Issued: 10 October 2016

Inflection point

By Jan Dehn

The latest IMF World Economic Outlook confirms that 2016 will see a strong pick-up in Emerging Markets' (EM)s growth premium versus Developed Markets (DM). QE policies in DM have inflicted considerable financial tightening on EM economies over the last few years, but the EM growth premium is now picking up and should continue to do so for several years. Higher relative and absolute EM growth rates should in turn lead to more inflows and stronger investment returns. The case for EM is also supported by much better valuations, stronger currencies and very healthy positioning.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.1	–	1.29%
MSCI EM Small Cap	12.1	–	0.54%
MSCI Frontier	10.4	–	0.10%
MSCI Asia	12.8	–	1.12%
Shanghai Composite	12.7	–	-0.94%
Hong Kong Hang Seng	8.0	–	3.57%
MSCI EMEA	9.7	–	0.13%
MSCI Latam	14.3	–	3.27%
GBI-EM-GD	6.22%	–	-0.21%
ELMI+	3.60%	–	-0.15%
EM FX spot	–	–	-0.14%
EMBI GD	5.07%	333 bps	-0.42%
EMBI GD IG	3.93%	213 bps	-0.48%
EMBI GD HY	6.67%	503 bps	-0.36%
CEMBI BD	4.99%	339 bps	-0.09%
CEMBI BD IG	3.89%	229 bps	-0.35%
CEMBI BD Non-IG	6.76%	516 bps	0.32%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.1	–	-0.60%
1-3yr UST	0.83%	–	-0.16%
3-5yr UST	1.26%	–	-0.38%
7-10yr UST	1.72%	–	-0.89%
10yr+ UST	2.45%	–	-2.31%
10yr+ Germany	0.01%	–	-2.70%
10yr+ Japan	-0.06%	–	-0.84%
US HY	6.12%	466 bps	0.45%
European HY	4.30%	473 bps	0.31%
Barclays Ag	–	244 bps	-0.48%
VIX Index*	13.48	–	0.19%
DXY Index*	96.58	–	0.89%
EURUSD	1.1178	–	-0.30%
USDJPY	103.04	–	1.37%
CRY Index*	188.32	–	2.00%
Brent	51.5	–	1.18%
Gold spot	1263	–	-3.77%

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

Emerging Markets

One of the four pillars supporting a bullish view of EM in 2016 is the rising EM growth premium; that is EM's excess growth relative to DM.

The rise in the EM growth premium was confirmed in the latest update of the IMF's World Economic Outlook, which was published last week. The IMF revised the EM growth premium up by 0.3% relative to its prior estimate from July of this year. The upgrade was due to a combination of higher expected growth for EM countries and outright lower growth for DMs. Specifically, the IMF now expects EM growth in 2016 to average 4.2%, up from 4.1% and sees EM growth rising to 4.6% in 2017. The IMF expects DM growth of 1.6% this year, down from 1.8% in its July Outlook. Within DMs, US growth was revised sharply lower from 2.2% to 1.6% for 2016, while UK growth was also revised lower following the potentially economically harmful Brexit decision.

The inflection point in the global growth story is now quite clear as the chart below shows. EM's growth premium is likely to continue to gently rise over the next few years. This matters to investment opportunities, because there is a strong positive correlation between EM's growth premium, EM currencies and ultimately investment returns. EM's growth premium declined significantly over the last few years due to the headwinds produced by the taper tantrum, the USD rally, the fall in commodity prices and the start of the Fed hiking cycle. EM survived these headwinds with remarkably low default rates and very few balance of payments crises, testifying to the underlying economic resilience of EM economies. Indeed, it is noteworthy that the EM growth premium never even came close to turning negative during these testing times.

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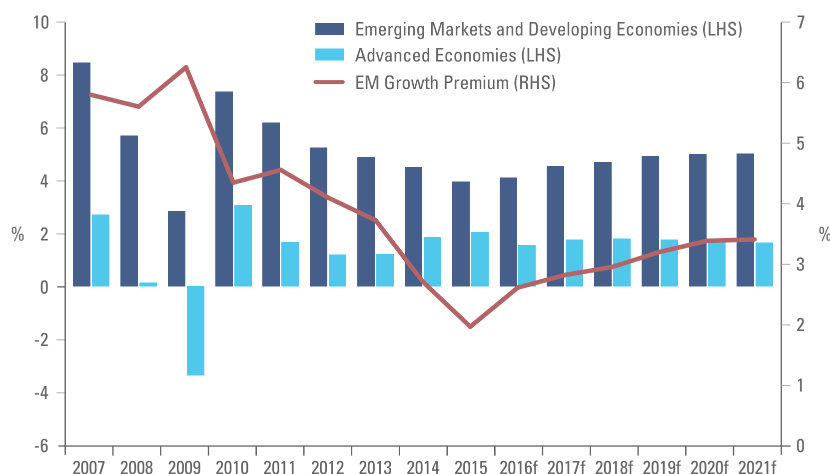
Emerging Markets

Fig 1: **Real GDP growth forecasts and EM growth premium – World Economic Outlook (IMF)**



Source: IMF WEO October 2016, Ashmore.

