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WEEKLY INVESTOR RESEARCH

Ashmore

The last QE trade

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EM markets are outperforming developed markets both in normal market conditions and during bouts of serious yield curve steepening in developed economies. The rally in long bonds in developed economies may be the second last of the big QE-sponsored trades. The final QE trade will be to take profits and rotate portfolios into non-QE markets, which now offer better return and less risk.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.0	–	-0.84%
MSCI EM Small Cap	12.1	–	-0.91%
MSCI Frontier	10.4	–	0.42%
MSCI Asia	12.6	–	-1.06%
Shanghai Composite	12.9	–	0.43%
Hong Kong Hang Seng	7.8	–	-1.77%
MSCI EMEA	9.6	–	-0.13%
MSCI Latam	14.8	–	-0.02%
GBI-EM-GD	6.35%	–	-0.45%
ELMI+	3.86%	–	-0.10%
EM FX spot	–	–	-0.04%
EMBI GD	5.22%	337 bps	-0.87%
EMBI GD IG	4.07%	215 bps	-0.99%
EMBI GD HY	6.84%	509 bps	-0.73%
CEMBI BD	5.05%	336 bps	-0.18%
CEMBI BD IG	3.97%	228 bps	-0.29%
CEMBI BD Non-IG	6.79%	510 bps	-0.01%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.0	–	-0.67%
1-3yr UST	0.86%	–	0.00%
3-5yr UST	1.33%	–	-0.16%
7-10yr UST	1.85%	–	-0.71%
10yr+ UST	2.62%	–	-2.09%
10yr+ Germany	0.17%	–	-2.63%
10yr+ Japan	-0.04%	–	-0.25%
US HY	6.19%	467 bps	-0.47%
European HY	4.06%	443 bps	-0.13%
Barclays Ag	–	243 bps	-0.68%
VIX Index*	16.19	–	2.85%
DXY Index*	98.35	–	-0.35%
EURUSD	1.0984	–	0.92%
USDJPY	104.73	–	0.86%
CRY Index*	189.21	–	-0.19%
Brent	49.7	–	-4.00%
Gold spot	1276	–	0.73%

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

Emerging Markets

EM markets are now outperforming developed markets both in normal market conditions and during bouts of serious yield curve steepening in developed economies. Last week German and US long bonds dropped by 2%, while local currency bonds in Emerging Markets (EM) – a widely despised asset class on account of recent FX volatility – were down a mere 45bps. EM spot FX was down just 4bps compared to 35bps for the broad Dollar index (DXY). Being dollar-denominated, EM sovereign bonds declined more than local currency bonds, but by virtue of fat spread cushions and supportive technicals they outperformed developed market bonds. EM High Yield (HY) corporate bonds dropped a mere basis point during last week's developed market long-bond slaughter, outperforming significantly compared to US HY which dropped 47bps on the week.

There are important differences between this steepening episode and past ones, such as the Taper Tantrum. In 2013, US 5y5y breakeven inflation expectations declined even as nominal bond yields increased sharply, which resulted in a dramatic rise in real bonds yields of some 200bps between late 2012 and Q3 2013. By contrast, the current sell-off in developed market bonds has almost exactly mirrored rising inflation expectations, wherefore real yields have remained low and relatively stable. As the chart below shows, US 5y5y real yields remain near the lowest levels in the last three years. Hence, inflation is hurting bonds in developed markets, but has little impact on EM.

The price action in October constitutes yet another important warning to global asset allocators about their positions in developed bond markets. German and US long bonds were up about 15% earlier this year, they dropped no less than one third of this return in just one month as German long bonds fell 5% and US long bonds were down 4.75%. Moreover, this recent bout of volatility is not the first warning. The curve also bear steepened ahead of the Fed's September meeting and German long bonds experienced a sharp rise in yields in the spring of 2015. The Fed's suggestion, in Q3 2015, that the USD rally poses a problem to the health of the US economy also has implications for total return expectations in Dollar bond markets.

