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WEEKLY INVESTOR RESEARCH

Ashmore

Debt versus funding

By Jan Dehn

Most investors view the debt problem in China as a given. Yet, China's debts are in line with debts in other EM countries given funding sources. China is a high saving/high investment/high growth economy and should have more credit outstanding, given its large domestic savings rate. The far bigger worry is that developed economies have considerably more debt with much lower savings rates.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	-1.93%
MSCI EM Small Cap	12.0	–	-1.77%
MSCI Frontier	10.4	–	-0.45%
MSCI Asia	12.6	–	-2.35%
Shanghai Composite	12.6	–	1.97%
Hong Kong Hang Seng	7.7	–	-3.48%
MSCI EMEA	9.6	–	-2.98%
MSCI Latam	14.4	–	1.70%
GBI-EM-GD	6.25%	–	-0.81%
ELMI+	3.79%	–	-0.71%
EM FX spot	–	–	-0.74%
EMBI GD	5.15%	335 bps	-0.48%
EMBI GD IG	3.99%	213 bps	-0.44%
EMBI GD HY	6.78%	510 bps	-0.53%
CEMBI BD	5.03%	339 bps	-0.03%
CEMBI BD IG	3.93%	229 bps	-0.10%
CEMBI BD Non-IG	6.79%	515 bps	0.08%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.0	–	-0.95%
1-3yr UST	0.82%	–	-0.01%
3-5yr UST	1.26%	–	-0.07%
7-10yr UST	1.77%	–	-0.44%
10yr+ UST	2.53%	–	-1.72%
10yr+ Germany	0.06%	–	-0.56%
10yr+ Japan	-0.05%	–	0.17%
US HY	6.13%	465 bps	0.15%
European HY	4.20%	461 bps	0.23%
Barclays Ag	–	243 bps	-0.13%
VIX Index*	16.54	–	3.06%
DXY Index*	97.98	–	1.05%
EURUSD	1.0998	–	-1.27%
USDJPY	103.96	–	-0.34%
CRY Index*	188.79	–	0.47%
Brent	51.3	–	-3.44%
Gold spot	1257	–	-0.22%

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

Emerging Markets

Market participants are fond of expressing concern, even outrage at China's alleged large stock of debt. How dare an Emerging Markets (EM) economy borrow nearly as much as the average developed market economy? Surely, China's high debt stock must be unsustainable, evidence of gross misallocation of capital and hence a sure sign that the country is about to collapse with a hard landing.

The curious thing, however, is that analysts have been calling for such a hard landing in China every single year for the past decade and, yet, it has still not happened. It is time for investors to take the doomsday merchants to task: why are their dire predictions failing over and over again?

There are two principal reasons why so many analysts get China wrong. One reason is that they do not give adequate credit to the quality of Chinese investment. China has invested hugely in infrastructure, which, as in any other country would be regarded as beneficial, especially over the long term. The other reason is that investors do not pay enough attention to how China's debt is funded. China has a relatively large stock of debt, because the domestic savings rate is so high. In fact, China has the world's highest rate of savings at 48% of GDP.[1] In practice, this means that the average Chinese worker stick roughly half of his or her pay check into a bank account every month. Over time, this has pushed the stock of deposits in the Chinese banking system to a whopping 177% of GDP (as at the end of 2015). Banks have no choice but to lend out this money, so it is the high level of deposits that constitutes the main reason why Chinese banks issue a lot of credit. The high level of credit in turn pushes up the country's rate of investment, which in turn results in higher growth rates than in other countries.

It is absolutely essential, therefore, to recognise that China is a high-saving/high investment/high growth economy. In the context of the huge rate of savings, China's credit numbers are far from outrageous. As at the end of 2015, China's total domestic credit stood at 249% of GDP. This actually compares favourably to the 289% of GDP average level of credit in developed economies.[2] Notice also that the Chinese banking system is not particularly leveraged (249%/177%), especially compared to Western banking systems that take in far fewer deposits, but lend out more than China.

[1] Based on our sample of 42 EM and developed economies.

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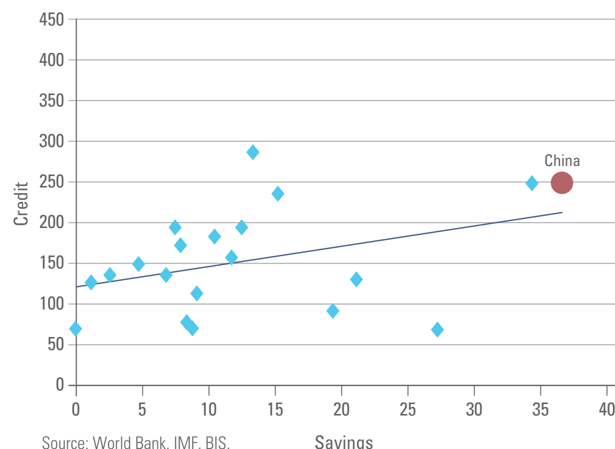
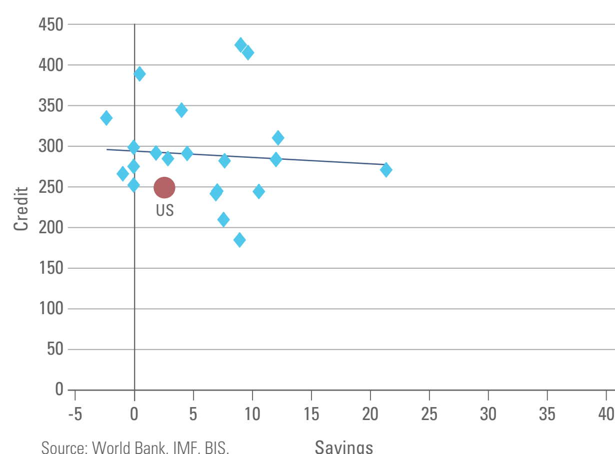
Another way to illustrate the rather unremarkable nature of China's debt stock is to compare it with other countries. To this end, we collected domestic credit and net savings data (both expressed as a percentage of GDP) for 42 EM and developed economies.[2] The two charts below show the relationship between credit (as a % of GDP on the vertical axis) and net savings (as a % of GDP on the horizontal axis) for EM and developed economies, respectively. Each dot represents a country, the line through the dots is a simple regression line and the enlarged dots refer to China and the US in the two charts, respectively.

Fig 1: **Emerging Markets – net national savings versus domestic credit (both % of GDP)**



Source: World Bank, IMF, BIS.

Fig 2: **Developed economies – net national savings versus domestic credit (both % of GDP)**



Source: World Bank, IMF, BIS.

The following observations are important:

1. **China's debt stock is normal, given funding:** China sits very close to the regression line in figure 1. This indicates that China's stock of domestic credit is entirely normal once account is taken of the country's unusually high net savings rate. Hence, focussing solely on liability side of the balance sheet is wrong.
2. **China and other EM countries are generally far less indebted than developed economies:** China's outstanding debt is about the same as that of the US and below the average for developed economies, but given China's much greater abundance of savings it is far less vulnerable to shocks. On average EM countries have 153% of GDP of domestic credit compared to 289% of GDP in developed economies.
3. **China and EM countries save far more than developed economies and tend to be self-funding:** China saves more than 10 times as much as the US (49% of GDP versus 3% of GDP, respectively). China saves about eight times more than the average developed economy. Across EM countries, the average savings rate is more than twice as high as that of developed economies (13% of GDP compared to just 6% in the average developed economy). In fact, EM countries tend to issue more credit only if they are saving more, which suggests that they are capital constrained – i.e. they don't have access to unlimited funding.
4. **By contrast, developed economies tend to save far less and rely on foreign savings:** The relationship between domestic savings and lending for rich countries is flat to downwards sloping (fig 2). This means that the more indebted are not constrained by domestic savings and that, at the margin, they rely on foreign (EM) savings.

[1] The 42 countries are: Argentina, Brazil, Chile, China, Czech Republic, Hong Kong SAR, Hungary, India, Indonesia, Israel, Korea, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey. Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom and United States. The sample size is constrained by the availability of net savings data – it is important to correct gross savings for capital depreciation, because countries with larger capital stocks obviously have much higher depreciation as a % of GDP than countries with small capital stocks.

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Emerging Markets

These simple relationships have important investment implications. The poor current policy mix in developed economies poses a potentially very serious risk to their financial stability. Quantitative easing, neglect of reforms, exorbitant debt levels and populism increase the risk that developed economies will not be able to repay their obligations the conventional way. Unless the situation gets better, it is only a question of time before EM central banks liquidate their investments in developed economies. This would not only create major currency realignments, but would also trigger significant retrenchment of consumption and therefore growth in developed economies.

- China: It is one of the most predictable events in the world: global market sentiment sours and the bears immediately surround China. The reason: last week's set of trade numbers looked weak, but actually reveal far more about demand in developed markets than in China. On the surface, the trade balance was not nearly as strong as expected, the surplus declining to 'just' USD 42bn. Looking closer, exports to the US, Europe and Japan declined at rates of 8.1% yoy, 9.8% yoy and 7.0% yoy, respectively. Granted, exports can be bulky, seasonal and impacted by idiosyncratic factors, but this slowdown in exports to developed countries is consistent with the IMF's recent World Economic Outlook, which slashed growth rates in the US and parts of Europe. As for imports, they painted a much healthier picture of domestic demand in China. While the headline import number was also softer than expected (-1.9 yoy), this was mainly due to price effects. Stripping those out, import volumes expanded at a rate of 6.3% yoy. Finally, a number of temporary factors may have impacted the numbers, including a recent typhoon, the G20 meeting and base/seasonal effects. Indeed, with respect to the latter both imports and exports increased in the month of September on a mom basis, after seasonal adjustment. The 3m rolling trade surplus, which tends to smooth over month by month volatility, moderated only marginally from USD 51bn to USD 49bn. In other news, producer prices inflation turned positive in China on the back of stabilising global commodity prices. Core CPI inflation rose by 0.1% in September to 1.7% yoy. Headline inflation rose more sharply (1.9% yoy versus 13% yoy expected) due to one-off effects such as typhoon-related weather and upwards revisions in some administered prices. Inflows into the Chinese bond market were the highest ever in September, according to Bank of America Merrill Lynch.

- Thailand: King Bhumibol Adulyadej passed away. Much loved, he was one of the unifying forces in a country often torn apart along class and regional lines, especially rural/urban. However, the King's importance was largely symbolic and emotional rather than institutional. The military government in Thailand has traditionally been the de facto force that keeps the feuding groups apart. The military is currently in charge. As such, it is unlikely that the King's passing will have much fundamental impact on day to day events in Thailand even if his death will be mourned by many for a long time. Also it is important to note that the political business cycle in Thailand tends to follow a fairly set pattern: Elections put populist politicians in charge, which tends to draw support from Thailand's largely impoverished rural population. Corruption and abuse of power then leads to discontent, particularly in the main cities. Civil unrest eventually prompts the military to take power. The military restores the law and attempts to end the deadlock by changing the constitution. New elections then put the populists back in power and the cycle repeats itself. Thailand's political business cycle is thus unique in the sense that it features temporary (typically benign) military dictatorships. Political instability, however, has rarely had major adverse effects on macroeconomic policies, which remain prudent. The old saying that 95% of political noise in EM has no significant or lasting impact on the real economy applies very much in the case of Thailand.

- South Africa: The case for investing in the South African bond markets hinges on high real yields in the context of a slowing growth with falling inflation and solid underlying macroeconomic fundamentals (debt, reserves, etc.). However, South African bond positions are also subject to bouts of volatility due to an ongoing power struggle, which is playing out within the governing ANC party. South African President Zuma is weak and vulnerable to attack on numerous fronts. His greatest fear is that he will be prematurely removed from power by the National Executive Committee (NEC) during the ANC Party conference next year, exactly the same way that former president Thabo Mbeki was removed from power (at the hand of Zuma, incidentally). Zuma is vulnerable on account of corruption charges and allegations that he co-operated with an influential family (the Guptas) to engineer so-called 'state capture', that is, employing the vast powers of the state in the service of a small exclusive group of people. Given these pressures, Zuma has decided that the best defense is a good attack, which led last week to formal fraud charges being levelled from the prosecutor's office against Finance Minister Pravin Gordhan. According to reports, Gordhan is alleged to have overstepped laws governing early retirement (relating to a third party). In response, last week Gordhan filed formal charges against the Guptas and others close to Zuma. This attack on Gordhan is causing volatility in the market, since Gordhan is an important anchor for business confidence in South Africa. In addition to going on the attack himself, Gordhan now has the option to appeal the charges against him. He also has strong support within the ANC. Gordhan is likely to present a prudent 2017 budget proposal later this month, which is a pre-requisite for avoiding a ratings downgrade. Zuma would love to see the back of Gordhan in order to gain greater control of state-owned enterprises, which would enable him to dole out jobs and other favours to his supporters. But Zuma's latest attack on Gordhan may also have been motivated by other considerations. Specifically, Zuma may wish to divert attention away from an Ombudsman's report about to be published on the Gupta 'state capture' case, which may yet prove damaging for Zuma. Abstracting from this high-level fight, it is important

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to bear in mind that the real power in South African politics lies with the National Executive Committee of the ANC. The Zuma-Gordhan spat is a very public display of positioning in order to sway the NEC one way or the other. At the end of the day, the NEC is as likely to sway either for or against Zuma and the final decision may not be taken until late next year. For now, we believe the political noise is therefore just that, noise, while South African fixed income markets continue to represent an interesting opportunity among many others within EM.

