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WEEKLY INVESTOR RESEARCH

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Value overtakes flows

By Jan Dehn

Sixteen weeks of outflows have created value in Emerging Markets fixed income against a backdrop of disappointing economic data in developed economies and better economic data in Emerging Markets. Indonesia successfully tapped global markets, Mexico launched its fiscal reform, and Argentina set aside nearly USD 10bn for debt service in 2014. The source of risk in the outlook is firmly concentrated in the developed economies, particularly in the US, where growth is now tracking just 1.7% in Q3, while significant big question marks surround the debt ceiling, the appointment of a new Fed Chairperson, and this week's FOMC meeting.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,000		2.73%
MSCI FM	552		4.11%
GBI-GD	6.72%		1.67%
ELMI+	4.42%		0.67%
EMBI GD	6.11%	318 bps	0.58%
EMBI GD IG	5.17%	224 bps	0.61%
EMBI GD HY	9.34%	661 bps	0.52%
CEMBI BD	5.97%	349 bps	0.62%
CEMBI BD HG	5.12%	262 bps	0.50%
CEMBI BD HY	7.89%	545 bps	0.74%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,688	1.02%
VIX Index	14.16	-9.40%
5 year UST	1.59%	-12 bps
10 year UST	2.82%	-10 bps
10 year Bund	1.94%	-2 bps
EURUSD	1.3366	0.83%
USDJPY	98.80	-0.79%
Brent	$112	-1.13%
Copper	$326	-2.22%
Gold	$1327	-4.52%

Emerging Markets

After 16 weeks of outflows from Emerging Markets, the net flow position turned positive in the past week, according to EPFR data. EPFR data is by no means comprehensive. We think flows have been concentrated in retail and other fast money flows, which got caught in highly speculative positions in April. Flows only have the power to drive markets for so long. Eventually, value arguments turn the market. We see considerable value now.

To illustrate, consider Emerging Markets (EM) local bond yields. At around 6.8%, EM local currency bond yields have now re-priced back to levels which are consistent with the much higher yields last seen in the US treasury market in the 2003-2007 period. Since yields in developed markets are still much lower than historical averages, relative value clearly favours Emerging Markets local bonds, which we expect to perform significantly better than developed markets fixed income over the next 12 months. We note that following the re-pricing of the past couple of months EM bond yields are now back at their 10 year averages. We do not expect borrowing costs at these levels to present any major challenges for governments or corporates, which remain significantly more fiscally sound than their counterparts in developed economies.

	Average yield		
Time period	Emerging Markets Local Currency Bonds (JP Morgan GBI-EM GD)*	10-year US Treasury	5-year US Treasury
2003-2007	6.84	4.36	3.88
2008-2013	6.85	2.81	1.72
2003-2013	6.85	3.54	2.73

Source: JP Morgan, Bloomberg, Ashmore.
* The duration of the JP Morgan GBI-EM GD bond index is 4.6 years.

Indeed, one of the most notable developments in Emerging Markets in the past week was Indonesia's re-appearance in the global bond market. Indonesia has been singled out along with India and Brazil as a 'crisis country', but there was no sign of this crisis when the sovereign issued USD 1.5bn of Sukuk bonds this week to complete its financing for 2013. There was USD 5.5bn of demand from 290 accounts of which two thirds was real money. Other Emerging Markets issuers also tapped the market, including Russia, Romania, South Africa, Sri Lanka's National Savings Bank, and Colombia's Ecopetrol. We expect a reasonably heavy issuance schedule in the coming months, although this follows a period of significant coupon and principal repayments earlier this summer.

Continued overleaf

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Emerging Markets

Indonesia also surprised the market by hiking policy rates by 25bps this week, following intra-meeting hikes last week. Indonesia's problem, like India's, is relatively simple; namely macroeconomic adjustment following a period of excessive domestic demand. Such problems are resolved with domestic demand restraint and currency adjustment, both of which are now underway. One of the special features of Indonesia is that policy makers usually wait for political cover before they act. This tends to create volatility, but once the volatility begins there is usually decisive action from the authorities. Most Emerging Markets, of course, do not have macroeconomic imbalances. The central banks in Korea, Philippines, Chile and Peru all left their policy rates unchanged this past week.

