Business as usual in EM as Fed fears paralyse global market sentiment

By Christian Schniewind

- Finance Minister Videgaray's replacement illustrates the institutional strength in Mexico
- Argentina's Supreme Court gives President Macri some good fiscal news
- China's trade balance shows signs of both stronger exports and imports
- Two European corporates without state backing issue bonds with negative yields – this is prima facie evidence of a credit bubble in developed markets, in our view
- Global market sentiment is paralysed by fear of the Fed following hawkish Fed speaker comments and ECB's 'failure' to ease

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.0	–	1.12%
MSCI EM Small Cap	12.0	–	1.15%
MSCI Frontier	10.1	–	0.37%
MSCI Asia	12.7	–	2.30%
Shanghai Composite	12.5	–	0.38%
Hong Kong Hang Seng	7.7	–	3.97%
MSCI EMEA	9.7	–	0.57%
MSCI Latam	13.5	–	-2.83%
GBI-EM-GD	6.21%	–	0.73%
ELMI+	3.54%	–	0.42%
EM FX spot	–	–	0.36%
EMBI GD	5.00%	331 bps	0.13%
EMBI GD IG	3.82%	207 bps	0.02%
EMBI GD HY	6.66%	506 bps	0.25%
CEMBI BD	4.90%	335 bps	0.07%
CEMBI BD IG	3.80%	225 bps	-0.01%
CEMBI BD Non-IG	6.83%	527 bps	0.21%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.0	–	-1.95%
1-3yr UST	0.80%	–	0.01%
3-5yr UST	1.24%	–	-0.09%
7-10yr UST	1.69%	–	-0.43%
10yr+ UST	2.40%	–	-2.04%
10yr+ Germany	0.05%	–	-1.01%
10yr+ Japan	0.00%	–	-0.50%
US HY	6.23%	479 bps	0.08%
European HY	3.98%	441 bps	-0.03%
Barclays Ag	–	243 bps	-0.51%
VIX Index*	20.15	–	8.17%
DXY Index*	95.29	–	-0.55%
EURUSD	1.1238	–	0.82%
USDJPY	102.11	–	-1.28%
CRY Index*	182.54	–	4.33%
Brent	47.4	–	-0.57%
Gold spot	1329	–	0.12%

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

Emerging Markets

- **Mexico:** Luis Videgaray, Mexico's reformist Finance Minister, became a victim of Donald Trump's grandstanding as he resigned in the wake of last week's meeting between President Peña Nieto and the Republican presidential candidate. His resignation should not cause concern, however. Mexico's institutional strength was demonstrated clearly with the appointment of Jose Antonio Meade as his replacement. Meade is an extremely experienced technocrat. A previous Finance Minister under the administration of President Felipe Calderon, Meade also served as Minister of Foreign Affairs and, importantly, as Minister of Energy. The latter should help the government to manage the relationship with Pemex, the national oil company, as it tries to rebalance via cuts in expenditure. Meade has also worked closely with Mexico's Central Bank Governor Augustin Carstens, so the close co-operation between the Finance Ministry and Banxico is likely to continue. This is important given that the government earlier this year announced a series of monetary and fiscal measures to stabilise the market and address budget issues. Meade presented Mexico's budget for 2017 last week: the government targets a primary surplus of 0.4% of GDP (raised from +0.2% of GDP previously) on the back of expected higher non-oil revenues and reduced expenditures.

- **Argentina:** In an important win for President Macri's battle for fiscal consolidation, the Supreme Court reinstated the electricity tariff increases, which had previously been struck down by a lower court. While the government did not follow due processes in instituting the increases in the first place – it failed to conduct public hearings prior to reducing subsidies – the court ruled in favour of the government on the grounds that the plaintiffs could not legitimately claim that they represented all electricity consumers in the Buenos Aires area. Subsidies are important in Argentina – they account for about 0.5% of GDP. In other news, the Central

Continued overleaf

Emerging Markets

Bank cut its monetary policy rate by 50 basis points to 27.75%, while underlining its desire to maintain an anti-inflationary bias. Headline inflation expectations remain slightly above target, while core inflation expectations are in line. Inflation is expected to decline significantly over the next twelve months.

- China: Trade data for August surprised on the upside as exports (in USD terms) declined less than expected. Exports contracted by2.8% yoy versus -4.0% yoy expected. The improvement was due to labour-intensive goods, such as furniture and clothing performed most strongly, rising by 5% yoy, while mechanical and electrical products also did well (up 4.4% yoy). Imports in USD terms rose to 1.5% versus -5.4% expected due to rising commodity imports. This points to rising levels of activity in the infrastructure sectors and generally to stronger levels of economic activity. In keeping with other Emerging Markets (EM) economies, inflation declined. August CPI was up 0.1% mom or +1.3% yoy versus 1.8% yoy in July and +1.7% yoy expected.

- Venezuela: The wrangling between the opposition and the National Electoral Council (CNE) continues. While local demonstrations in front of CNE offices were hardly newsworthy due to their low turnout, the opposition is gearing up for a 24 hour protest on September 14 with the aim of pushing the CNE to release the dates for the next step of President Maduro's recall referendum, which clears the way for the collection of signatures to recall the president. 20% of the electorate must support a recall in order to be successful. Government agencies appear to be keen to postpone the recall referendum beyond January 2017 at which point only Maduro is recalled, not the government as a whole. This would allow the current administration, ex-Maduro, to engage in negotiations with the opposition to facilitate economic adjustment and a gradual process towards sharing of power.

- South Korea: The Bank of Korea kept its policy rate on hold at 1.25% in line with expectations. A further rate cut cannot be ruled out as domestic demand appears to be softening; the latest Nikkei manufacturing PMIs printed below 50, following four consecutive readings above the expansionary mark. The worldwide recall of Samsung's Galaxy Note 7 could dent exports in the near future, but not by a lot, in our view. Korea's economy is well developed and highly diversified, so a single product will not have a large or lasting impact on the economy.

- Malaysia: Industrial production posted a solid print at 4.1% yoy in July supported by mining activity and electricity generation. The August trade surplus has narrowed to RM 1.9bn from RM 5.5bn as exports declined at a faster pace than imports. The Bank Negara Malaysia kept policy rates unchanged at 3.0% after surprising the market in July with a 25bp cut. Malaysia is another small open economy which is likely to ease policy further as inflation remains subdued.

- Brazil: Petrobras is on the verge of completing the sale of its Southeast pipeline to a consortium led by Brookfield asset management. The company has embarked on an asset sale program to reduce its large debts. The sale is expected to generate proceeds of USD 5.2bn. More sales should be expected in line with the company's divestment goal for 2016, which stands at approximately USD 14bn of which so far USD 6.6bn has been realised.

- Czech Republic: Industrial output declined by 14.1% yoy. This was a larger than expected decline – the market had expected a decline of 5.7% yoy. Much of the decline, however, was due to earlier than usual holidays in the auto sector, notably at Skoda and Hyundai. On the currency front, officials from the Czech National Bank hinted at a coming change in FX policy, suggesting that the cap for the Koruna against the Euro could be abandoned sometime next year. This should allow the Koruna to appreciate and therefore push down inflation. Yields on the 2-year government bonds in the Czech Republic dropped by about 30bps following the news.

- Flows: Flows to the asset class remained positive across the board with inflows of 0.55% AUM or USD 1.3bn into EM Debt funds and 0.21% AUM or USD 1.85bn to EM Equity funds according to EPFR Global. We note that EPFR Global data failed to cover large sections of the investment universe, notably local flows into EM markets plus allocations by a number of institutional investors. Our view is that inflows to EM are just starting after a long period of outflows from mid-2013 to Jan-2016. Most institutional investors remain heavily underweight EM assets.

Snippets:

- Colombia: Consumer price inflation moderated sharply in August, when prices declined by 0.32% mom versus +0.16% mom expected. The decline was driven by lower food inflation following the end of a truckers' strike that had temporarily pushed prices up during the previous month. This will be welcome news to the Central Bank which recently kept rates steady during the recent spike in inflation.
- India: Services PMI rose to its highest level since January 2013, reaching 54.7 in August. This was materially higher than in July (51.9). The composite PMI rose from 52.4 to 54.6. Positively, the improvement was broad-based, but seemed, in part at least, to be driven by seasonal effects such as an increase in activity ahead of an upcoming festive period.