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Fig 1: **Yield curve bear steepening: why EM does not care much**

Source: Ashmore, Bloomberg.

Specifically, there are three reasons why investors should be worried about developed market bonds.

- First, valuations are extremely stretched. Short duration bonds already trade with materially negative real yields. Now that long bond yields have also fallen investors should ask where and how they are going to realise further upside?
- Second, developed bond markets are vulnerable, because the US economy is clearly experiencing inflation. While core Personal Consumption Expenditure (PCE) inflation – the Fed's preferred inflation gauge – is only rising at a pace of 1.7% yoy the low inflation reading in the PCE index mainly reflects that medical expenses, i.e. medicine and medical services, are recorded in the index at subsidised Medicare prices, not market prices. The core CPI index, which measures medical expenses at market prices, is already at 2.3% yoy, which is well above the Fed's 2% yoy inflation target. This means that the Fed is basically clinging to administered prices in order to sustain the pleasant fiction that inflation is not a problem. Clearly, if the market was to take the Fed to task over inflation – which is inevitable at some point – long bond yields could rise much, much higher.
- Thirdly, the technical demand from the QE central banks for bonds is waning. QE purchases have been the overwhelming driving force behind the fixed income rally in rich countries since the Developed Market Crisis of 2008/2009. QE purchases are waning for numerous reasons. In the US the Fed was forced to taper, because far too much money was chasing assets in the US, which was causing bubbles and pushing the USD towards overvaluation. In Europe, the ECB is now considering tapering as well, because it is running out of bonds to buy, not because it wants to tighten policy. As QE bids fade so will the upwards momentum in developed market fixed income, which in turn will force investors to face the fact that the bonds have little value beyond the momentum created by the central banks.

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How bad could the developed market bond rout get? Undoubtedly, there is a great deal of profit-taking involved in the steepening episodes this year. Positions are already being squared ahead of year-end and the next Fed hike in December is a convenient pre-text for reducing exposure.[1] There are other compelling fundamental reasons for believing that the bear steepening in developed bond markets will not go too far. Developed economies are almost universally over-indebted with declining productivity and slow growth rates, while their asset prices are extremely overvalued after years of QE stimulus. In the US the Dollar is about 20% over valued in real terms. Under these conditions a large and sustained rise in real long bond yields would wreak havoc on developed economies and markets alike, which is something that governments and central banks will probably not countenance for very long.

The big question, then, is what the governments and central banks can or would do if and when markets suddenly got serious about dumping long bonds. Look to Japan, which is already way ahead of the curve in preparing for this eventuality. Japan knows that the economy could be sunk outright by a sudden rise in long yields, so they have simply killed off the bond market by adopting direct yield curve targeting. By committing to keeping the 10 year yield at zero the Bank of Japan has ensured that the long end of the curve remains well-anchored regardless of what happens with Japanese fiscal policy, global inflation and the US yield curve. The BoJ is sending a very clear signal that they are nowin charge of the entire yield curve, which allows markets to focus on FX and stocks instead. We expect other QE central banks gradually to move in the same direction over time.

These are the reasons why it is, in our view, inadvisable to invest in developed market bonds today: there is no yield and significant capital gains are only possible in the event of a recession. On the other hand, if inflation increases it is likely that the market will not be allowed to push up yields to compensate. Instead, the market will simply be killed off'

So what are investors to do? The first step is to face reality. The developed economies rally in long bonds earlier this year was the second-last QE trade, i.e. the trade wherein investors extended duration to the very maximum in order to squeeze out the very last juice from the QE trades. Unfortunately, it may prove difficult to get out of these trades. Since a major bloodbath in duration would damage developed economies and their markets so much it would most likely not be allowed to happen. Much of the money in these markets is already locked in by new regulation and financial repression. More could be forced to stay.

This means that the final QE trade – taking profits on positions in the QE markets and rotating exposure into the non-QE trades – may have to be expressed in stocks and currencies rather than bonds. The non-QE markets are today both safer and more rewarding places to invest. At USD 18.5trn, or 20% of the world's outstanding bonds, the EM fixed income markets make up a significant part of the non-QE universe. EM currencies and stocks are extremely cheap after years of distortions caused by QE central banks. EM countries have demonstrated strong fundamental resilience over the last few years by surviving four extremely violent external shocks in the shape of the Taper Tantrum, the start of the Fed hiking cycle, a dramatic Dollar rally and the collapse in commodity prices. Despite the headwinds, the EM growth premium never fell below 2%, while defaults, balance of payment crises and IMF emergency assistance programmes remained few and idiosyncratic throughout. The EM growth premium is now picking up. Relative and absolute valuations strongly favour EM, while positioning remains extremely supportive. This is why the attraction of EM today is that it offers both greater return and less risk than anything on offer in developed economies.

- Index developments: According to JP Morgan, Sukuk bonds will be included in the EMBI Global Diversified index at the October month-end rebalancing. Four bonds from Indonesia, Malaysia, Pakistan and Turkey will be added with a combined index weight of about 0.6%. In other news, the November 2017 PDVSA bonds will be removed from the index as they fall below the one year maturity threshold. Turkish bonds will be removed from the IG only version of the EMBI index and Hungarian bonds will be added following actions by ratings agencies. Surinam has issued its inaugural sovereign Dollar bond and will join the EMGI Global Diversified index in due time. We also expect Argentina soon to join the local currency government bond index (GBI EM GD), but there has so far been no pronouncement on the matter.

- Argentina: The fiscal deficit has reached 4.18% of GDP ytd, which suggests that the deficit may end up wider this year than last year (4.23% of GDP). This would be consistent with the government's policy of tightening monetary policy and softening the blow to the economy through easier fiscal policy. The central bank left the policy rate unchanged at 26.75%. The trade surplus rose strongly to USD 2.1bn for the Q1-Q3 2016 period compared to a deficit of USD 1.2bn in the same period last year. Economic activity contracted at a pace of 2.6% yoy, which was not as bad as expected (-2.9% yoy) and far better than last year, when the economy contracted at a pace of 6.0% yoy. Activity rose on a month-on-month basis.

- Brazil: The constitutional change to place a cap on government spending was approved with an overwhelming majority in the second of two votes required in the Lower House. The bill will now go to the Senate for two votes. The wide margin of approval bodes well for the next reform, which seeks to limit social security payments to within sustainable levels. Meanwhile, inflation continues to soften in Brazil. Wholesale price inflation was 0.16% mom in October, which was lower than in September (0.20% mom) and much lower

[1] The almost universal practice of squaring positions into year-end is clearly crazy and flies in the face of any notion of long-term investment planning. The only institutions that gain from this practice are market-makers, who generate some additional returns as clients cross the bid-offer spread completely unnecessarily.

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than in the same month last year (1.89% mom). Real wages are also falling and unemployment is still rising. All this suggests that the bond market has more upside. Brazil's current account deficit also declined to just USD 0.5bn in September, which is the lowest reading since 2007. In the second round of the municipal elections (held yesterday) the PT party of former presidents Lula and Dilma was decimated, while Joao Doria, protégé of PSDB governor Geraldo Alckmin in Sao Paulo, won to cement the status of Alckmin as a leading PSDB candidate for president in 2018, while Aecio Neves' candidate failed to win in Belo Horizonte.

- China: China introduced new macro-prudential measures to manage wealth management products. Under the new rules, wealth management products will be counted as part of banks' balance sheets, thus giving the banks (and bank regulators) incentive to monitor closely this part of the credit market. Services sector activity picked up, according to Standard Chartered Bank's services sector tracker, an index of economic activity. The index rose to 8.0% yoy in September from 7.8% yoy in August. Industrial profits rose 7.7% yoy in September.

- Venezuela: PDVSA completed an exchange of near-term bonds for longer-term maturities resulting in a significant decline in bonds maturities next year. Participation was 39.43%, which means that the investors who participated received significantly over-collaterised new bonds (51% of shares in CITGO, a Venezuelan-owned chain of petrol stations in the US, were pledged to participants in the swap regardless of the level of participation). PDVSA will save roughly USD 1bn in debt repayments this year and next due to the swap. FX reserves dropped to USD 10.9bn following the government's repayment of coupon and principal on the 2016 PDVSA bond. Meanwhile, political tensions continue to rise. The government will view with some relief the lack of widespread participation in protests called by the opposition following the government's decision to place obstacles in the path of a recall referendum. Talks mediated by the Vatican are set to go ahead. In a positive development, the CISNEROS group invested USD 1bn in PDVSA oil projects. This shows that PDVSA is becoming more open to private investment and that early movers are putting money to work in the country.

Snippets:

- Chile: Retail sales and manufacturing production both significantly outperformed expectations. Retail sales rose at a pace of 7.4% yoy versus 3.8% yoy expected, while manufacturing was up 1.4% yoy (the consensus expectation was for a decline of 2.0% yoy). Unemployment was also lower than expected. Mario Marcel was appointed as president of the central bank.
- Colombia: The central bank left rates unchanged at 7.75% in line with market expectations. Moody's applauded the planned tax reform as a positive development. The package of reforms was submitted to Congress last week.
- Dominican Republic: Tourism revenues rose to 7.2% of GDP in the first three quarters of the year compared to 6.8% of GDP at the same time last year. The current account deficit narrowed to 0.4% of GDP from 0.6% of GDP over the same period. Real GDP growth was strong at 6.9% yoy in the Q1-Q3 2016 period.
- El Salvador: The trade deficit for the January to August period narrowed to USD 2.9bn compared to USD 3.2bn over the same period last year.
- Hungary: The central bank cut reserve requirements and the overnight lending rate. The central bank also placed a cap on deposit rates and injected liquidity using FX swaps.
- Indonesia: The 2017 Budget was approved in parliament with a deficit target of 2.4% of GDP. The final approved version of the budget saw energy subsidies slashed, electricity tariffs raised and infrastructure spending boosted.
- Mozambique: A restructuring of the country's external debt looks increasingly likely due to a serious deterioration in the public sector's debt dynamics.
- Mexico: The trade deficit narrowed for the second consecutive quarter to USD 13.8bn in Q3 2016 from USD 16.1bn in Q2 2016 and USD 20bn in Q1 2016. Retail sales exhibited solid growth in August (+8.9% yoy versus 5.8% yoy expected). The government tapped its long EUR denominated bond.
- Panama: Tourism revenues rose to USD 3.1bn in January to August compared to USD 2.9bn in the same period last year. However, Panama Canal toll revenues dropped to USD 1.26bn from USD 1.32bn over the same period.
- Poland: The government announced that it has secured 97% of the financing it requires this year.
- Russia: The Central Bank of Russia left rates unchanged at 10% and maintained its hawkish stance that rate cuts can only resume next year.
- Singapore: Industrial production rose at a pace of 6.7% yoy in September versus 1.0% yoy expected and 0.5% yoy in August.
- South Africa: The government budget, which was published last week, was widely regarded as prudent with plans to cut spending and increase taxes in order to bring down the deficit between now and FY 19/20.
- South Korea: Real GDP rose at a pace of 2.7% yoy in Q3 2016 versus 2.6% yoy expected. The approval rating of President Park Guen-hye took a sharp tumble following allegations of influence peddling.
- Taiwan: Q3 GDP was stronger than expected at 2.03% yoy versus 1.8% yoy expected. Industrial production was also strong.
- Thailand: Exports and imports both beat expectations in September (3.4% yoy and 5.6% yoy respectively).

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Global backdrop

With about a week left to the US presidential election uncertainty about the outcome increased sharply following news that an FBI probe into Hillary Clinton's email practices will be re-opened. US GDP growth was 2.9% qoq annualised in Q3, but the fact that inventory accumulation accounted for one fifth of the growth bodes poorly for Q4 growth unless aggregate demand takes off significantly in the last few months of the year. US GDP is on track for substantially weaker growth this year than last year. The employment cost index is also rising, which raises the spectre of stagflation next year. In general, the global backdrop remains beset by uncertainties emanating almost exclusively from developed economies. In addition to the US election, the disrupting elements include the return to zero inflation in Japan, a possible Fed hike in December, the Italian referendum on 4 December, weak European banks, the UK's triggering of Article 50 expected in Q1 2017, the ECB's challenges regarding bonds left to buy as well as the upcoming French and German elections next year.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.07%	16.37%	7.89%	-1.77%	0.56%
MSCI EM Small Cap	-1.32%	7.78%	3.88%	-0.32%	2.55%
MSCI Frontier	0.18%	2.41%	-2.16%	-0.76%	3.99%
MSCI Asia	-1.36%	11.20%	5.60%	2.04%	4.28%
Shanghai Composite	3.32%	-10.49%	-6.12%	15.92%	7.28%
Hong Kong Hang Seng	-0.70%	2.73%	-6.00%	1.30%	1.71%
MSCI EMEA	-1.38%	16.70%	-0.36%	-8.97%	-3.64%
MSCI Latam	9.36%	44.85%	31.16%	-6.66%	-5.35%
GBI EM GD	-1.25%	15.61%	10.00%	-4.40%	-1.49%
ELMI+	-0.89%	6.44%	3.55%	-3.61%	-1.87%
EM FX Spot	-0.82%	4.69%	0.27%	-10.38%	-7.97%
EMBI GD	-1.20%	13.39%	11.38%	6.71%	6.55%
EMBI GD IG	-1.43%	11.32%	8.98%	5.78%	5.24%
EMBI GD HY	-0.93%	15.63%	14.08%	7.58%	8.34%
CEMBI BD	-0.04%	11.07%	8.97%	5.64%	6.07%
CEMBI BD IG	-0.53%	8.14%	6.60%	5.30%	5.56%
CEMBI BD Non-IG	0.72%	16.11%	12.97%	5.92%	7.09%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.81%	5.88%	3.97%	8.72%	12.98%
1-3yr UST	-0.11%	1.42%	0.98%	0.71%	0.64%
3-5yr UST	-0.40%	3.04%	2.28%	1.98%	1.61%
7-10yr UST	-1.52%	5.39%	4.32%	4.36%	3.64%
10yr+ UST	-4.75%	9.24%	7.36%	9.38%	6.11%
10yr+ Germany	-5.02%	11.47%	7.24%	11.66%	9.19%
10yr+ Japan	-0.74%	10.94%	12.54%	7.47%	6.57%
US HY	0.65%	15.86%	10.44%	4.70%	7.17%
European HY	1.06%	8.49%	6.89%	6.18%	10.35%
Barclays Ag	-0.86%	7.58%	6.59%	4.80%	5.19%
VIX Index*	21.82%	-11.09%	7.43%	17.75%	-45.96%
DXY Index*	3.02%	-0.29%	0.58%	24.10%	31.01%
CRY Index*	1.55%	7.42%	-3.27%	-31.91%	-40.84%
EURUSD	-2.28%	1.18%	0.56%	-20.32%	-22.36%
USDJPY	3.36%	-12.77%	-13.51%	7.23%	38.11%
Brent	1.32%	33.34%	1.35%	-54.65%	-54.77%
Gold spot	-3.06%	20.17%	10.33%	-5.70%	-26.85%

*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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