- Brazil: With a large majority the Lower House approved a bill to constitutionally limit spending. 366 deputies supported the bill, easily surpassing the 308 required votes in favour. The bill will be subject to a second round of voting in the Lower House, before undergoing another two votes in the Senate. A bill to address the lack of sustainability in the government's social security outlays is also expected this year. Petrobras has adopted a new formula for pricing fuel, which implies changes in fuel prices on a monthly basis. This is exceptionally good news for the company's finances. In the past, the government's manipulation of fuel prices was used to win political support at the expense of the company's economic health. In its latest revision to fuel prices undertaken last week, Petrobras announced that fuel prices will be cut by 3.2%, which should help Brazil's already declining inflation to fall even faster. The central bank is widely expected to begin a long cutting cycle this week.

Snippets:

- Argentina: Core inflation decelerated to 1.5% mom in September from 1.7% mom in August. The central bank left the policy rate unchanged at 26.75%.
- Chile: Business confidence picked up sharply to 43.6 in September from 40.2 in August.
- Czech Republic: Inflation declined marginally to 0.5% yoy in September from 0.6% yoy in August.
- Colombia: The finance ministry confirmed the intention to submit a tax reform for approval this year that may raise as much as 2.0% of GDP in net new revenues.
- Croatia: A coalition led by the HDZ party has formed a government – Fitch applauded this move saying that near-term political risks were now lower.
- Hungary: Inflation was 0.6% yoy in September, up from -0.1% yoy in August. Core inflation rose 0.1% to 1.4% yoy.
- India: September's trade deficit was marginally wider than anticipated (USD 8.3bn versus USD 8.0bn expected and USD 7.7bn in August). Wholesale price inflation was 3.57% yoy in September versus 3.9% yoy expected. Inflation declined to 4.3% yoy in September from 5.0% yoy in August. Industrial production was stronger than expected.
- Indonesia: The fiscal deficit as at end-September was much lower than expected. At just 1.8% of GDP the deficit is much lower than at the same time last year (-2.2% of GDP), mainly due to a very successful tax amnesty.
- Malaysia: Sequential industrial output increased 10.6% qoq (saar) in August.
- Mexico: Minutes from the central bank's 29 September meeting showed unanimity behind the decision to hike rates 50bps and suggested that the Bank of Mexico is ready to hike even more if Donald Trump becomes US president.
- Peru: One of EM's most commodity dependent economies, Peru grew 5.5% yoy in August, which was materially faster than expected (4.9% yoy). The central bank left rates unchanged at 4.25%. The trade deficit narrowed to 0.4% of GDP in twelve months to August versus 1.4% of GDP over the same period last year.
- Romania: Inflation was -0.6% yoy in September compared to-0.2% yoy in August.
- Russia: Fitch revised the outlook for Russian sovereign debt to stable from negative. The rating was unchanged at BBB-. The current account surplus was larger than expected in Q3 2016 at USD 1.9bn (consensus was USD 0.2bn).
- Singapore: Non-oil domestic exports picked up 0.3% mom in September, a little bit better than expected against an overall weak backdrop. Q3 GDP growth contracted by more than expected, but the Monetary Authority of Singapore left the FX policy instruments unchanged.
- South Korea: Bank of Korea maintained the policy rate at 1.25% in its October meeting.
- Turkey: Prime Minister Yildirim said the government will soon attempt to change the constitution in order to vest more powers with President Erdogan. Industrial production recovered somewhat following a weak point previously due to the attempted coup.
- Venezuela: PDVSA, the state-owned oil company, extended the deadline for a swap of bonds maturing near-term into longer-dated bonds to 17 October as the company struggles to obtain the desired participation rate. The terms of the exchange are so attractive that many investors are opting to simply hold on the bonds, thus driving down the rate of participation below PDVSA's target of 50%.

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Global backdrop

The FOMC minutes made it clear that the committee is not clear about how much slack exists in the US labour market, but is still on track to hike rates by 25bps in December of this year. The uncertainty surrounding the precise level of the frictional level of unemployment was increased by the rise in the unemployment rate in September (by 0.1% to 5.0%). This rise was due mainly to an increase in labour market participation. Clearly, if workers are now successfully being induced to seek gainful employment there may be a great deal more of slack in the US labour market than the current unemployment rate would imply. After all, the participation rate dropped from a peak of 67.3% of the potential labour force in 2000 to a low of 62.4% in late 2015, a drop that was widely ascribed structural drivers at the time. Yet, the participation rate is now rising again with the latest number up slightly at 62.9%. Potentially, if the drop in the participation rate is fully reversed the labour force could rise by another 4%. This may be why Fed Chairwoman Janet Yellen talked of the case for running the economy a bit "hot" before tightening aggressively. The market took this to mean a higher risk of inflation and a dovish Fed and so the yield curve steepened again. The steepening of the yield curve also reverses the strongest gains made in developed markets this year.

In general, the global market backdrop could well continue to be uneasy in the next few months due to five risk factors all of which originate in rich countries. In addition to the prospect of the first Fed hike in 2016 on 14 December, one can expect position squaring to reduce liquidity going into year-end. Third, the US election is focusing minds between now and 8 November. Fourth, the Italian referendum on 4 Dec could yet throw up a few surprises. Finally, the markets will also be able to make a meal of Britain's activation of Article 50 in Q1 2017 (not forgetting the coming referendum on Scottish Independence and elections in France and Germany next year). Against this backdrop, EM is likely to hold up well, in our view. Technicals remain good as do fundamentals and valuations. Based on EM's strong outperformance versus developed economies this year and the poor prospects for meaningful returns elsewhere next year we think flows to EM are likely to pick up meaningfully in 2017 from a very low base. Some USD 60bn is estimated to have flowed into EM fixed income and equity markets this year, which is small money in an asset class, where fixed income alone is USD 18.5trn.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.66%	15.52%	8.50%	-1.62%	1.98%
MSCI EM Small Cap	-1.24%	7.86%	5.73%	0.31%	3.69%
MSCI Frontier	-0.35%	1.86%	-0.57%	-0.72%	4.22%
MSCI Asia	-1.26%	11.30%	7.93%	2.24%	5.83%
Shanghai Composite	1.97%	-11.66%	-4.14%	13.60%	7.37%
Hong Kong Hang Seng	0.20%	3.66%	-3.10%	0.56%	4.02%
MSCI EMEA	-2.85%	14.96%	-2.83%	-8.52%	-2.32%
MSCI Latam	5.02%	39.10%	27.16%	-7.38%	-4.56%
GBI EM GD	-1.01%	15.89%	9.88%	-3.52%	-1.00%
ELMI+	-0.86%	6.47%	3.25%	-3.34%	-1.51%
EM FX Spot	-0.88%	4.63%	-0.72%	-10.03%	-7.62%
EMBI GD	-0.90%	13.74%	12.69%	7.39%	7.08%
EMBI GD IG	-0.91%	11.91%	10.05%	6.48%	5.68%
EMBI GD HY	-0.88%	15.69%	15.78%	8.30%	9.01%
CEMBI BD	-0.12%	10.98%	9.87%	6.12%	6.56%
CEMBI BD IG	-0.45%	8.23%	7.43%	5.83%	5.91%
CEMBI BD Non-IG	0.40%	15.74%	13.98%	6.31%	7.92%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.55%	6.17%	9.32%	9.91%	14.14%
1-3yr UST	-0.17%	1.36%	0.55%	0.71%	0.63%
3-5yr UST	-0.45%	2.99%	1.42%	2.18%	1.62%
7-10yr UST	-1.33%	5.60%	3.40%	4.91%	3.63%
10yr+ UST	-4.00%	10.10%	7.47%	10.54%	5.81%
10yr+ Germany	-3.25%	13.55%	11.34%	12.88%	9.60%
10yr+ Japan	-0.67%	11.03%	12.74%	7.60%	6.48%
US HY	0.55%	15.74%	11.19%	5.19%	8.09%
European HY	0.54%	7.93%	7.64%	6.29%	11.37%
Barclays Ag	-0.60%	7.86%	7.01%	5.26%	5.60%
VIX Index*	24.45%	-9.17%	9.90%	22.70%	-50.46%
DXY Index*	2.64%	-0.66%	3.64%	23.01%	27.00%
CRY Index*	1.33%	7.18%	-5.34%	-34.09%	-39.98%
EURUSD	-2.11%	1.25%	-2.90%	-19.58%	-19.94%
USDJPY	-2.51%	15.64%	14.95%	-5.82%	-26.10%
Brent	4.59%	37.63%	1.68%	-52.97%	-53.42%
Gold spot	-4.48%	18.45%	7.35%	-4.80%	-24.77%

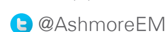
*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more 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.

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

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