Issued: 24 October 2016

WEEKLY INVESTOR RESEARCH

Ashmore

Core inflation will drive the rate cutting cycle in Brazil

By Jan Dehn

The rate cutting cycle has begun in Brazil and the behaviour of core inflation, not politics, will determine the future pace of cuts. Venezuela's government raised the stakes in its battle to survive a recall referendum by cancelling the collection of signatures on judicial grounds. In the Philippines, President Duterte's tilt towards China looks more sensible given broader global trends. Saudi Arabia's big bond bonanza created a new set of benchmark bonds for Middle East sovereigns and corporate issuers alike. The breakdown of Chinese Q3 GDP suggests that the shift from export to consumption-led growth is progressing well. Colombia's tax reform is submitted to Congress despite the recent FARC referendum defeat. South African growth may be lower than expected in Q3 after a slew of weak high frequency data. Malaysia's prudent budget increases odds of further easing from the central bank. Chile votes for more market-friendly leaders in local elections. Nigeria seems to be realising that FX policy is not quite right. Meanwhile, in the rich countries ECB suggested yet more easing, while the talk of yield curve control in the US makes perfect sense given the economic reality.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.1	–	1.59%
MSCI EM Small Cap	12.1	–	0.84%
MSCI Frontier	10.4	–	0.12%
MSCI Asia	12.7	–	0.98%
Shanghai Composite	13.0	–	0.89%
Hong Kong Hang Seng	7.9	–	2.00%
MSCI EMEA	9.6	–	1.64%
MSCI Latam	14.9	–	4.15%
GBI-EM-GD	6.25%	–	0.20%
ELMI+	3.87%	–	0.07%
EM FX spot	–	–	0.09%
EMBI GD	5.08%	334 bps	0.57%
EMBI GD IG	3.94%	213 bps	0.47%
EMBI GD HY	6.69%	506 bps	0.68%
CEMBI BD	4.99%	340 bps	0.26%
CEMBI BD IG	3.90%	232 bps	0.21%
CEMBI BD Non-IG	6.73%	515 bps	0.33%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.0	–	0.41%
1-3yr UST	0.83%	–	0.06%
3-5yr UST	1.25%	–	0.20%
7-10yr UST	1.73%	–	0.52%
10yr+ UST	2.48%	–	1.33%
10yr+ Germany	-0.01%	–	0.82%
10yr+ Japan	-0.05%	–	0.17%
US HY	6.01%	458 bps	0.58%
European HY	3.98%	442 bps	0.65%
Barclays Ag	–	244 bps	0.43%
VIX Index*	13.34	–	-2.78%
DXY Index*	98.61	–	0.72%
EURUSD	1.0882	–	-1.07%
USDJPY	103.90	–	0.01%
CRY Index*	189.40	–	-0.07%
Brent	51.7	–	0.27%
Gold spot	1266	–	0.83%

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

Emerging Markets

- **Brazil:** The Brazilian central bank has begun to cut rates, but the behaviour of core inflation, not politics, will determine the pace this time. The central bank is likely only to cut rates reluctantly as it is mindful of the need to restore the credibility the institution lost under former president Alexandre Tombini. The monetary policy committee known as COPOM started the rate cutting cycle with a modest 25bps reduction in the policy rate, which still kept it at a very high 14%. Ashmore believes that the pace of cuts will depend on core inflation, which as it happens, is moving in the right direction. In the first half of October, a measure of core CPI inflation dropped to 7.59% yoy from 7.92% yoy in September. A number of factors currently support Brazilian domestic fixed income, including a bill to limit fiscal spending, still very high real interest rates, weak economic growth and a stronger currency among others. In addition, the overall quality of macroeconomic policy is improving, which is supporting a downwards move in inflation expectations. Better public sector management also prompted Moody's last week to raise its credit rating for state-energy giant Petrobras from B3 to B2 and to improve the outlook for the company's credit rating from negative to stable. Moody's said its decision reflected improvements in the business environment facing the company as well as the company's improved liquidity profile. The market has been on this page for most of 2016. For example, the mid-yield on the 2021 5 3/8% Petrobras dollar-denominated bond has declined from a high above 14% in January to 5.2% as of last week, a rally in price terms of 45% ytd. In other good news, Reuters reported at the weekend that Petrobras has settled four lawsuits with major US investors.