Why is the growth premium now picking up? The headwinds on EM growth in recent years were temporary and their effects mainly cyclical. The tighter financial conditions faced by EM countries were caused in the main by capital flight triggered by a giant portfolio shift back to DMs as investors responded to asset price movements generated by the QE programs of the Fed, ECB, BOE and BOJ. EM countries also had to adjust to large currency movements as the dollar surged, shifting resources across sectors, a process that renders them temporarily unemployed. However, these changes have made EM countries far more competitive, because most maintained strict inflation and fiscal discipline during the downturn. This is why the ongoing cyclical upswing is now led by strong improvements in EM's external balances, which in turn is pushing up both FX reserves and growth via higher net exports.

Why is the improvement in EM growth premium likely to be sustained going forward? EM real effective exchange rates are back to 2003 levels, i.e. long before the subprime crisis and the EM local currency bond rally of the mid-2000s. EM currencies have rallied just 5% this year following a decline of 40% since 2010, in some cases even more. Bond yields are also much higher than before, particularly relative to US yields, while EM equity valuations are significantly below historical valuations. EM central banks have room to cut rates, economies have room to grow and it will be a long time before currency appreciation becomes a major constraint to expansion.

The case for EM also rests on three other pillars. Firstly, valuations are good. The attraction of EM fixed income is not just that real yields have risen about 300bps since 2013, but also that DM yields are clearly completely distorted (due to QE and misguided regulation). EM equities recently became more tech-heavy than the S&P 500 Index, yet they still trade below historical valuations. These valuations simply make no sense.

Secondly, the outlook for EM currencies has improved. EM FX has outperformed the USD this year as more and more investors – and US policy makers – realise that the US economy cannot stomach much more FX appreciation. Investors like to have money invested in currencies that go up, so as capital flows back, EM financial conditions will ease and growth will pick up further in an exact reversal of the financial tightening of the last few years.

Thirdly, positioning is supportive. Most institutional investors reduced exposure to EM fixed income – or simply did not add to EM as their AUM went up – in the period since 2013. So far, about USD 50bn has flowed back to EM (bonds and equities combined), mainly in retail and ETFs, but this is an almost insignificant amount, given that the EM fixed income asset class alone is (valued at) USD 18.5trn. More importantly, institutional flows have barely begun and will probably not take off in earnest until early next year given the typical lag between performance and allocations. Currently, positioning is therefore very light, which means that market risks are asymmetric – few sellers during bouts of risk aversion and potentially many inflows in response to better sentiment.

That is not to say that EM has no risk. There will always be idiosyncratic risks within an asset class of more than 65 countries. Indeed, a small number of EM countries get things wrong every year. Such risks can – and should – be mitigated by active management. The biggest risk facing EM investors, however, comes from DMs, where politics, reluctance to reform, diminishing policy options, vanishing growth, declining productivity and ridiculously over-valued markets make them look like freak shows. Given these pre-conditions, a recession or inflation in any of the major DMs would cause major problems, mostly for DMs themselves, but clearly EM asset prices would also become more volatile as a result.

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Emerging Markets

- **Brazil:** Two of the three main conditions for the start of the easing cycle in Brazil are now being satisfied. First, a constitutional amendment that caps growth in government spending at a maximum of the previous year inflation for the next 20 years passed its first hurdle in Congress. A special lower house committee tasked with vetting the reform voted in favour of the bill with an overwhelming majority (23 versus 7). The committee also rejected eight amendments put forward by the opposition to water down the proposal. Second, the September CPI surprised on the downside at 0.08% mom versus 0.18% mom expected, which means that yoy inflation declined to 8.48% from 8.97% in August. The downwards surprise in consumer prices was mainly caused by lower than expected prices for food and durable consumer goods and services. The central bank's third condition for starting the easing cycle is that inflation expectations decline. This is now also starting to happen. In the last Focus survey release on 30th September, the market expected CPI inflation to average 7.23% in 2016 compared to 7.34% four weeks ago. Following last week's inflation surprise, expectations declined by a further 10bps. If inflation ends the year between 6.5% and 7% then the real policy rate would be an eye-watering 7.25% - 7.75%. To put this in context, over the last 10 years the average real rates as measured by the Selic – IPCA has been around 5%. If inflation converges to the 4.5% target at the end of 2017 as the central bank expects then nominal rates will have to be at single-levels by the end of next year just to keep the monetary policy stance at its historical average. However, if the government is going to reduce its budget structurally over the next 20 years then real interest rates ought to fall for structural reasons too. This is why Brazilian local bonds are so interesting. The current policy rate is 14.25%.

