Issued: 30 August 2016

WEEKLY INVESTOR RESEARCH

Ashmore

EM flows have barely begun – the value is compelling

By Jan Dehn

- Much has been made about recent inflows to EM, but we think institutional investors have barely begun to allocate and the value proposition remains extremely strong in local bonds.
- Michel Temer set to become Brazil's next president this week as attention turns to fiscal matters.
- Colombia will also soon embark on fiscal reform after the peace accord referendum on 2nd October.
- Clouds are gathering over South Africa, where we see no end to the political struggle at the heart of the ANC government.
- Global markets waited for Jackson Hole with baited breath – central bankers have become far too important to stimulus addicted markets.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.8	–	-0.88%
MSCI EM Small Cap	12.1	–	-0.54%
MSCI Frontier	9.8	–	-0.39%
MSCI Asia	12.4	–	-0.35%
Shanghai Composite	12.7	–	-0.47%
Hong Kong Hang Seng	7.5	–	-1.09%
MSCI EMEA	9.7	–	-3.69%
MSCI Latam	13.7	–	-0.80%
GBI-EM-GD	6.27%	–	-1.78%
ELMI+	3.44%	–	-0.64%
EM FX spot	–	–	-1.41%
EMBI GD	4.94%	336 bps	0.11%
EMBI GD IG	3.76%	213 bps	-0.04%
EMBI GD HY	6.63%	513 bps	0.27%
CEMBI BD	4.90%	344 bps	0.06%
CEMBI BD IG	3.77%	232 bps	0.04%
CEMBI BD Non-IG	6.77%	529 bps	0.10%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	-0.08%
1-3yr UST	0.82%	–	-0.10%
3-5yr UST	1.19%	–	-0.17%
7-10yr UST	1.57%	–	-0.14%
10yr+ UST	2.22%	–	0.16%
10yr+ Germany	-0.09%	–	-0.54%
10yr+ Japan	-0.07%	–	-0.23%
US HY	6.30%	489 bps	0.25%
European HY	4.00%	447 bps	0.27%
Barclays Ag	–	245 bps	0.09%
VIX Index*	12.86	–	0.48%
DXY Index*	95.83	–	1.29%
EURUSD	1.1164	–	-1.25%
USDJPY	102.50	–	-2.20%
CRY Index*	184.63	–	-3.74%
Brent	49.5	–	-0.98%
Gold spot	1319	–	-1.37%

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

Emerging Markets

Much has been made about recent headlines calling attention to inflows to the EM asset class. It is worth remembering that the asset class has seen outflows for more than three years and that outflows from EM currencies began as far back as late 2010. Most institutional investors are 'still on the beach' and remain heavily underweight. We think dedicated EM investors have increased exposure a bit and a few large cross-over investors have belatedly announced that they are more positive on EM. However, overall the flows have been modest, in our view. More importantly, the value proposition embedded in EM fixed income remains very strong. This is perhaps most evident in the most hated asset class on earth, EM local currency bonds. Looking overleaf, figure 1 shows EM local currency government bond yields and CPI inflation (weighted by JP Morgan's GBI-EM GD benchmark index, which is the market's preferred benchmark index). Figure 2 shows EM real yields versus real US 5 year bond yields. The relationship between yields and inflation in EM has been particularly interesting since the Taper Tantrum in May 2013, where yields have gone up by 220bps, while inflation in EM has declined by nearly 100bps. As a result, the real yield in EM is now high by historical standards, which in turn means that investors are paid and that EM central banks have plenty of room to ease policy should circumstances require. The same cannot be said for developed countries, where yields are negative in real terms and room to employ monetary policy has largely been exhausted. For far more detail on the case for EM local bonds please see *"Emerging Markets Local Currency bonds – the stars are aligned"*, Market Commentary, 3 August 2016.

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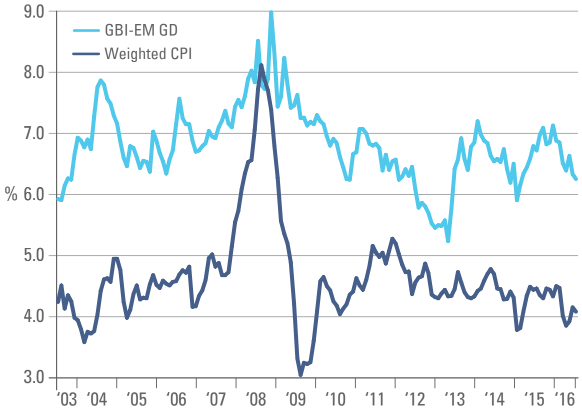
Emerging Markets

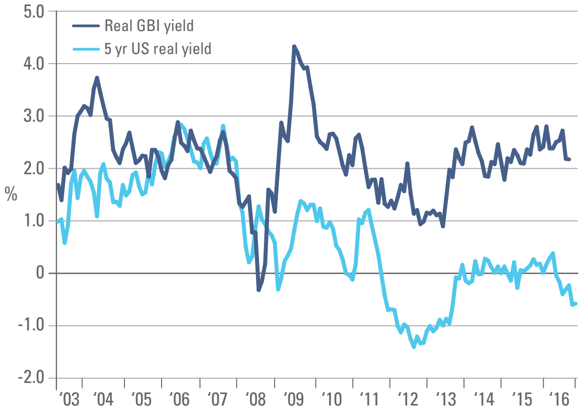
EM local currency bond yields

Fig 1: **EM inflation and yields**



Source: Ashmore, Bloomberg.

Fig 2: **Real yields: EM vs US**



Source: Ashmore, Bloomberg.

- **Brazil:** Barring any last minute surprises, we expect Michel Temer to formally become president of Brazil this week following the conclusion of the Senate's impeachment trial against President Dilma Rousseff. Temer's administration is best thought of as a technocratic care-taker administration pending the next election scheduled for 2018 at which point Temer's party, the PMBD, is likely to retreat to the role of supporter of either PT or PSDB. Currently, we think the odds favour a PSDB-led government post-2018, given the major challenges facing the PT party and its leader, former President Lula. PSDB will be happy to see major reforms undertaken during PMDB's time in office.

All eyes should now turn to fiscal matters. Both houses of the Brazilian congress last week passed the guidelines for the 2017 fiscal bill without changes relative to the version passed at committee stage some weeks ago. Notably, the bill includes a key measure that limits spending growth next year to this year's inflation. The Temer administration will seek to change the Constitution with a view to embedding this fiscal rule permanently into the legal framework once the Dilma trial is out of the way. The fiscal bill implies that the primary deficit will decline to BRL 143bn in 2017 compared to BRL 164bn this year. With GDP set to rise next year the improvement in the fiscal balance should be very evident. The other part of the fiscal reform effort relates to pensions. The Lula administration changed the rules governing pension entitlements in such a way that the pension system is now on a completely unsustainable footing. Finance Minister Henrique Meirelles hopes to change this. The bill has yet to be sent to Congress, but we expect this to happen in the coming month.

Turning to the economy, the 12 months rolling rate of decline of the labour force – measured as cumulative payroll losses – has now moderated for four months in a row. While jobs are still being lost, the 12 month rolling rate of loss has moderated from 1,884K in March to 1,722K in July. Payrolls are still deteriorating in more investment intensive sectors such as manufacturing, but there is now improvement in both services and commerce, where labour makes up the bulk of the factors of production. The greater cyclical sensitivity of manufacturing versus services is a classic characteristic of business cycles in all economies. Hence, the improvement in services and commerce is rightly regarded as good news, because it foretells a coming upswing in more capital intensive sectors later on. Credit to the private sector also increased at a real rate of 6.3% mom in July compared to a decline of 4.7% mom in June. Directed credit – that is loans that are allocated in accordance with government directives – expanded at a much more moderate pace of 0.6% mom. Mid-month CPI inflation printed 0.45% mom in August, down from 0.54% mom in July.

- **Colombia:** The government has reached a final agreement on the terms of a permanent peace with the FARC rebel movement. The Colombian people will now be asked to approve the terms of the peace accord in a plebiscite on 2nd October this year. Polls suggest a small majority against the deal due to the perception that the government has conceded too much to FARC. Still, our base case is the peace agreement is approved. A successful outcome should also put President Juan Manuel Santos in a strong position to win a Nobel Peace Prize for his country, in our view. More importantly, if the peace deal passes the government is likely to engage immediately in fiscal reform. Colombia has delayed adjusting to lower oil prices in order to preserve support for the peace deal. This has resulted in a widening of the trade deficit. For example, the June trade deficit was USD 0.81bn versus USD 0.74bn in May and Colombia remains one of a very small number of EM countries that have not improved their external balances in recent years. This may now change.

- **South Africa:** President Jacob Zuma's term ends in 2019 and in December 2017 the ANC holds its leadership election. Much of the current political noise in South Africa today, including the rising pressure on Finance Minister Pravin Gordhan to resign, revolves around these two pivotal events. Jacob Zuma wants to

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Emerging Markets

serve out his term and ensure that he does not go to jail for corruption and other possible crimes during, or after leaving, office. This means that he must control the ANC, which is still the main source of political power in the country. Zuma is currently leader of the ANC and hence very powerful, but to hold on to this power he must ensure that he is either re-elected or that one of his own people assumes the mantle of ANC party leader in December 2017. Between now and then, the key to controlling ANC is clientelism, that is, bestowing patronage in exchange for political support. Patronage – money and jobs – is primarily sourced from South Africa's state-owned enterprises (SOEs). While Zuma recently successfully wrested control of South Africa's SOEs from Cyril Ramaphosa, a reformer, he can only extract rent from the SOEs if he also controls the Ministry of Finance, which currently exercises considerable oversight and control over the finances of the SOEs. This is why Zuma is now seeking to remove Finance Minister Pravin Gordhan from office and, indeed, why in December 2015, he attempted unsuccessfully, to put one of his 'yes-men' David van Rooyen into the post of finance minister.

From an investor's perspective, there is little scope for positive fundamental economic or political news under current conditions. From an investor's perspective the fact that Zuma is trying to control key institutions solely in order to further his own political objectives is just plain ugly. At best, the deep divisions between Zuma and good guys, including reformers such as Gordhan, will continue to paralyse the government and hence make it very likely that South Africa will not do the economic reforms required to return the country to strong sustained growth. In turn, further sovereign ratings downgrades look likely. At worst, Zuma dismisses Gordhan and further marginalises other reformers within the ANC. In this scenario, the fiscal situation steadily deteriorates as the Finance Ministry gradually loses control over the finances of the SOEs, even, perhaps, the Budget itself. Eventually, South Africa's otherwise sound fiscal position and therefore overall macro-economic stability and growth could go to pot. Between these two scenarios, we think a bad scenario is more likely. The only scenario where Zuma is forced to step down and reformers are propelled into power is one in which South Africa plunges into a genuine economic crisis. Unless and until this happens, South Africa remains a deteriorating credit, where the ANC looks increasingly bad, weakening versus other political parties, but not necessarily weakening Zuma in the process.

That is not to say that South Africa does not present trading opportunities, but the investment opportunities are mainly determined by the price action that occurs against the fundamental backdrop outlined above. Default and the risk of a major balance of payments crisis remain low but the market is prone to overpricing some events and mistiming key turning points, so South Africa will continue to offer tactical trading opportunities. It makes sense to approach such opportunities with a bias to the lighter side exposure-wise, buying on very big dips and being prepared to lighten up to an underweight position when the market recovers from temporary bouts of excessive bearish price action and/or positioning.