Continued overleaf

Ashmore

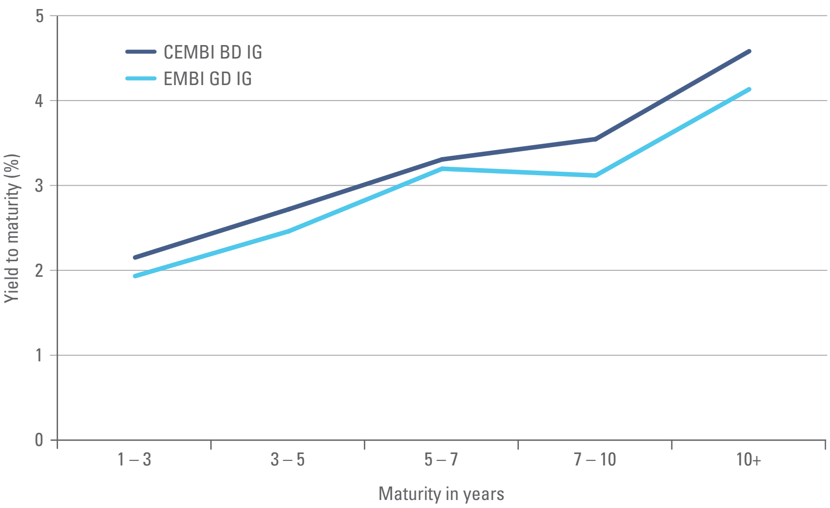
Emerging Markets

- **Philippines:** Headline inflation declined to 1.8% yoy in August. This was below market expectations of a 2.0% increase.
- **South Africa:** GDP surprised on the upside with a qoq saar growth of 3.3% for Q2 2016. There were strong contributions from the mining and manufacturing sectors; that said, both sectors posted weak results in August (declining by 2.4% mom and 1.5% mom respectively).
- **Taiwan:** August exports surprised on the upside at +1.0% yoy (versus 0.3% expected). This follows a strong print in July (+1.2% yoy). The continued outperformance of electronics ahead of product launches in September led the improvement on exports. August CPI declined sharply to 0.6% yoy from 1.2% yoy in the previous month on the back of lower food price inflation.
- **Turkey:** The Central Bank reduced the lira reserve requirement across all maturities by 50 basis points, helping liquidity in local markets.

Global backdrop

Two corporates in Europe issued bonds with a negative yield for the first time. The corporates were not state-backed. Henkel, a German industrial, commercial and consumer chemical company, issued EUR 500m two-year bonds with a yield of -0.05%. The bonds are rated A2 by Moody's. Sanofi, a French pharmaceuticals manufacturer, issued EUR 1bn note maturing in 2020 at the same yield of -0.05% (Moody's rated the bonds A1). The fact that corporate bonds trade with negative yield are prima facie evidence of a bubble in developed market fixed income, in our view. Investors are not paid for credit risk, liquidity risk or duration risk. The universe of negative yielding securities within European investment grade corporates now stands at USD 1.2trn. About 55% the issues with negative yields are in the 1-3 year maturity bucket, while about 25% of the bonds have maturities of 3-5 years. The remainder has maturities of longer than 5 years. By contrast, investment grade-rated EM corporates / sovereigns denominated in USD compare favourably in yield terms and continue to offer upside potential, in our view. For more details, see *"Switch from Eurozone IG bonds to EM IG EUR-denominated bonds"*, Market Commentary, 15 July 2016 and *"Superior returns and lower risk in EM IG corporate bonds"*, The Emerging View, 5 July 2016.

Fig 1: **Investment-grade rated EM bonds continue to offer value**



Source: Ashmore, JP Morgan.