- **China:** The Sixth Plenum is approaching (24-27 October 2016). The Plenum elects future Chinese leaders. The best of these ultimately emerge among the new top leadership at the Party Congress scheduled for 2017. We expect President Xi Jinping to emerge strengthened and that his government will accelerate reforms, but also that the government's focus, until the Party Congress occurs, will now increasingly shift to politics. The Caixan Services PMI index moderated slightly to 52 in September from 52.1 in August. FX reserves declined by USD 19bn to USD 3.2trn.

- **Venezuela:** The government postponed for a second time the execution of a swap of 2017 PDVSA bonds into longer-dated securities. This became necessary after the market responded very positively to the government's most recent amendment of the terms of the swap. Following the amendment, so many bondholders began buying 2017 bonds – on the view that default risk for these bonds was now very low – that not enough investors are left to surrender their bonds into the exchange, hence making the exchange impossible. This is clearly a question of getting the incentives right and the market will now focus on how the Venezuelans will achieve this.

- **Colombia:** President Juan Manuel Santos was awarded the Nobel Prize for Peace for his effort at ending the 50 year civil war in Colombia. His government said it will push ahead with a planned tax reform in spite of losing the referendum on a peace agreement with the FARC. Proponents and opponents of the peace agreement met and decided to move forward in order to find a formula for peace that works for the majority of Colombians. In economic news, inflation declined outright in September, falling 0.05%, which took the annual rate of inflation to 7.27% yoy from 8.10% yoy last month. Inflation has fallen by nearly 2% in the last two months.

- **Corporates:** The YTD default rate for EM corporates in the CEMBI corporate bond index declined to 2%, according to JP Morgan, the index provider. JP Morgan's figures refer specifically to 'true defaults', that is, defaults from non-payment ignoring restructurings and rescheduling of debt many of which result in no reduction of principal. Even if one takes restructurings and rescheduling into account, the EM default rate is only 3.3%, which is not only below its own long-term average, but also compares favourably with the US HY default rate, which, according to Bank of America, has reached a new high of 6.67%. Bank of America's methodology only looks at the number of incidences of default episodes (as a percentage of the total number of companies). Even on this metric, EM looks attractive with a default rate approximately 2% below the US default rate YTD.

Snippets:

- **Argentina:** The central bank left the policy rate unchanged at 26.75% pending a further decline in inflation expectations before resuming cuts. The central bank has already cut rates by 11.25% in this cycle as monetary policy is gradually brought back to normality after severe mismanagement during the Kirchner Administration.
- **Chile:** GDP picked up more than expected in August, rising at a rate of 2.5% yoy versus 2.0% yoy expected. CPI inflation was 0.25% mom in September versus 0.60% mom expected.
- **Costa Rica:** The trade deficit narrowed to 6% of GDP ytd from 6.7% of GDP over the same period last year.
- **Dominican Republic:** Remittances from DR workers overseas swelled to 4.9% of GDP year to August.
- **Ecuador:** The current account swung into a surplus of USD 900m in Q2.
- **Egypt:** PMI slumped to just 46 in September. Much additional adjustment is required to bring the economy back on track, so the worst is far from over in Egypt.
- **India:** The RBI cut rates by 25bps in a move justified by a more positive consumption outlook amidst declining inflation risks as seasonal rains arrive in an orderly fashion.

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Emerging Markets

- **Malaysia:** The trade surplus increased to USD 2.1bn from USD 0.5bn in July. Exports rose 1.5% yoy versus -2.3% yoy expected.
- **Mexico:** Consumption moderated to 2.2% yoy in July from the 3.2% yoy in June. Investment declined by 1.2% in August. Inflation in the second half of September picked up to 0.48% mom versus 0.46% mom expected. Being located so close to the US is currently Mexico's largest potential liability.
- **Philippines:** September's FX reserves rose to USD 85.9bn compared to USD 80.6bn in the same month of 2015.
- **Russia:** Inflation keeps falling. In September, inflation dropped to 6.4% yoy, below both expectations (6.5% yoy) and last month's inflation (6.9% yoy)
- **South Korea:** FX reserves reached an all-time high of USD 378bn in September.
- **Taiwan:** Exports weakened sharply in September due to the effects of Typhoon Megi, which wiped out several working days in the month. Exports declined at a rate of 1.8% yoy versus 2.8% yoy expected.