- **Argentina:** Growth continues to soften while the Macri administration seeks to squeeze years of excess demand out of the economy. Economic activity declined at a rate of 4.3% yoy in June, while unemployment is drifting higher and industrial production is suffering. The silver-lining – indeed the purpose – of this pain is that inflation is falling and the central bank is gradually able to cut rates. Indeed, the central bank resumed rate cuts last week, taking the 35-day Lebac rate down by another 50bps to 28.75%. National CPI inflation thus declined to 2% mom in July from 3.1% mom in June and the trade balance has moved into surplus. The broader question is whether the political cost of the necessary economic medicine dispensed by the Macri administration will rise to levels that can threaten the government's hold on power and thus put an end to reforms.

Snippets:

- **China:** The stock market in China is now larger than the stock market in the whole of Europe. Chinese equities make up 16% of global equities compared to 15% for Europe. It is inevitable that China bond and stock markets as well as her currency, the RMB, will become the dominant reference markets over the next couple of decades.
- **Dominican Republic:** Real GDP growth surged to 7.4% yoy in H1 2016 from a still very strong 7.2% real GDP growth rate in H2 2015. The current account is in surplus and reserves are rising. Fiscal and monetary policies are stable.
- **El Salvador:** Remittances rose to USD 2.59bn in the period from January to July versus USD 2.44bn over the same period last year. Remittances make up more than 15% of GDP.
- **Hungary:** The central bank left the policy rate unchanged at 0.9%.
- **Malaysia:** CPI inflation rose 0.3% mom in July, taking the yoy rate to 1.1% (versus 1.2% yoy expected)
- **Mexico:** The current account deficit widened marginally from 2.8% of GDP in Q1 2016 to 2.98% of GDP in Q2 2016 due to falling oil prices and lower oil production. Core inflation was just 0.13% mom in July, which kept the yoy core inflation rate stable at 2.97%. The government trimmed its borrowing requirement to 3.0% of GDP from 3.5% of GDP previously. GDP expanded at a pace of 2.5% yoy in Q2 2016 versus 2.4% yoy expected.

Continued overleaf

Emerging Markets

- **Mongolia:** Moody's cut Mongolia's credit rating to B3 with a negative outlook from B2 in response to serious fiscal deterioration.
- **Panama:** Trend growth moderated to 4.2% yoy in June from 4.4% yoy in May.
- **Peru:** Real GDP expanded at a 3.7% yoy clip in Q2 2016. This constituted an acceleration from the rate of growth in the same quarter last year (3.2% yoy).
- **Taiwan:** Industrial production contracted at a pace of 0.3% yoy in July.
- **Venezuela:** The International Centre for Settlement of Investment Disputes (ICSID) has awarded Rusoro, a Canadian-Russian mining company, USD 1.2bn in compensation for the government's theft of its property. The original claim was USD 3bn.

Global backdrop

Global financial markets trod water last week while waiting to hear Fed Chairwoman Janet Yellen's comments at Jackson Hole. The simple fact that one central banker matters that much to such a large market tells you everything you want to know: developed markets have become dangerously addicted to stimulus from a central banker whose credibility is steady being eroded. After Yellen spoke the markets concluded that no major changes had happened. However, this perception was changed after Stanley Fischer mentioned the FED could still hike rates twice this year, in a clear attempt to shake things up a bit. The reality is that any hiking remains both data and market valuation dependent. If conditions falter, then the FED is likely to push hikes further down the road as they did in the 2Q15 and 2Q16. The market has reacted by moving the likelihood of a September hike to 36% and December to 61%. The long end of the curve was little changed with the 10yr trading at 1.58% early Tuesday from 1.56% before Yellen's speech. The flattening on the yield curve doesn't bode well for financial institutions and risky assets.