In Mexico, the government presented its fiscal reform to parliament. This follows the recent introduction of reforms to the state oil company and electricity sector. Combined, this set of reforms will materially improve trend growth rates in Mexico, in our view. They should also increase fiscal revenues by 1.4% of GDP by 2014 and by a full 3% of GDP when fully implemented. This is welcome news even as the pace of Mexico's current cyclical slowdown may be slowing. This week saw stronger than expected Mexican retail sales as well as manufacturing activity. Elsewhere in Emerging Markets, Brazilian retail sales surprised on the upside at 3.7% yoy versus 1.2% expected. Malaysian industrial production in July rose 7.6% yoy, up from 3.7% in June.

Finally, we note that Argentina's Congress this week approved a re-opening of the exchange for investors still holding un-restructured bonds from the 2001 default. The decision to re-open the exchange is unlikely to prevent an eventual final ruling in favour of the holdouts. For this reason, Argentina's credit rating was cut to CCC+ by Standard & Poor's, citing legal risks. Against this backdrop, the government's willingness to pay remains high. This week the government made final repayment of the Bonar 13 bond, while Finance Minister Hernan Lorenzino announced that the government will set aside USD 9.8bn of central bank reserves to pay foreign currency-denominated debt in 2014.

Global backdrop

The wait is almost over. The triple whammy of uncertainties – September's critical FOMC meeting, Fed succession, and the debt ceiling debate – are all three approaching resolution after a long summer where these events hovered over the market like the sword of Damocles.

The immediate concern is what the Fed will do about tapering. We think the Fed will commence tapering of QE next week, not because it wants to tighten policy, but because the policy clearly does not work as intended (it has created an addiction to QE sugar highs in the equity market). We expect tapering to be accompanied by enhanced forward guidance. One big question is what the Fed will project for the Fed funds rate in 2016. Our best guess is that they will place their Fed funds forecast roughly where the market is right now, namely that Fed funds will be around 2.25% by September 2016 (implying nine hikes of 25bps between now and then). We think this is too aggressive. Inflation is below the Fed's target, growth is tracking far below trend (see below), and labour market participation just reached new lows. Most importantly, we do not think the US economy can handle materially higher real rates until the overall debt burden in the economy – currently 405% of GDP – has been reduced.

As for Fed succession and the debt ceiling question, we think the Fed will continue to maintain dovish policies regardless of who among the main contenders is appointed as Chairperson, and that the debt ceiling debate will ultimately be resolved. However, both questions are fraught with complications. Votes are required in the Republican-dominated House of Representatives in order both to raise the US government's debt ceiling and to approve the Administration's choice of Fed Chair.

It is possible that the US Administration may opt to resolve the debt ceiling and Fed Chair succession before the Syria vote, though the situation remains highly fluid. What is obvious, however, is that the outcome of ongoing talks between Russia over Syria could have a major impact on both the Fed succession and debt ceiling questions. US polls show little support for further military adventures so President Obama's best strategy may be to play for time, hoping he can eventually strike a deal over Syria with Russia that avoids military action. This could eliminate the need to go to Congress altogether, thus avoiding a defeat, which would almost certainly embolden House Republicans to play hardball over the debt ceiling and Fed Chair votes.

There is another important implication of the Syria situation. If the conflict does indeed get resolved through a compromise with Russia (say, President Obama calls off the bombers in exchange for President Assad agreeing to supervision of chemical weapons, etc.) then it is hard to escape the conclusion that the world has changed.

Despite its unambiguous status as the world's most formidable military power, the US will have found itself forced by lack of support from key foreign allies and domestic resistance into a compromise solution dictated by an Emerging Markets country (Russia). The message is clear: The days of global hegemonic rule by a small number of developed countries in their own narrow self-interest is over.

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Global backdrop

There were only a handful of data releases in developed economies over the past week, but a few of them were meaningful enough to warrant comment. First, the US economy is now tracking just 1.7% growth in Q3 following inventory and retail sales data. Consumer confidence disappointed too. At this pace of growth, there is no case for imminent tightening of monetary policy (tapering is going ahead for an entirely different reason). Second, US mortgage applications fell another 13.5% in the past week to hit the lowest level since December 2000. This means that mortgage applications have declined by more than 60% since Fed Chairman Bernanke's tapering announcement in May of this year. The fall in mortgage applications coincides with a rise in real mortgage rates. Third, both Italian and French activity data softened over the past week. With these data and Emerging Markets picking up growth, it is very hard to spot the reason for the consensus view that developed markets are now going to have stronger growth than Emerging Markets.

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