Global backdrop

Global markets are increasingly focused on three pivotal events in Q4, namely the US election, a possible December Fed hike and the usual position-squaring that tends to happen towards year-end. Hillary Clinton has been doing better versus Donald Trump of late, which points to continuity in US politics, that is, no major legislation and reform and hence continued reliance on a dovish Fed. The latest US payroll data was a bit softer than expected, but the main 'news' was a pick-up in the participation rate, which suggests that it may take longer before tighter labour markets become inflationary.

Industrial production picked up smartly in both France and Germany, while the UK government flip-flopped on various policy proposals, adding further uncertainty to an already unclear economic outlook.

We do not think any of these events pose any major threat to EM fundamentals, so to the extent that they trigger temporary volatility in asset prices we think investors should buy into weakness. We think 2017 is shaping up to becoming another strong year for EM, because the arguments supporting the EM markets – yield, FX, the cyclical upswing and positioning – remain intact. In addition, strong returns in 2016 will likely convince many to allocate more.

Looking beyond the upcoming events in Q4, the bigger challenge for global asset allocators lies in the fact that global financial markets are still positioned for stronger US performance, weaker European performance and outright disasters in EM. This positioning, while not justified by fundamentals, made sense as long as the QE trades performed. However, the QE trades are no longer performing, so current positioning implies a great deal of pain for investors if EM and Europe perform welland if the US continues to underperform in growth and policy terms.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.29%	17.79%	10.48%	-0.38%	3.56%
MSCI EM Small Cap	0.54%	9.81%	8.46%	1.18%	5.29%
MSCI Frontier	0.10%	2.32%	0.03%	-0.35%	4.68%
MSCI Asia	1.12%	13.99%	10.98%	3.59%	7.45%
Shanghai Composite	-2.54%	-13.36%	0.48%	13.95%	7.60%
Hong Kong Hang Seng	3.57%	7.14%	-0.42%	2.17%	6.30%
MSCI EMEA	0.13%	18.49%	0.75%	-7.15%	-0.56%
MSCI Latam	3.27%	36.78%	21.17%	-7.14%	-3.56%
GBI EM GD	-0.21%	16.83%	11.36%	-3.11%	-0.40%
ELMI+	-0.15%	7.23%	4.56%	-3.00%	-1.04%
EM FX Spot	-0.14%	5.41%	0.42%	-9.77%	-7.22%
EMBI GD	-0.42%	14.28%	13.63%	7.82%	7.61%
EMBI GD IG	-0.48%	12.40%	10.93%	6.81%	6.16%
EMBI GD HY	-0.36%	16.30%	16.79%	8.94%	9.60%
CEMBI BD	-0.09%	11.02%	10.37%	6.26%	7.14%
CEMBI BD IG	-0.35%	8.33%	7.83%	5.95%	6.25%
CEMBI BD Non-IG	0.32%	15.65%	14.69%	6.52%	9.10%

Continued overleaf

Ashmore

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.60%	7.19%	10.30%	11.03%	15.70%
1-3yr UST	-0.16%	1.37%	0.80%	0.70%	0.64%
3-5yr UST	-0.38%	3.06%	1.93%	2.18%	1.64%
7-10yr UST	-0.89%	6.06%	4.73%	4.93%	3.48%
10yr+ UST	-2.31%	12.04%	10.78%	10.86%	5.42%
10yr+ Germany	-2.70%	14.19%	12.67%	12.83%	9.17%
10yr+ Japan	-0.84%	10.83%	13.19%	7.50%	6.38%
US HY	0.45%	15.63%	11.64%	5.25%	8.59%
European HY	0.31%	7.69%	7.69%	6.40%	12.15%
Barclays Ag	-0.48%	8.00%	7.69%	5.33%	5.70%
VIX Index*	1.43%	-25.97%	-21.08%	-18.20%	-62.76%
DXY Index*	1.17%	-2.08%	1.87%	20.10%	24.63%
CRY Index*	1.07%	6.91%	-7.09%	-34.47%	-37.96%
EURUSD	-0.55%	2.97%	-1.59%	-17.32%	-18.07%
USDJPY	1.69%	-14.18%	-14.16%	4.95%	34.38%
Brent	4.95%	38.12%	-2.20%	-53.94%	-52.74%
Gold spot	-3.99%	19.02%	8.55%	-1.89%	-24.65%

*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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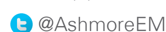

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