FED policies also have implications for other policy makers. After all, the sentence coined by the U.S. secretary of Treasury John Connally in 1973: "the USD is our currency, but your problem", remains true. The fall in the USD versus JPY caused some consternation in Japan, which last week racked up its fourth consecutive negative inflation print, despite years of full-on QE and plenty of fiscal stimulus during the early stages of Prime Minister Shinzo Abe's Three Arrows strategy. It is amazing that policy makers have still not figured out – in Japan and elsewhere within the QE universe – that additional stimulus is not the answer to the problem. The state of the world remains the same: QE central banks have created huge bubbles in stock and bond markets and triggered a highly counter-productive USD rally over the last few years. Investors have chased those trades and now find themselves overwhelmingly long. Return prospects are speculative at best. This explains why a certain degree of nervousness is detectable in sections of those markets. Meanwhile, for now, EM just looks far better. Stronger growth, higher yields, less debt, appreciating currencies, room to ease both monetary and fiscal policy, higher reserves and way better technicals.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.76%	15.05%	12.30%	1.86%	0.53%
MSCI EM Small Cap	1.27%	7.17%	10.07%	3.29%	1.56%
MSCI Frontier	-0.75%	0.01%	-3.24%	0.04%	3.14%
MSCI Asia	2.97%	10.43%	12.56%	5.24%	4.37%
Shanghai Composite	3.15%	-11.55%	-3.02%	16.23%	6.21%
Hong Kong Hang Seng	6.03%	2.35%	1.64%	2.70%	1.93%
MSCI EMEA	-0.28%	17.68%	2.81%	-3.97%	-3.69%
MSCI Latam	1.91%	35.15%	20.11%	-4.32%	-6.38%
GBI EM GD	0.69%	15.49%	11.55%	-1.54%	-2.25%
ELMI+	0.40%	6.63%	5.35%	-2.22%	-2.51%
EM FX Spot	0.30%	5.24%	0.53%	-8.88%	-8.73%
EMBI GD	1.93%	14.46%	14.45%	9.02%	6.90%
EMBI GD IG	1.70%	13.46%	12.71%	8.40%	5.78%
EMBI GD HY	2.20%	15.45%	16.46%	9.54%	8.46%
CEMBI BD	1.30%	10.94%	10.02%	6.86%	5.98%
CEMBI BD IG	1.01%	8.75%	8.27%	6.77%	5.69%
CEMBI BD Non-IG	1.79%	14.70%	12.87%	6.72%	6.59%

Continued overleaf

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.54%	8.25%	12.06%	12.32%	14.92%
1-3yr UST	-0.22%	1.35%	1.17%	0.72%	0.62%
3-5yr UST	-0.48%	3.22%	2.95%	2.67%	1.60%
7-10yr UST	-0.81%	6.99%	7.09%	5.82%	3.93%
10yr+ UST	-0.92%	16.60%	16.56%	12.66%	8.41%
10yr+ Germany	-1.40%	17.05%	17.61%	13.81%	10.69%
10yr+ Japan	-1.84%	12.50%	16.05%	8.76%	7.12%
US HY	2.10%	14.35%	9.20%	5.43%	7.68%
European HY	1.60%	7.90%	6.61%	7.22%	11.38%
Barclays Ag	0.48%	8.79%	9.10%	5.92%	5.68%
VIX Index*	8.34%	-29.38%	-50.63%	-24.40%	-60.90%
DXY Index*	0.31%	-2.84%	-0.29%	16.74%	29.59%
CRY Index*	2.00%	4.82%	-6.32%	-36.59%	-45.85%
EURUSD	-0.09%	2.78%	-0.42%	-15.57%	-22.69%
USDJPY	-0.43%	17.29%	18.27%	-4.22%	-25.13%
Brent	16.51%	32.70%	-1.16%	-56.61%	-56.61%
Gold spot	-2.37%	24.33%	16.24%	-5.45%	-28.13%

*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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