In a week cut short by the US Labour day, the headlines were dominated by data in the first half of the week and by Fed speakers in the latter half. The US non-manufacturing ISM dropped to its lowest level since February 2010 (51.4 versus 54.9 expected) with a particularly weak employment component. Later in the week, however, a number of Fed officials issued statements that were widely regarded as hawkish, triggering a large shift higher in US treasury yields, a sizeable drop in US stock prices and a spike in the VIX index. Such developments are extremely potent in liquidity addicted developed markets. Sentiment was not aided by the ECB's 'failure' to extend QE. ECB President Draghi's comments on the shortage of eligible bonds for QE rightly gained considerable attention.

PMIs were stronger than expected in the UK, rising 5.5 points to 52.9. This prompted pundits to conclude that Brexit fears were overdone. Such conclusions are misplaced. Brexit has not yet even begun. The UK is likely to face tougher times ahead due to lingering unresolved concerns about relations with trading partners the world over. A cautious note was also struck by BoE Governor Carney, who said the central bank stood ready to act if the UK economy were to experience a significant slowdown.

Continued overleaf

Ashmore

Global backdrop

The price of oil was volatile over the week as rumours about an agreement on a stabilisation of the oil market between Russia and Saudi Arabia came and went (the "productive meeting" seemed to be no more than a damp squib). Towards the back-end of the week, WTI rallied again, closing the week at USD 45.88 per barrel following news of a large drop in US crude inventories. The increased volatility is consistent with an approaching demand / supply equilibrium.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.88%	16.93%	15.48%	0.46%	1.07%
MSCI EM Small Cap	1.47%	9.38%	12.92%	2.62%	2.10%
MSCI Frontier	0.83%	0.45%	-3.74%	0.94%	3.26%
MSCI Asia	2.66%	13.85%	15.46%	4.60%	4.91%
Shanghai Composite	-0.21%	-11.29%	-3.06%	14.29%	6.93%
Hong Kong Hang Seng	5.55%	8.53%	5.30%	2.29%	3.14%
MSCI EMEA	2.50%	17.79%	7.18%	-5.56%	-2.96%
MSCI Latam	-0.77%	32.52%	23.06%	-7.41%	-6.18%
GBI EM GD	1.15%	16.07%	15.29%	-1.82%	-1.67%
ELMI+	0.58%	7.05%	7.03%	-2.34%	-1.78%
EM FX Spot	0.52%	5.17%	2.59%	-9.15%	-8.15%
EMBI GD	0.05%	14.36%	14.12%	8.97%	6.69%
EMBI GD IG	-0.27%	13.03%	12.38%	8.26%	5.49%
EMBI GD HY	0.41%	15.73%	16.06%	9.59%	8.36%
CEMBI BD	0.05%	11.01%	10.34%	7.04%	5.85%
CEMBI BD IG	-0.05%	8.72%	8.52%	6.92%	5.52%
CEMBI BD Non-IG	0.24%	14.97%	13.33%	6.94%	6.53%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.95%	5.71%	12.00%	10.66%	15.45%
1-3yr UST	0.03%	1.39%	1.18%	0.74%	0.62%
3-5yr UST	-0.05%	3.06%	2.83%	2.73%	1.50%
7-10yr UST	-0.56%	6.17%	6.21%	5.93%	3.24%
10yr+ UST	-2.86%	12.98%	13.81%	12.35%	6.47%
10yr+ Germany	-1.95%	14.56%	14.83%	13.47%	9.00%
10yr+ Japan	-1.59%	10.16%	13.25%	8.18%	6.49%
US HY	0.04%	14.40%	8.39%	5.37%	7.48%
European HY	0.05%	8.15%	6.74%	7.15%	11.29%
Barclays Ag	-0.72%	7.94%	7.86%	5.85%	5.26%
VIX Index*	50.15%	10.65%	-13.15%	41.01%	-47.78%
DXY Index*	-0.76%	-3.39%	0.10%	16.94%	22.83%
CRY Index*	1.29%	3.63%	-7.21%	-37.50%	-45.36%
EURUSD	0.72%	3.52%	-0.69%	-15.50%	-17.84%
USDJPY	-1.27%	-14.95%	-15.08%	2.58%	32.27%
Brent	0.68%	27.04%	-1.62%	-57.95%	-57.81%
Gold spot	1.53%	25.21%	19.83%	0.56%	-26.79%

*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.

Ashmore

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 347 0649

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

Other locations
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper