romania saw healthy improvements in their real GDP growth rates in Q2 2016. Poland's yoy real GDP growth rate only picked up from 3.0% in Q1 to 3.1% in Q2, but the acceleration was dramatically stronger in Hungary (2.6% yoy from 0.9% yoy) and Romania (6.0% yoy from 4.3% yoy). Domestic demand growth and stronger external balances were behind the better than expected numbers.

- Russia: Tensions between Russia and Ukraine are rising again. The jury is out as to why this is happening and why now. One theory is that Ukraine was the instigator. Ukraine has a strong, even existential, interest in ensuring that the US continues to provide support. To this end, it is advantageous for Ukraine to paint Putin and Russia as baddies, because this reflects badly on Donald Trump, who has expressed considerable fondness for Putin. To the extent that this increases the odds that Hillary Clinton becomes the next US president, this in turn should ensure that US foreign policy towards Ukraine continues along existing lines. Why then, is Putin rising to the Ukrainian provocation? One obvious reason is that Putin has no choice. He cultivates an image of himself as a strong leader. Besides, a bit of foreign policy action rarely hurts at home. Putin has state Duma elections coming up and he may take the view that both Europe and the US are too weak to seriously punish him. After all, Obama is leaving office soon and Europe is divided after Brexit. He may also take the view that a foreign policy distraction is a good pretext for a bit of political housecleaning at home, explaining the exit of long-standing supporter, Chief of Staff Sergei Ivanov. As for the investment implications, we note that Russia's ability and willingness to pay remain solid. If spreads should blow out materially we think investors should prepare to buy. In 2015, Russia was one of the best trades in the world after investors massively over-sold the sovereign bonds following the annexation of Crimea in 2014. Meanwhile, the Russian economy is turning a corner. Year on year growth rates improved sharply in Q2 2016 (-0.6%) from Q1 2016 (-1.2%), which implies positive growth in both Q1 and Q2 on a qoq sa basis. Inflation declined 0.1% last week after declining 0.2% the week before.

- Index developments: According to Standard Chartered Bank, JP Morgan is expected soon to make an announcement regarding the possible inclusion of Sharia compliant bonds (aka Sukuks) in its suite of benchmark indices. JP Morgan has not yet made any announcement. If this is confirmed in the days or weeks ahead, we would regard it as a positive development. The Sukuk universe is small, but it is an important segment in some countries, notably in Malaysia.

Snippets:

- Argentina: CPI inflation slowed sharply in July to 2.0% mom from 3.1% yoy in June.
- Chile: The central bank left rates unchanged at 3.5%.
- Hong Kong: The rate of growth was much stronger than expected in Q2. On a yoy basis, real GDP rose 1.7% versus 0.9% yoy expected and 0.8% yoy last.
- India: Activity and prices both picked up in June and July, respectively. Industrial production rose to 2.1% yoy in June from 1.1% in May, while CPI inflation accelerated from 5.77% yoy in June to 6.07% yoy in July, mainly due to rising food prices. Core inflation picked up 10bps to 5.4% yoy. Good rains suggest a decent harvest and lower food prices in the coming months.

[1] *"Probably the best bond market in the world"*, The Emerging View, September 2014.

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Emerging Markets

- **Indonesia:** The trade surplus narrowed to USD 600m in July from USD 880m in June. The overall balance of payments was in surplus in Q2 2016 to the tune of USD 2.2bn.
- **Malaysia:** The economy expanded at a rate of 4.0% yoy in Q2, in line with expectations. Industrial production was up at a rate of 5.3% yoy in June versus 2.8% yoy in May and 2.5% yoy expected. The current account surplus in Q2 2016 was 0.6% of GDP, while the capital account surplus rose to 2.0% of GDP. There was also a decent pick up in FDI (1.3% of GDP) and the overall balance of payments surplus increased to 2.9% of GDP in Q2 2016 from -6.6% of GDP in Q1 2016.
- **Mexico:** The central bank left rates unchanged at 4.25%. Industrial production rose at a rate of 0.6% yoy in June, up from 0.5% yoy in May.
- **Peru:** Consumer confidence following the election of President Pedro Pablo Kuczynski increased to the highest level in ten years.
- **Philippines:** The central bank left the policy rate unchanged at 3.0%
- **Poland:** Inflation turned negative in July (-0.1% mom). This took the yoy inflation rate to -0.9% from -0.8% in June. Core is tracking around -0.2% yoy.
- **Singapore:** Q2 GDP was revised to 0.3% qoq saar from 0.8% qoq saar in an earlier flash release. This was still acceleration from 0.1% qoq saar growth in Q1 2016.
- **South Korea:** Bank of Korea left rates unchanged at 1.5%.
- **Thailand:** The economy expanded at a faster than anticipated clip of 3.5% yoy in Q2 2016. The consensus expectation was for 3.2% yoy growth.
- **Turkey:** The current account deficit widened to USD 4.94bn in June from USD 3.17bn in May and USD 4.30bn expected.
- **Zambia:** Zambian President Edgar Lungu is narrowly ahead of his main challenger for the presidency Hakainde Hichilema after votes have been counted in 90 out of 156 constituencies.

Global backdrop

Former Fed Chairman Ben Bernanke's recent article about the FOMC's shifting long-term projections for the US economy does not make comforting reading.[2] The significance of these shifts is considerable, because, as steady state variables, ideally they should be stable. After all, the FOMC sets interest rates, asset purchases and other policies precisely in order to close the gap between the current values of these and other economic variables and their expected terminal equilibrium values. Yet, they have been extremely volatile. Bernanke shows that the FOMC has changed its expectations of:

- the terminal fed funds rate by 29%
- the equilibrium unemployment by 17%
- the trend growth by 20%

To put just one of these statistics in context, the FOMC's estimate of the terminal fed funds rate has changed literally 10 times as much as the 10 year Treasury yield between June 2012 and June this year (29% versus 2.5%). Other than the growing suspicion that FOMC itself is now a major contributor to global financial market instability what lessons should investors draw from the FOMC's shifting sentiment about America's long-term macroeconomic equilibrium?

First, they should conclude that the FOMC really has no idea what they are doing when it comes to making forecasts about the economy. This not as harsh a criticism as it sounds. No one has covered themselves in glory in recent years when it comes to forecasting, especially investment banks, which have consistently over-estimated US growth even one-quarter-ahead for years on end. However, there is one important difference between the FOMC and everyone else, namely that the FOMC sets policy. Hence, the risk of policy mistakes is far greater than many will admit.

The risk of policy-mistakes is given even greater impetus when one takes into account that the FOMC's mistakes are not random. The FOMC has consistently erred to the side of optimism. Perhaps they are deliberately misleading the market. After all, the recovery strategy adopted by the US (and most other QE governments) hinges on bringing about recovery in the real economy by stimulating financial markets. Now, more than ever, after years of asset price inflation, the FOMC clearly has strong incentives to ensure asset prices do not collapse. Hence, they will go out of their way to make things seem ok, even if they are not. Conclusion: not only is the risk of policy mistakes higher than you think, but the resulting damage, if a mistake happens, may turn out to be larger than you fear due to the bias of the FOMC towards asset price inflation.

[2] https://www.brookings.edu/2016/08/08/the-feds-shifting-perspective-on-the-economy-and-its-implications-for-monetary-policy/

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Global backdrop

Arguably, the FOMC's consistent over-estimation of the equilibrium unemployment rate constitutes a bright spot among its forecast errors. However, the decline in the terminal unemployment rate is driven by a decline in expected inflation, i.e. the FOMC deems that unemployment can decline further before wage inflation begins to become a problem. But the only reason unemployment can fall further before inflation becomes a problem is that growth is expected to be slower. And why is growth expected to be slower? Because of lower investment rates and declining productivity growth. And investment rates and productivity growth are lower because….well….no one knows! Our view is that debt lies at the heart of the problem. However, it is nearly impossible to get policy makers to publicly admit that debt is a major problem, perhaps because they all know that the entire financial system in developed economies rests on debt and other types of credit.

Apropos productivity, output per hour in the US non-farm business sector, aka labour productivity growth, dropped into negative territory in Q2, according to new data from the US Bureau of Statistics. The productivity rate of -0.5% qoq saar compares to consistently positive productivity growth rates between +3% and +6% in the early 2000s. At face value, the decline in productivity suggests that growth and therefore inflation will be sluggish and that wage inflation will not be a problem. One can only hope so. Rising inflation at a time of such sluggish growth would raise the spectre of stagflation. Unfortunately, the FOMC's model of the economy does not take into account the broad direction of political change. A large number of voters across the QE economies are getting frustrated with the status quo, which has only delivered stagnation and rising inequality. The demand for change, particularly demand for greater economic prosperity lies behind this frustration. Absent appetite among politicians to tackle the underlying problems of debt the likelihood is rising all the time that governments will pursue ever more populist measures, including protectionism, scape goating, helicopter money, inflation and currency manipulation. There are ways out of debt other than repaying it, but they are not good for bond holders.

Finally, the Bank of England was unable to buy all the bonds it wanted as part of its recently expanded QE programme. The reason was that investors wanted to hold on to the paper with the result that nominal yields on short-dated tenors of the Gilt curve were pushed into negative territory. Real yields have been negative for some time. The other reason why the BOE could not execute its full purchase programme was that liquidity was low. This is a direct consequence of the government's own regulatory changes. While, with one hand, the government tightens regulation, which reduces trade volumes, it runs bigger fiscal deficits, which increases the size of the market, while asset purchases by the BOE become more and more pivotal for the state of financial markets. Policy-makers, however, do not appear to see any problem with this situation whatsoever. Do you?

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.29%	16.75%	8.60%	1.06%	1.14%
MSCI EM Small Cap	2.88%	8.86%	4.96%	1.82%	1.57%
MSCI Frontier	-0.18%	0.59%	-8.91%	-0.75%	3.31%
MSCI Asia	3.83%	11.35%	7.26%	4.55%	4.54%
Shanghai Composite	2.47%	-12.13%	-19.85%	15.92%	5.93%
Hong Kong Hang Seng	6.67%	2.96%	-9.71%	2.63%	2.16%
MSCI EMEA	3.87%	22.57%	3.09%	-4.30%	-2.05%
MSCI Latam	4.73%	38.88%	18.09%	-5.82%	-5.20%
GBI EM GD	2.57%	17.65%	10.04%	-2.81%	-1.42%
ELMI+	1.37%	7.67%	5.48%	-2.67%	-2.08%
EM FX Spot	1.81%	6.83%	-0.51%	-9.53%	-8.25%
EMBI GD	1.51%	13.99%	13.43%	7.87%	7.03%
EMBI GD IG	1.57%	13.32%	11.22%	7.36%	5.99%
EMBI GD HY	1.44%	14.59%	16.20%	8.30%	8.49%
CEMBI BD	0.90%	10.49%	8.22%	6.24%	5.86%
CEMBI BD IG	0.71%	8.43%	7.09%	6.20%	5.68%
CEMBI BD Non-IG	1.21%	14.06%	9.91%	6.01%	6.23%

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.61%	8.32%	7.03%	11.24%	15.57%
1-3yr UST	-0.08%	1.49%	1.28%	0.76%	0.66%
3-5yr UST	-0.21%	3.49%	3.26%	2.56%	1.67%
7-10yr UST	-0.46%	7.37%	7.41%	5.50%	4.08%
10yr+ UST	-0.91%	16.62%	14.99%	12.52%	8.92%
10yr+ Germany	-0.87%	17.68%	15.77%	13.27%	11.17%
10yr+ Japan	-1.09%	13.36%	16.85%	9.22%	7.37%
US HY	1.24%	13.39%	7.98%	4.95%	7.45%
European HY	1.09%	7.36%	5.66%	6.98%	11.08%
Barclays Ag	0.27%	8.56%	8.11%	5.62%	5.46%
VIX Index*	-2.70%	-36.57%	-9.98%	-21.59%	-63.76%
DXY Index*	0.20%	-2.95%	-0.83%	17.91%	29.64%
CRY Index*	0.92%	3.71%	-7.72%	-37.53%	-44.73%
EURUSD	-0.13%	2.82%	0.75%	-16.37%	-22.72%
USDJPY	-0.88%	-15.73%	-18.67%	3.91%	31.66%
Brent	11.42%	26.90%	-3.51%	-57.42%	-56.96%
Gold spot	-0.81%	26.25%	19.90%	-1.92%	-24.11%

*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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