Emerging Markets

- **Venezuela:** Political tensions in Venezuela hit new highs last week when the Judiciary suspended collection of signatures for a referendum to recall President Nicholas Maduro. The opposition responded by passing a motion in the National Assembly calling for President Nicholas Maduro to be placed on trial for violating the principles of democracy. While the charges have merit, there is no obvious way for such a trial to go ahead, since the Judiciary, which would oversee such a trial, has been usurped by Maduro for political purposes. Indeed, the Judiciary is one of the few remaining institutions under President Maduro's control and he is using its associated institutions aggressively to avoid being removed from power. The opposition is likely to respond to the news by calling mass demonstrations. This should increase the level of political noise in the near-term, since nearly 80% of Venezuelans support Maduro's recall from office, according to Datanalysis, a credible Venezuelan pollster. A severe erosion of civil order cannot be ruled out. If that were to happen, however, we would expect the military to intervene to bring about an orderly transfer of power, probably followed by fresh elections, since the Venezuelan military has not sought direct power since the 1950s. In other news, the government extended yet again the deadline for completion of a debt swap after failing to secure its own target of 50% participation. The swap would see near-term maturities converted into bonds with longer repayment periods, thus easing the repayment profile for PDVSA, the state owned oil company. Ironically, the negative political news may actually increase participation in the swap. Participation rates have been low, because the terms of the swap have been deemed attractive enough to lead many investors to conclude that it will go ahead. In that scenario, however, the most profit can be made by holding on to the bonds maturing next year instead of submitting them into the swap, thus negating the swap in the process. The negative political news, however, places dark clouds over the political outlook for next year and may raise concerns in some quarters about PDVSA's ability to pay its obligations next year; investors with such fears could therefore be induced by the current political noise to submit their 2017 bonds into the swap.

- **Philippines:** President Duterte's visit to China further deepened relations with that country at the expense of US relations. The closer ties between Philippines and China may yet prove to have an element of playing off both China and the US to obtain various concessions, but strategically it is clear that China's influence in the region – and globally – will only increase over time. The rise of China will inevitably result in weakened Western influence, especially in Asia. Excessive meddling in the interest of national self-interest by Western powers during the Cold War period has left a legacy of mistrust towards the West in many EM countries, a mistrust which is now accompanied by relative economic decline and hence an inability to sustain influence. In other news, the public finances in the Philippines improved sharply in August, where revenues were up 18.6% yoy versus 9.5% yoy for expenditures. This took the primary surplus to PHP 56bn compared to PHP 31.bn in the same month of last year. Remittances from foreign workers rose at a pace of 16% yoy in August, up from 5% yoy in July.

- **Saudi Arabia:** The government successfully issued three bonds maturing in 2021, 2026 and 2046. This USD 17.5bn transaction was a success, which drew more than expected demand and placed at lower than anticipated spreads. Moreover, the bonds were large and liquid, which means that Saudi Arabia now has a good set of benchmark bonds, which are likely to become major reference markers for other bonds in the region. The bonds will, however, not enter the JP Morgan EMBI bond index due to Saudi Arabia's high per capita income. Saudi Arabia has the luxury of adjusting demand slowly in response to lower oil prices, because the government reduced its stock of debt from more than 100% of GDP to just 2% of GDP in the ten years leading up to start of the decline in oil prices in mid-June 2014.

- **China:** Real GDP growth was 6.7% yoy in Q3 2016. Bank lending also picked up in September. The growth number was smack in line with expectations, but the breakdown of the growth number is revealing about the direction of reform in China. Consumption contributed 4.8 percentage points to the overall growth number – indeed, retail sales expanded at a rate of 10.7% yoy in September compared to 10.6% last month. Meanwhile, exports detracted 0.5 percentage points. China's growth rate is slowing due to the large number of deep reforms undertaken by the government in order to transform China from an export-led to a consumption-led economy. China has enormous potential to grow as a consumption-led economy on account of a gross savings rate close to 50%. China's slowing growth rate is not a major political problem, because the rising share of consumption in GDP means that ordinary Chinese are experiencing better times even if the overall economy is growing more slowly.

- **Colombia:** The government has submitted its tax reform to Congress despite the recent referendum defeat over its proposal for peace with the FARC rebel movement. The tax reform will lower corporate taxation and increase taxes on individuals. According to Finance Minister Cardenas the tax reform will raise 0.8% of GDP in new revenues in 2017 rising to 2.7% of GDP by 2022. Weakened by its recent referendum defeat the government may have to make concessions on the tax reform, but we expect the reform to pass and ultimately to make a significant contribution to the public finances. Retail sales slowed, manufacturing picked up sharply and the trade deficit narrowed to USD 1bn in August compared to USD 1.4bn in August last year.

- **South Africa:** A slew of economic indicators released last week, including retail sales, manufacturing production and mining output were weaker than expected. These data surprises point to downside risks to current expectations for growth in Q3 2016 of about 3%. Core inflation in September was 0.1% lower than expected at 5.6% yoy. There is currently no incentive for businesses to take major risks in South Africa on

Continued overleaf

Emerging Markets

account of a deep political crisis at the heart of the ANC government. Over the weekend Jackson Mthembu, Chief whip of ANC, called on the Zuma Administration to step down. If a change in leadership were to take place it would likely happen at next year's ANC party congress.

- Malaysia: The 2017 Budget proposed to reduce the fiscal deficit to 3.0% of GDP from 3.1% of GDP expected this year, mainly due to reduced spending. The weaker fiscal impulse is likely to create room for the central bank to maintain an easing bias next year. Indeed, inflation in September was lower than anticipated at 1.5% yoy (versus 1.8% yoy expected).

- Chile: The conservative opposition movement Vamos, led by former president Sebastian Pinera, won the majority of seats in local elections across Chile. Chile is the latest country in Latin America to turn towards more market-friendly politicians, the others being Argentina, Brazil and Peru. President Bachelet's administration has failed to pass reforms and been bogged down by corruption scandals. Chile has a general election in November next year. The central bank left rates unchanged at 3.5%.

- Nigeria: Senate President Bukola Saraki has given the strongest indication yet that the government is realising that the Naira is not trading at fair value. Despite devaluing the currency, the government has failed to let markets clear, wherefore trading in the currency remains severely impeded. A successful devaluation requires three conditions to be met. First, the currency must be allowed to find its own level. Second, the authorities must allow all current and past contracts to clear at the market determined level. Thirdly, government policies must address the underlying cause of the weaker currency, usually by tightening monetary and/or fiscal policies. So far, Nigeria has only satisfied the first of these three conditions.

Snippets:

- Argentina: The current account deficit narrowed to just USD 2.8bn in Q3 2013 compared to USD 4.0bn in the same quarter last year.
- El Salvador: The economy expanded 2.4% yoy in H1 2016, which was a slight acceleration from the same period in 2015 (2.3% yoy). The fiscal deficit narrowed to 0.8% of GDP in the first eight months of 2016 compared to 1.6% of GDP over the same period in 2015.
- Indonesia: Bank Indonesia cut the policy rates by 25bps to 4.75%.
- Peru: The fiscal deficit narrowed to 3.4% of GDP in September from 3.5% of GDP in August, based on 12m rolling numbers.
- Russia: Industrial production contracted in the month of September by 0.3%.
- Singapore: Core CPI declined to 0.9% yoy in October from 1.0% yoy in September.
- South Korea: The trade surplus narrowed slightly in the first 20 days of October to USD 1.7bn from USD 2.0bn in the first 20 days of September.
- Turkey: The Turkish central bank surprised a market conditioned to expecting a strong easing bias by not cutting rates in its October meeting. The decision not to change rates is positive for the credibility of monetary policy, in our view.

Global backdrop

Contrary to rumours, rather than announce Tapering of its bond purchases, the European Central Bank indicated that it may introduce yet more easing at its upcoming December meeting, including a possible extension of the QE programme and loosening of limits on the maximum amount that can be bought of each bond.

The ECB's dovish stance plays neatly into a number of other temporary factors that are currently weighing on sentiment and driving up the value of the USD against the EUR (though not against EM FX which rallied 9bps versus the USD last week). In addition to the normal year-end position squaring, the EURUSD move is fed by the apparent demise of Donald Trump and the expectations of a Fed hike in December. Risk factors also weigh on sentiment about EUR, including the uncertainty surrounding the UK's exit from the European Union, an Italian referendum on constitutional change in early December and German and French elections next year. On the other hand, Spain appears to have found some political stability under a new Rajoy-led minority centre-right government.

Long bonds in developed economies rallied modestly last week after a steep sell-off that began in late September. US policy makers are now openly discussing the shape of the US yield curve. We think this is a significant development, which follows hot on the heels of the decision by the Bank of Japan to directly target a particular yield at the long end of its government bond curve (0% for the 10 year bond). Why are policy makers concerning themselves with long bond yields? On one hand, they say they are concerned about banks. Banks can better make money when the curve is steep as they borrow at the short end and lend at the long end. However, at the same time a steeper curve presents major challenges for home owners and other borrowers and given the enormous indebtedness in Western economies bear steepening can also hurt market sentiment in general, especially if long yields rise in real terms. The steepening this time around has been driven nearly entirely by rising breakeven inflation, with no move in real yields. Hence, it has been positive for risk appetite.

Continued overleaf

Emerging Markets

The real significance of the creeping tendency towards yield curve control in developed economies is that it reflects the simple fact that the US in particular is approaching full employment. This means that inflation can be expected to rise over the next few years. Sadly, growth is still weak and productivity is actually falling. This means that the Fed faces the prospect of stagflation, i.e. a clear trade-off between growth and price stability. Will the Fed favour growth or price stability? Impaled on the horns of such a nasty dilemma we think the Fed will ultimately favour growth, keeping real rates more or less constant by only hiking in line with rising current inflation. Influential voices at the Fed have already called for a change in the inflation target. The real issue facing policy-makers then becomes how the markets respond; they can be expected to react to a pro-inflation bias at the Fed by pricing in a greater inflation risk premium, which would bear steepen the curve. In response, the Fed and regulators can be expected to take measures – as Japan has just done – to keep yields low, or at least lower than where the market would otherwise take them. But keeping yields low by whatever means available would clearly be negative for currencies. Seen in this light bear steepeners and stronger USD can be expected to be temporary events.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.92%	17.35%	8.96%	-1.75%	2.63%
MSCI EM Small Cap	-0.41%	8.77%	5.03%	-0.01%	4.10%
MSCI Frontier	-0.24%	1.98%	-0.69%	-1.01%	4.27%
MSCI Asia	-0.30%	12.39%	6.86%	1.99%	6.45%
Shanghai Composite	2.87%	-10.88%	-4.99%	14.08%	8.60%
Hong Kong Hang Seng	1.09%	4.58%	-5.13%	0.65%	5.07%
MSCI EMEA	-1.25%	16.85%	-0.28%	-9.12%	-1.83%
MSCI Latam	9.38%	44.87%	33.48%	-6.54%	-3.48%
GBI EM GD	-0.81%	16.12%	11.15%	-3.96%	-0.68%
ELMI+	-0.79%	6.55%	3.67%	-3.47%	-1.32%
EM FX Spot	-0.79%	4.73%	0.42%	-10.23%	-7.38%
EMBI GD	-0.33%	14.39%	12.95%	7.16%	7.13%
EMBI GD IG	-0.44%	12.44%	10.57%	6.28%	5.72%
EMBI GD HY	-0.21%	16.48%	15.65%	7.97%	9.06%
CEMBI BD	0.14%	11.27%	9.59%	5.85%	6.49%
CEMBI BD IG	-0.24%	8.45%	7.24%	5.57%	5.85%
CEMBI BD Non-IG	0.73%	16.12%	13.56%	6.04%	7.80%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.15%	6.60%	8.40%	9.33%	13.97%
1-3yr UST	-0.11%	1.42%	0.78%	0.71%	0.64%
3-5yr UST	-0.25%	3.20%	1.97%	2.13%	1.63%
7-10yr UST	-0.82%	6.14%	4.44%	4.84%	3.66%
10yr+ UST	-2.72%	11.57%	9.32%	10.50%	6.18%
10yr+ Germany	-2.46%	14.48%	12.43%	13.10%	9.45%
10yr+ Japan	-0.50%	11.22%	13.39%	7.49%	6.58%
US HY	1.13%	16.41%	11.08%	5.02%	7.78%
European HY	1.19%	8.63%	7.77%	6.30%	11.14%
Barclays Ag	-0.18%	8.32%	7.52%	5.21%	5.53%
VIX Index*	0.38%	-26.74%	-7.75%	1.06%	-54.41%
DXY Index*	3.29%	-0.03%	1.52%	24.53%	29.70%
CRY Index*	1.65%	7.52%	-2.23%	-32.76%	-40.55%
EURUSD	-3.19%	0.24%	-1.59%	-21.15%	-21.88%
USDJPY	2.54%	-13.46%	-14.20%	6.81%	36.53%
Brent	5.30%	38.57%	7.65%	-51.72%	-53.65%
Gold spot	-3.77%	19.29%	8.87%	-5.99%	-23.42%

*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.

Continued overleaf

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

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2016.

Important information: This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised and regulated by the Financial Conduct Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. Past performance is not a reliable indicator of future results. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment.