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WEEKLY INVESTOR RESEARCH

Ashmore

The Freak Show

By Jan Dehn

- EM economies are the only 'normal' countries left in the world economy, while developed countries look more and more like economic and political 'freak shows'
- The Colombian government and the FARC rebels are due to sign a Peace Agreement in Cartagena today
- Moody's ratings downgrade of Turkey forces ratings-dependent investors to sell near the lows having bought near the top on the last upgrade
- Mexican inflation increase was a surprise
- Brazilian inflation took a tumble to raise prospects of rate cuts in Q4
- China introduces credit default swaps to enable credit investors to hedge default risk
- Japan's adoption of yield curve control packs a powerful message about future fiscal policy

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.1	–	3.65%
MSCI EM Small Cap	12.2	–	2.92%
MSCI Frontier	10.2	–	1.13%
MSCI Asia	12.8	–	3.03%
Shanghai Composite	12.5	–	1.08%
Hong Kong Hang Seng	7.8	–	2.09%
MSCI EMEA	10.0	–	4.25%
MSCI Latam	13.9	–	4.35%
GBI-EM-GD	6.17%	–	1.96%
ELMI+	3.47%	–	0.89%
EM FX spot	–	–	1.37%
EMBI GD	4.96%	333 bps	1.59%
EMBI GD IG	3.83%	214 bps	1.48%
EMBI GD HY	6.55%	503 bps	1.71%
CEMBI BD	4.90%	342 bps	0.66%
CEMBI BD IG	3.82%	234 bps	0.50%
CEMBI BD Non-IG	6.80%	531 bps	0.96%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	1.20%
1-3yr UST	0.76%	–	0.05%
3-5yr UST	1.15%	–	0.18%
7-10yr UST	1.61%	–	0.52%
10yr+ UST	2.34%	–	1.62%
10yr+ Germany	-0.09%	–	2.16%
10yr+ Japan	-0.05%	–	1.16%
US HY	6.24%	487 bps	0.82%
European HY	4.23%	469 bps	0.44%
Barclays Ag	–	245 bps	0.74%
VIX Index*	12.29	–	-3.08%
DXY Index*	95.46	–	-0.38%
EURUSD	1.1227	–	0.47%
USDJPY	100.86	–	-1.05%
CRY Index*	183.10	–	2.31%
Brent	46.3	–	0.83%
Gold spot	1335	–	1.64%

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

Emerging Markets

Sometimes you need to point out the evident for it to become obvious. Today, Emerging Markets (EM) countries are the only 'normal' countries left on earth; meaning countries with normal business cycles, healthy traditional drivers of growth, conventional economic policies, sensible levels of debt, prudent levels of reserves, balanced inflation risks and, above all, rationally priced assets.

In glaring contrast, developed economies look like economic and political 'freak shows' after years of QE, rising debts, neglect of reforms and political deterioration. Developed markets are severely distorted, developed governments seriously indebted and developed economies bogged down with major productivity challenges. Never has reliance on short-term stimulus and neglect of long-term reforms been greater. Policy-makers appear to be in denial about the seriousness of the problems – or maybe they are sugar-coating the facts to make them easier to swallow – and politicians are rushing headlong into populism and protectionism. Tonight's presidential debate in the US is only likely to reinforce the freakishness, in our view.

It is particularly worrying that developed economies have become so addicted to stimulus. Across most countries the state has embarked on the most gratuitous manipulation of markets since the Great Depression and the run-up to the Second World War. The addiction to stimulus makes it more difficult – and potentially far more costly – to change tack.

EM's co-existence in the world economy alongside the 'freak show economies' of the developed world today poses the single largest risk for EM investors. If just one of the major QE economies were to crash the odds

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are that many others would follow, because almost all developed economies share the exact same symptoms. Moreover, investors are disproportionately concentrated in these markets. Developed markets are substantially over-weighted versus EM in narrow, concentrated portfolios. This means that if one market goes under then investors can be relied upon to take profits in the others and hence spread contagion like wildfire through the entire developed market complex. EM would undoubtedly experience higher volatility if this were to occur.

Aside from the possibility of spill-over of negative risk sentiment from a crisis in developed markets, EM investors are relatively safe within EM. Sure, EM countries are individually risky. There are no risk free markets. However, EM risks tend to be highly idiosyncratic. There are more than 65 countries in the main EM benchmark index and they are a genuinely diverse bunch. About 5% of EM countries get into difficulty each year, mostly self-inflicted, but with 95% of EM countries doing alright in any given year the risks are idiosyncratic and can be mitigated through active management.

Much focus is directed at the Fed, but the Fed is hiking rates at a pace of roughly 25bps per year. Given the level of yields in EM, this does not pose a meaningful risk, in our view. The reason why markets worry so much about Fed hikes is a different one: even a measly 25bps hike can certainly be destabilising if asset prices are overvalued and underlying economic fundamentals are very weak. These conditions happen to prevail in most developed markets, but they are not present in most EM economies, where growth is twice as fast and yields much, much higher. Indeed, to the extent that weakness creeps into EM asset prices leading up to FOMC meetings investors could use such weakness as an opportunity to buy.

Last week's FOMC meeting was a perfect case in point: EM gave up a bit of performance leading up to the meeting. The FOMC did nothing. Immediately afterwards EM rallied. This year's strong EM performance has followed a similar pattern, following the start of the Fed hiking cycle last December. Given strong technicals and still very attractive valuations, a very similar pattern can be expected this December, when the Fed, presumably, hikes in order to maintain its once-a-year pace of interest rate normalisation.

- Colombia: The government and FARC rebels are due to sign a peace accord in Cartagena today. The historical signing will be followed by a referendum on the peace settlement scheduled for 2nd October this year. Polls suggest that the outcome of the referendum is too close to call, so scenario analysis is the right way forward. It is clear that even if the peace deal is approved the challenges are not over. It will prove difficult to deal with the criminal elements within FARC as well as rehabilitation of soldiers, etc. The process of re-integrating rebels into the economy also carries political downside risks, mainly for the incumbent President Juan Manuel Santos. However, since this is Santos' last term he can be expected to take the pain. Teething problems would, however, increase the odds that an anti-peace candidate emerges as front-runner ahead of Colombia's next election in 2018. This should not matter much from an investment perspective, however, since all mainstream parties in Colombia seem sensible. If the peace deal is rejected, or if, say, one of the two sides reneges on the agreement it is likely that the government would revert to the military option. This would take peace prospects back to square one and years could pass before another attempt at peace could be made. While this would generate negative headlines the reality in Colombia would not change as much. After all, the Colombian military has been very successful in curbing FARC attacks and pushing the organisation out of the main cities and far into the bush. One thing seems certain: Colombia will not go back to the bad old days of lawlessness and violence that still (wrongly) taint the country's image. Even so, approval of the peace accord is clearly better for Colombia for the longer term and, not unlike the uneasy deal struck between Protestants and Catholics in Northern Ireland, the longer the peace lasts the more it becomes institutionalised. The risk of civil war is always greatest immediately after civil war. In other news, the current account deficit in Colombia narrowed sharply in H1 2016, according to new official data. The deficit shrank to 4.8% of GDP versus 6.5% of GDP for the full year 2015. Other EM countries have also experienced sharp improvements in their external balances due to weaker currencies and steady low inflation. Colombia's improvement was delayed by reluctance on the part of the government to adjust to sharply lower oil prices, mainly in order to increase odds of approval of the peace referendum on 2 October 2016.

- Turkey: The Moody's ratings agency downgraded Turkey from Ba1 to Baa3 with stable outlook. This may precipitate some technical selling by ratings-sensitive funds. JP Morgan will eliminate Turkey from the investment grade sub-index of the EMBI Global Diversified Index starting 31 October 2016. Turkey's local bonds are already due for exclusion on 30th September due to an earlier downgrade by Standard & Poor's. JP Morgan estimates USD 48bn of securities are managed against the IG version of the EMBI GD, where Turkey's weight is 7.4%. In addition, some USD 23bn is believed to follow the IG-version of the corporate benchmark, CEMBI BD, which includes six Turkish corporates. Finally, Barclays Bank expects some USD 3-3.5bn of selling by the end of this month from investors who are benchmarked to the Bloomberg Barclays Global Aggregate indices. It is notable that Moody's upgraded Turkey in 2012, when it was near the top of the market, while the decision to downgrade Turkey follows some three years of a bear market for EM during the Taper Tantrum, USD rally, the start of the Fed hiking cycle and lower commodity prices. Clearly, trading based on ratings agency recommendations exposes investors to serious risk of buying at the top and selling at the bottom. A more sensible alternative is to carry out one's own ongoing research; most investors who follow Turkey closely will have been aware of the deteriorating macroeconomic and institutional fundamentals for

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some time. To them, a downgrade per se is no surprise, though the timing can never be predicted with accuracy. In other news, the Turkish central bank's monetary policy committee narrowed the interest rates corridor by 25bps by reducing the upper band of the corridor from 8.5% to 8.25%. The repo rate and the lower band of the rate corridor were unchanged at 7.5% and 7.25%, respectively. By tightening the bid offer spread for government liquidity the government is reducing the funding risk for investors, so this decision constitutes an easing of monetary policy. The committee justified its decision to ease on the grounds that the economy is experiencing a temporary slowdown following the recent coup attempt. CPI inflation is also on a decelerating path, according to the central bank. The central bank appears to be slowly moving back towards a more orthodox monetary policy regime, where the policy rate rather than the uncertainty surrounding the availability and cost of liquidity constitutes the main policy instrument. That, all else even, is positive, in our view.

- Brazil: Monthly inflation was materially lower than expected in the first half of September, declining to 0.23% mom from 0.45% mom in August and lower than expected (0.33% mom). A combination of very high real interest rates and a stronger currency plus much more sensible fiscal policies is bringing about the disinflation that supports a bullish view on local bonds in Brazil. Market attention will now turn to the possibility of earlier than previously anticipated rate cuts. In another positive development, police arrested former finance minister Guido Mantega, who oversaw an erosion of economic policy that led directly to Brazil's current economic malaise and economic hardship for millions of Brazilians. Mantega's arrest was made on the grounds of corruption, however, not his ineptitude as finance minister. In other news, Globo, a local daily, reported that the text of the government's reform of the social security system is complete and that President Michel Temer will seek to present the bill to parliament ahead of municipal elections scheduled for 2 October 2016.

- Mexico: In contrast to Brazil, Mexican inflation surprised materially to the upside in the first half of September. At 0.54% mom, inflation was nearly twice as high as expected. But in a uniquely Mexican quirk, tomato prices accounted for literally half of the surprise. Unless the shock in the price of red tomatoes spreads permanently into the broader Mexican price indices we would not worry about this. In fact, Mexico has a well-established inflation targeting regime, which is unlikely to unravel over the price of a single fruit. Having said that, retail sales are picking up strongly (7.9% yoy in July), so there may be a broader case for the central bank to adjust policy. The bigger source of price volatility, however, is MXN, which has proven extremely sensitive to US elections polls. While Donald Trump appears to loath Mexicans and the Clinton name is closely (positively) associated with NAFTA, we think the volatility in MXN created by US politics is excessive and investors should buy into excessive weakness. The opportunities to trade the currency in the next few months will be plentiful; today is a case in point as the US gears up for the first presidential debate.

- China: Credit default swaps and credit-linked notes are being introduced in China. As China shifts emphasis from non-tradable loan financing to bond financing and as interest rates are liberalised, there will be a rise in default rates. Both opportunities and challenges will materialise as a result. Investors who are good at credit work can actively avoid the weaker credits, while others will want to hedge. Hence: CDS. CDS can also be used to trade credit from the long side, of course, so the launch of CDS and CLN instruments will increase the overall liquidity in the market. One can only be baffled that index providers have still not included China's local markets in the main benchmarks.

- Argentina: Real GDP contracted much more than expected in q2 2016 (-3.4% yoy versus -2.5% yoy expected). The weak economic performance is no big surprise following more than a decade of excessive demand-side stimulus and terrible supply-side policies under the former Kirchner regime. The government is tightening monetary policies and expanding fiscal policy in a bid to bring about economic equilibrium without crashing the economy. This is why the government continues to issue copious volumes of debt. The government can do this for a while due to the benign repayment profile and overall low levels of government debt in Argentina. At the same time, the government is trying to generate a positive supply-side response by improving business conditions. The central bank cut rates by another 50bps to 26.75%.

- India: The Reserve Bank of India completed the process of modernising the institutional arrangements for setting monetary policy with the appointment of the remaining three members of the Monetary Policy Committee. India is now a pure inflation targeting central bank with a clear rule-based approach. In other news, the current account deficit narrowed to just USD 270m in Q2 2016 compared to a deficit of USD 6.2bn in the same quarter last year.

- Russia: The government has tapped the 2026 bond, a bond the government originally issued earlier this year. When the bond was first issued, it was not immediately Euroclearable and global custodians refused to store the bond. Moreover, western investment banks refused to enter the bond into benchmark indices due to fears about political interference, despite the fact that Russian primary sovereign bond issues were never sanctioned (over Crimea). Since then, however, Euroclear has agreed to settle the bond. Demand for the USD 1.3bn tap exceeded USD 7.5bn. The bond issue is now very large and may enter indices after all.

- Venezuela: The electoral council (CNE) continues to raise obstacles to a referendum to recall President Nicholas Maduro from office. In the latest twist, the CNE – an institution whose independence can be called into question – ruled that the opposition must obtain a minimum of 20% of voters' fingerprints as a precondition

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for launching the referendum in each of Venezuela's 23 states, not just at national level. The CNE also ruled that the recall referendum can only be held in Q1 2017, that is, during the second half of Maduro's term. Timing matters, because in the second half of the term, only Maduro would be recalled, not the entire government. This timeline has been our – and the market's – base case all along, so this merely formalises what most investors were expecting. We believe Maduro's successor will be inclined to enter into agreements with the opposition, paving the way for better policies and eventually an opposition government starting in late 2018 or early 2019. In other news, in relation to the government's intention to carry out a swap of near-term maturities for longer dated bonds both the Moody's and S&P ratings agencies indicated that they would view a bond swap as 'distressed', i.e. a credit event leading to a rating of 'Selective Default' (SD). Moody's said that the swap would nevertheless still be good news for Venezuelan sovereign credit risk. According to JP Morgan, an SD rating would not trigger CDS as long as PDVSA continues to meet its obligations. There would also be no impact on index inclusion as long as the liquidity of bonds does not change meaningfully. With prices of PDVSA bonds already well into the distressed territory we think the views of the ratings agencies are pretty irrelevant.

Snippets:

- Hungary: The central bank decided to absorb less liquidity than previously in a move that constitutes an easing of monetary policy. The central bank also reduced its inflation expectation by 10bps to 0.4% and by 30bps to 2.3% for 2016 and 2017, respectively.
- Indonesia: Bank Indonesia cut rates by 25bps to 5.0%. Growth is strong and inflation is falling, while external balances are healthy. The tax take from an amnesty has now risen to IDR 32trn, well ahead of expectations.
- Malaysia: Inflation rose to 1.5% in August from 1.1% in July, the uptick was driven mainly by diesel prices rather than broad-based price increases.
- Nigeria: The central bank left rates unchanged at 14%. Nigerian inflation is 17.6% yoy.
- Panama: Tourism receipts are on track to reach 8.2% of GDP this year, given a strong pick-up in tourism receipts in the first seven months of 2016 (USD 2.84bn versus USD 2.69bn at the same time last year).
- Pakistan: State Bank of Pakistan left rates unchanged at 5.75%.
- Peru: President Kuczynski's approval rating rose to 63% in September from 61% in August. Kuczynski does not have a majority in congress, so his approval rating is key to his ability to strike deals with the opposition. The Peruvian electorate has a healthy propensity to drop its support for ineffective presidents. Hence, this is good news.
- Philippines: The central bank left rates unchanged at 3.0%, but indicated the inflation risks were tilted to the upside, partly due to a tax package currently underway in parliament. Strong imports reduced the current account surplus to 0.1% of GDP in Q2 2016.
- Singapore: Industrial production was 0% mom in August versus 0.1% mom expected.
- South Africa: The South African Reserve Bank (SARB) left rates unchanged at 7.0%, but the accompanying statement was more dovish than expected. Moody's assigned a two thirds probability to no downgrade of the sovereign rating this year.
- Taiwan: Exports rose 8.3% yoy due to a broad-based pick-up in demand.
- Ukraine: The US government issued USD 1bn in credit guarantees to the Ukraine government following approval of the IMF agreement last week.

Global backdrop

By far the most significant development in the global backdrop last week was the change in the Bank of Japan's policy framework. The overall policy stance did not change, but the Bank of Japan (BOJ) switched from managing interest rates by controlling the quantum of assets purchased to direct targeting of yields at the long end of the curve.

While this change may seem semantic, it is in fact monumental. By targeting a specific yield – in this case 0% yield for 10 year bonds – the BOJ is effectively forcing itself to buy whatever the Treasury issues (or selling if demand for bonds rises too far). Another way of saying the same thing is that this policy change is a de facto carte blanche for a switch back to fiscal stimulus in Japan. We think markets should expect more fiscal spending now.

Japan has therefore come full circle. The journey that started with conventional rate cuts and then moved on to asset purchase, while all the time stimulating fiscally has now reached its inevitable conclusion: the need to directly control yields. Direct control of yields is necessary, because with Japan's enormous debt burden and the government's complete inability to make deep reforms there is quite simply no alternative but to return to fiscal spending as the scope for monetary policy is being exhausted.

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Global backdrop

Obviously, the increase in the debt burden associated with fiscal stimulus would ordinarily push up term yields, which in turn could seriously hurt the economy, so the BOJ is preventing this with orchestrated repression of yields. The combination of increasing supply of long bonds and repressed yields ought to manifest itself in a weaker currency.

The change in monetary policy framework in Japan has significance far beyond Japan itself. Other QE economies are likely to follow suit. A switch back towards fiscal stimulus is already widely expected in both the UK and the US, while the ECB's constraints to QE are well understood.

The problem is that the average government debt to GDP ratios have already increased dramatically from 71% in 2007 to 105% by 2015 and will now have to rise significantly further if fiscal policy is to have a meaningful impact on demand. Clearly, this ought to matter for bond yields. However, if natural bear steepening pressures are repressed in order to prevent the fallout on the economy, then QE currencies must fall.

From an EM perspective, this might be attractive. EM currencies will rise and the effect on EM economies will mainly be positive. While stronger currencies can become a brake on exports, EM currencies are currently cheap. Besides, reforms allow economies to export via productivity gains instead. More importantly, higher EM currencies would attract capital inflows that would then ease financial conditions and lead to stronger growth.

Finally, a word on the Fed. Last week's Fed decision offered few surprises. They did nothing. Three FOMC members wanted to hike, but three did not want to move at all. Hence, the committee is balanced albeit more polarised. The fairest interpretation of the statement and Fed Chairwoman Janet Yellen's comments at the post-meeting press conference is that the FOMC remains on track to hike rates at a pace of about 25bps per year. This should not worry anyone in EM. The bigger risk to markets stem from the vulnerabilities that exist within developed economies on account of their overvalued asset prices, poor growth rate, rising debts and lack of policy options. Within this context, even small policy mistakes by the QE central bankers and other policy makers could easily cause considerable damage – for a deeper explanation of this problem please see *"The Rational Fear of Policy Mistakes"*, Market Commentary, 22 September 2016.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.86%	18.06%	19.07%	-0.67%	4.15%
MSCI EM Small Cap	2.46%	10.44%	13.43%	1.72%	5.13%
MSCI Frontier	1.46%	1.08%	-1.47%	-0.73%	4.02%
MSCI Asia	3.14%	14.38%	18.46%	3.44%	7.79%
Shanghai Composite	-1.62%	-12.54%	-0.61%	13.51%	7.14%
Hong Kong Hang Seng	2.86%	5.76%	6.78%	0.80%	5.68%
MSCI EMEA	4.63%	20.24%	9.76%	-6.88%	0.40%
MSCI Latam	-0.04%	33.49%	31.66%	-8.61%	-3.33%
GBI EM GD	2.04%	17.09%	17.35%	-3.17%	0.14%
ELMI+	0.72%	7.21%	7.49%	-2.97%	-0.96%
EM FX Spot	0.92%	5.59%	4.09%	-9.84%	-6.96%
EMBI GD	0.48%	14.86%	14.81%	7.94%	7.72%
EMBI GD IG	-0.18%	13.13%	12.94%	7.06%	6.29%
EMBI GD HY	1.24%	16.69%	16.84%	8.84%	9.67%
CEMBI BD	0.20%	11.17%	10.79%	6.39%	6.68%
CEMBI BD IG	-0.03%	8.75%	8.49%	6.23%	6.05%
CEMBI BD Non-IG	0.58%	15.37%	14.66%	6.37%	8.04%

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.18%	7.62%	14.12%	10.64%	16.20%
1-3yr UST	0.14%	1.49%	1.11%	0.74%	0.66%
3-5yr UST	0.25%	3.37%	2.68%	2.42%	1.62%
7-10yr UST	0.01%	6.77%	6.23%	5.42%	3.24%
10yr+ UST	-1.98%	14.00%	14.09%	11.77%	5.35%
10yr+ Germany	-0.13%	16.69%	14.77%	14.04%	8.81%
10yr+ Japan	-0.44%	11.44%	13.88%	8.16%	6.43%
US HY	0.27%	14.66%	10.08%	5.01%	7.87%
European HY	-0.43%	7.62%	7.54%	6.65%	11.85%
Barclays Ag	-0.22%	8.49%	8.26%	5.67%	5.55%
VIX Index*	-8.42%	-32.51%	-47.97%	-12.59%	-68.50%
DXY Index*	-0.59%	-3.22%	-0.84%	18.55%	21.82%
CRY Index*	1.60%	3.95%	-6.45%	-36.15%	-39.60%
EURUSD	0.62%	3.42%	-0.16%	-16.76%	-17.03%
USDJPY	-2.48%	-15.99%	-15.89%	1.89%	32.08%
Brent	-1.51%	24.28%	-4.67%	-57.58%	-55.43%
Gold spot	1.96%	25.74%	17.90%	0.79%	-17.94%

*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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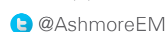
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