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WEEKLY INVESTOR RESEARCH

Ashmore

Philippines powers ahead

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The Philippines has shown that weak growth in developed markets is no obstacle to growth in EM. Supporters of Ecuador's President Rafael Correa are preparing an option which he may not be able to resist. Fitch keeps Turkey at investment grade. Argentina's Supreme Court deals the government a blow over subsidies. China's Shenzhen-Hong-Kong Stock Connect gets the green light from regulators and we welcome sukuks into the JP Morgan suite of benchmark indices. India replaces quality with quality at the RBI. We also report on Brazil, Colombia, Venezuela and Zambia plus the snippets and a discussion of the volatility caused by the US monetary policy authorities.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	0.09%
MSCI EM Small Cap	12.3	–	-0.17%
MSCI Frontier	9.5	–	-0.16%
MSCI Asia	12.5	–	0.01%
Shanghai Composite	12.7	–	1.91%
Hong Kong Hang Seng	7.4	–	0.54%
MSCI EMEA	10.0	–	0.10%
MSCI Latam	14.0	–	-0.63%
GBI-EM-GD	6.16%	–	0.33%
ELMI+	3.41%	–	0.00%
EM FX spot	–	–	0.22%
EMBI GD	4.94%	335 bps	0.41%
EMBI GD IG	3.73%	208 bps	0.29%
EMBI GD HY	6.67%	517 bps	0.56%
CEMBI BD	4.90%	343 bps	0.39%
CEMBI BD IG	3.77%	231 bps	0.28%
CEMBI BD Non-IG	6.76%	528 bps	0.56%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	0.06%
1-3yr UST	0.78%	–	-0.05%
3-5yr UST	1.20%	–	-0.22%
7-10yr UST	1.60%	–	-0.47%
10yr+ UST	2.29%	–	-1.06%
10yr+ Germany	-0.03%	–	-1.02%
10yr+ Japan	-0.08%	–	-0.16%
US HY	6.33%	495 bps	0.53%
European HY	4.09%	454 bps	0.21%
Barclays Ag	–	244 bps	-0.14%
VIX Index*	11.34	–	-0.21%
DXY Index*	94.88	–	-0.75%
EURUSD	1.1283	–	0.89%
USDJPY	100.74	–	-0.51%
CRY Index*	188.78	–	6.10%
Brent	50.2	–	3.78%
Gold spot	1334	–	-0.38%

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

Emerging Markets

- **Philippines:** The economy continues to grow at a phenomenal pace. In Q2 2016, the Philippine economy expanded at a rate of 7.0% yoy, which was well ahead of expectations (6.6% yoy). On a sequential basis, the economy accelerated strongly in Q2 (7.4% qoq saar versus 5.1% qoq saar in Q1 2016). We expect the strong performance of the economy to continue as the Duterte administration begins to roll out much needed infrastructure spending programmes. The government remains firmly committed to not exceeding the 3.0% of GDP fiscal deficit ceiling. Remittances rose 4.8% yoy in June to USD 2.3bn.

- **Ecuador:** Supporters of President Rafael Correa have submitted enough signatures to trigger a referendum that could lift the current term limit and hence pave the way for Correa to run for president again. The signatures have to be approved by the electoral council and the referendum request has to be approved by the constitutional court. All of this should be entirely doable prior to next year's scheduled general election, thus giving Correa the option to remain in office. Correa says he does not want to run again, but, obviously, if the people demand it he will have no choice, will he? Correa's record with respect to financial markets has been highly ambiguous. In 2008, he chose deliberately to default on the 2012 and 2030 bonds, which he deemed to be illegitimate. On the other hand, his strong governance, achieved in part by undermining the balance of powers in Ecuador, has ushered in a period of stability the country has not experienced in decades. As such, Ecuador's experience echoes that of the Andean countries in general over the past 150 years, namely bouts of instability, populism and crises during periods of democracy and stability and growth during periods of authoritarian governments, providing, of course, the authoritarian leaders in question have been benign rulers (sadly not the case in most instances).

- **Turkey:** Fitch Ratings left Turkey's sovereign external debt rating unchanged at BBB-, that is, investment grade. Fitch Ratings lowered the outlook to negative due to the recent coup attempt. We think an imminent downgrade from Fitch is now highly unlikely barring big surprises on the economic or political front. We also think that the Erdogan Administration is in a stronger position politically than before the coup attempt, something that has traditionally given comfort to the market.

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Emerging Markets

- **Argentina:** The Supreme Court delivered some bad news to the government last week, when it ruled that the government has not followed the correct procedure for raising utility prices. Hence, the subsidy reductions – which form a key part of the government's programme of fiscal adjustment – have to be reversed. However, the damage is not nearly as severe as seems. The government merely has to conduct so-called 'townhall' meetings – public hearings – to allow the general public to voice its views about the changes in subsidies in order to implement the policy change. We expect this to happen in short order. The Supreme Court's ruling only applied to residential consumers, but may or may not be extended to other sectors in which case the government will also have to follow the procedures prescribed by the Court for those sectors. In other news, the central bank cut the 35-day Lebac interest rate by another 50bps to 29.25% as core inflationary pressures gradually wane.

- **China:** China's regulators have now given the green light for the so-called Hong-Kong Shenzhen Stock Connect to go live within four months. The bridge will allow investors in China's second largest stock exchange, and those based in Hong-Kong to trade each other's stocks seamlessly, thus providing a wider range of stocks to both. There will no longer be aggregate quota limits for the size of trading, a change that also applies with immediate effect to the Shanghai-Hong Kong Stock Connect. The speed with which China is integrating, upgrading and liberalising its financial markets is truly astonishing, in our view. We believe Index providers and global investors need to pay far more attention.

- **Index news:** Following recent speculation, JP Morgan announced that starting at the end of October Sharia compliant financial instruments, aka sukuks, will be eligible for inclusion in the bank's suite of indices, which also happen to be the main benchmarks used by institutional investors, including the EMBI GD, CEMBI BD, GBI-EM GD and JACI indices. JP Morgan estimates that sukuk instruments will comprise an estimated 0.35%, 0.62%, 0.56%, 0.99% and 0.54% in these indices, respectively. Approximately USD 650bn of assets under management tracks these indices, according to the bank. We strongly support the inclusion of sukuk bonds, which have become important financial instruments and are already traded extensively by asset managers the world over, including Ashmore.

- **India:** Urjit Patel will replace Raghuram Rajan as governor at the Reserve Bank of India on 4th September. Extremely experienced and competent, we think monetary policy will be in good hands with Patel, who is likely to continue the orthodox line adopted by his predecessor. In addition, Mr Patel has experience of banking reform and has worked on developing the debt market in India. These are both areas that require further work, in our view. Patel has been deputy governor of the RBI since 2013.

- **Brazil:** The central bank has reduced the volume of daily reverse repo swaps in a bid to limit downwards pressure on the currency. The central bank recently stepped up the volume of swaps in order to prevent excessive appreciation of BRL, but is now fine-tuning its interventions in light of recent developments in currency markets prompted by various comments by members of the FOMC in the United States (see global backdrop section).

- **Venezuela:** Reuters reports that Credit Suisse is working with PDVSA about a possible swap of bonds maturing in 2017, possibly into longer-dated securities. Such a swap would be expensive, but would provide Venezuela with much more room to deal with its current political and economic challenges, including a recall referendum against President Nicholas Maduro.

- **Colombia:** The adjustment of the external balances continues. Exports are improving sequentially at a faster pace than imports and the trade deficit is narrowing. The annualised trade deficit in Q2 2016 narrowed to USD 13bn from USD 15.5bn in Q1 2016, which means that the current account deficit should shrink by about 1% of GDP this year to about 5.5% of GDP, in our view.

- **Zambia:** President Edgar Lungu was confirmed winner in the first round of Zambian presidential election after winning just over 50% of the popular vote. Focus will now turn to Zambia's relations with the IMF and associated reforms. Zambia's economy is undiversified (tourism and mining) and has suffered from the fall in copper prices in recent years.

Snippets:

- **Chile:** GDP declined by much less than expected in Q2 2016 (-0.4% qoq versus -0.7% qoq expected). The current account deficit of USD 0.6bn was narrower than expected (USD 0.9bn).
- **Indonesia:** Bank Indonesia left the main policy rate unchanged at 5.25%. BI reduced the interest rates corridor around the 7-day reverse repo rate to 75bps and reduced the lending facility rate to 6% from 7%. The latter are policies aimed at managing short-term liquidity conditions.
- **Mongolia:** S&P Ratings lowered Mongolia's sovereign debt rating to B- with stable outlook. See last week's publication for a discussion of the economic situation facing Mongolia.
- **Peru:** Economic activity slowed to a rate of 3.6% yoy in June from 4.8% yoy in May.
- **Poland:** Following strong Q2 GDP data, a number of indicators weakened in July, including industrial production, construction spending and retail sales (all softer than anticipated).
- **Russia:** Retail sales picked up sequentially in July, while industrial production had a set-back. The Russian economy remains on track to growth modestly at a rate between 0.5% and 1.0% qoq saar in Q3.

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Global backdrop

US monetary policy authorities are once again the main source of instability in global markets. A lower than expected inflation number, a set of FOMC minutes that did not indicate any urgency to hike rates and a number of high profile public statements from FOMC members, are taking place against a broad backdrop of improving high frequency economic indicators. There is understandably a bit of confusion in the market. Several FOMC members pointed to a growing likelihood of a hike in the Fed funds rate this year, while at the same time arguing in favour of an overhaul of the entire monetary policy framework, including an increase in the Fed's inflation target. One source of confusion is therefore: why raise the inflation target and hike at the same time, especially since there is very little imminent inflation? Investors should discount much of what is being said, in our view. They should also not be too focused on the short-term volatility. The obvious absence of strong inflationary pressures means that the Fed's desire to hike mainly reflects a desire to buy some insurance against future downturns. At the same time, we think they are extremely keen to avoid upsetting the US markets and the US economy and, indeed, global markets. The US economy will grow only 1.5% this year. It is not strong enough to handle material rises in real rates due to a number of serious vulnerabilities, including an over-valued US dollar, stretched stock market valuations, record-low bond yields, negative productivity and extremely high levels of debt as well as rising political uncertainty and increasing odds of a fiscal splurge under the next US administration. There is also lingering uncertainty about the impact of Brexit on investment and consumption spending in Europe and the UK, though decent retail sales in the UK alleviated some of those concerns for now. We think the Fed ultimately aims to keep real rates stable, which means that policy rates will broadly rise in line with inflation, not ahead of it. As such, the pace of Fed hikes will likely be modest in both nominal and real terms and the impact on the US dollar will be limited too. Fed Chairwoman Janet Yellen will be the main focus this week, but we do not expect her to resolve any fundamental dilemmas at Jackson Hole.

As far as EM investors are concerned, we do not think EM is seriously threated by prospect of a Fed hike. Earlier this year the markets had priced in three Fed hikes and EM FX was still up versus the Dollar, while EM bonds strongly outperformed developed market bonds. We do not expect a strong adverse reaction in EM markets ahead of the next Fed hike – whenever it may be – but we think EM markets will perform strongly after a hike.

Stepping back and looking at developed economies from a greater height one cannot help being struck by the glaring lack of economic dynamism despite unprecedented stimulus. First, they stimulated their economies using fiscal policy until they had, on average, increased their debt to GDP ratios by roughly 30%. Then they exploited the full range of monetary policies including zero interest rates and quantitative easing. The talk is now of yet more fiscal stimulus and possibly raising the inflation target, perhaps using helicopter money in a bid to achieve both. One cannot help being struck either by the endless fascination with demand side stimulus, the constant denial of the existence of a debt problem and the complete lack of attention to supply-side policies. It is quite clear that a second foray into fiscal policy would add even further to the debt problem, in fact it would worsen it and risk greater retrenchment of private sector spending. It is also quite clear that raising the inflation target would not (directly) address the underlying problems of debt and falling productivity growth. Or to put things in a slightly different way – governments in developed economies are trying to achieve ever smaller increments of economic growth at ever higher costs in terms of the available policy instruments, which are clearly not working properly. The end-game, as far as we can see, can only be erosion in the confidence of markets in the currencies and the credit worthiness of developed economies. This does not bode well for investors with large amounts of wealth invested in such assets, because their future purchasing power will surely be eroded.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.38%	16.85%	11.37%	1.53%	1.56%
MSCI EM Small Cap	2.70%	8.68%	7.58%	2.31%	1.98%
MSCI Frontier	-0.34%	0.43%	-6.38%	-1.06%	3.43%
MSCI Asia	3.83%	11.36%	9.58%	4.65%	5.12%
Shanghai Composite	4.42%	-10.46%	-16.35%	16.93%	6.82%
Hong Kong Hang Seng	7.24%	3.51%	-5.81%	1.90%	2.62%
MSCI EMEA	3.97%	22.69%	6.99%	-3.66%	-1.95%
MSCI Latam	4.07%	38.01%	21.52%	-4.66%	-5.21%
GBI EM GD	2.91%	18.05%	12.61%	-1.63%	-1.68%
ELMI+	1.38%	7.67%	6.30%	-2.28%	-2.16%
EM FX Spot	2.03%	7.06%	1.38%	-8.88%	-8.31%
EMBI GD	1.93%	14.46%	14.48%	8.70%	6.80%
EMBI GD IG	1.86%	13.65%	12.22%	8.28%	5.71%
EMBI GD HY	2.00%	15.23%	17.28%	8.86%	8.31%
CEMBI BD	1.29%	10.92%	9.19%	6.71%	5.74%
CEMBI BD IG	1.00%	8.74%	7.74%	6.68%	5.48%
CEMBI BD Non-IG	1.77%	14.69%	11.44%	6.44%	6.28%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.67%	8.39%	7.36%	12.21%	16.68%
1-3yr UST	-0.14%	1.43%	1.22%	0.75%	0.64%
3-5yr UST	-0.43%	3.27%	2.93%	2.69%	1.61%
7-10yr UST	-0.93%	6.86%	6.66%	6.13%	3.64%
10yr+ UST	-1.96%	15.38%	13.27%	13.53%	7.48%
10yr+ Germany	-1.88%	16.48%	14.83%	13.86%	10.24%
10yr+ Japan	-1.24%	13.18%	16.94%	9.34%	7.13%
US HY	1.77%	13.99%	8.62%	5.32%	7.48%
European HY	1.30%	7.58%	5.93%	7.06%	11.01%
Barclays Ag	0.13%	8.41%	8.06%	6.02%	5.36%
VIX Index*	-4.47%	-37.73%	-59.54%	-23.17%	-73.28%
DXY Index*	-0.68%	-3.81%	-0.14%	16.43%	28.08%
CRY Index*	4.29%	7.17%	-1.34%	-34.53%	-43.10%
EURUSD	0.96%	3.93%	-2.88%	-15.53%	-21.42%
USDJPY	-1.30%	-16.09%	-14.92%	2.05%	31.15%
Brent	18.18%	34.60%	10.38%	-54.34%	-53.69%
Gold spot	-1.23%	25.71%	15.52%	-3.04%	-29.68%

*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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