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Ashmore

Echoes of late 2015

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There are a number of obvious similarities in the outlook for EM going into next year and where markets were last year. In late 2015 markets had also been too fearful only to give way to strong returns in subsequent quarters. The big change between now and then – Donald Trump's election – is unlikely to live up to extremely bullish expectations now being priced into the US economic outlook – and hence in the USD, stocks and bond yields. As such, we think this quarter constitutes an attractive entry point for investors considering adding exposure in EM.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.7	–	1.34%
MSCI EM Small Cap	11.9	–	0.11%
MSCI Frontier	10.4	–	-0.34%
MSCI Asia	12.4	–	1.27%
Shanghai Composite	13.7	–	2.16%
Hong Kong Hang Seng	8.2	–	4.72%
MSCI EMEA	9.5	–	1.28%
MSCI Latam	13.9	–	1.33%
GBI-EM-GD	6.94%	–	-0.32%
ELMI+	4.31%	–	-0.05%
EM FX spot	–	–	-0.19%
EMBI GD	5.92%	355 bps	-0.10%
EMBI GD IG	4.59%	218 bps	-0.04%
EMBI GD HY	7.60%	531 bps	-0.16%
CEMBI BD	5.53%	331 bps	-0.05%
CEMBI BD IG	4.48%	226 bps	-0.21%
CEMBI BD Non-IG	7.21%	499 bps	0.19%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.6	–	1.23%
1-3yr UST	1.11%	–	-0.04%
3-5yr UST	1.81%	–	-0.11%
7-10yr UST	2.33%	–	-0.02%
10yr+ UST	2.99%	–	0.29%
10yr+ Germany	0.22%	–	0.08%
10yr+ Japan	0.02%	–	0.09%
US HY	6.62%	459 bps	0.38%
European HY	4.16%	466 bps	0.33%
Barclays Ag	–	238 bps	0.01%
VIX Index*	12.34	–	-1.01%
DXY Index*	100.84	–	-0.21%
EURUSD	1.0654	–	0.23%
USDJPY	111.96	–	1.01%
CRY Index*	185.73	–	3.29%
Brent	46.9	–	-4.11%
Gold spot	1193	–	-1.73%

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

Emerging Markets

At this time last year Emerging Markets (EM) were fearful of an expected hike in US interest rates the usual (and somewhat myopic) year-end position squaring. The resulting weakness in late 2015 and early 2016 was an excellent entry point that ensured strong performance for the asset class in subsequent quarters on the back of a combination of attractive yields, an improving growth picture, EM currency appreciation and very strong technicals. Indeed, investors who bought into the value created in late 2015 have had good returns in 2016, even taking into account the pull-backs in late 2016.

The outlook now looks very reminiscent of last year at this time in several respects, although there are also some differences.

First, like last year, investors have been served with an extremely enticing entry point. The pullback in EM asset prices this year has been less important compared to last year. Instead, the main driver has been sharp moves in the US dollar and the Treasury curve caused by the election of Donald Trump to the presidency in the US. We think, however, that the market reaction has been irrationally exuberant, which is why this pullback, like last year's, is a good time to allocate. Historical experience shows that big events, such as Trump's election, give rise to outsized moves in asset prices in EM that are typically not mirrored in worsening fundamentals. In other words, they are buying opportunities.

Second, the moves in the US markets are overdone with investors too complacent. The rise in US stock markets, the Dollar and bond yields look unsustainable. They price in a 'perfect' scenario, which, to us, is unlikely to materialise. At the most fundamental of levels, stimulating demand into a stagnant supply-side will be inflationary, which is why the long end of the yield curve is selling off. The US economy will be able to stomach such high yields, but only as long as growth is strong. This is why Trump has to increase fiscal spending. The problem, however, is that the trend growth rate in the US looks unlikely to rise materially under a populist Trump; if anything larger government deficits and trade protection will lower America's trend growth rate. Hence, additional fiscal spending will translate into wider current account deficits and higher inflation.

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Remember that the economy is already close to full employment, given typical frictional unemployment and recent declines in labour participation rates. The Fed is at least eight hikes away from just reaching a non-negative policy rate, a gap it will not be able to close without causing a recession. This is why the rapid surge in the Dollar following Trump's election from an already overvalued level in real effective exchange rate terms does not look sustainable at all.

Thirdly, there is a very strong case for EM on its own merits. The average absolute yield in EM bonds is now higher in several themes (incl. local currency government debt and high yield sovereign debt) than when the Fed had rates at 5.25% in late 2006 prior to the Subprime Crisis. The EM growth premium already started to pick up this year and looks set to continue to rise on the back of extremely attractive real exchange rates (back to 2003 levels). Technicals are also excellent. Institutional investors did not allocate in 2016, while a decent chunk of the USD 50bn of flight-prone ETF flows that flowed into EM this year has now pulled out again.

Finally, EM debt is favourable to developed market debt in an environment of volatile US bond yields. EM bonds are unambiguously preferable for three reasons. Firstly, they have lower duration than developed market bonds, so volatile yields will have less impact on P&L. Second, EM bonds have fat yield and spread cushions that ensure given losses arising from moves in the underlying curve are offset by carry, where no such protection exists in US bonds. Thirdly, EM countries are vastly less indebted than developed economies, so that any given rise in the cost of borrowing will have a smaller overall macroeconomic impact (as a percentage of GDP).

- **TPP:** President-elect Donald Trump announced that he will withdraw the US from the Trans-Pacific Partnership, a trade agreement between the US and Asian economies, from day one of his presidency. We find this completely unsurprising, because both he and Hillary Clinton indicated that much during their campaigns. There is a heavy irony in the US withdrawal from TPP, however. The TPP was a US initiative specifically designed to limit the growing influence of China in Asia. Indeed, this was why China was explicitly not invited to participate in the agreement. The demise of TPP will therefore directly reduce US influence in Asia, leaving a vacuum, which China is certain to exploit. China is going to open its economy over the coming decades and Chinese consumption will become the most important driver of demand in the world as China's growth shifts from exports to consumption. China's economy will be four times larger than the US economy by 2050, but China's consumption will rise even faster given the starting point of a 49% savings rate. As a result, China will also eventually become a net importer. It is therefore entirely rational for Asia's exporters to shift their trade focus away from a stagnating and increasingly protectionist US towards a reforming and increasingly open China.

- **Brazil:** President Michel Temer did not waste any time in letting his leading manager in Congress go after proof emerged that Geddel Vieira Lima had peddled undue influence using his office. Temer has historically acted quickly and decisively whenever credible accusations have been aimed at members of the government team. Even so, Lima's resignation is awkward for Temer, who will now need to find someone of Lima's persuasiveness to lead the process of passing a tough fiscal reform in the Senate (the fiscal reform has already been passed in the Lower House). The task of finding a replacement for Lima is made more difficult by the fact that most members of the political establishment might not have a clean slate either. The saving grace, if that is the right expression, is that both PMBD (Temer's party) and PSDB (centre-right) have strong incentives to push through the reforms at a time when the PT (party of former presidents Lula and Dilma) is disintegrating under the weight of its own corruption-related problems.

The current account deficit continued its dramatic improvement. Following October's official figures, which included a sharp outperformance of Foreign Direct Investment (FDI), the 12 months current account deficit has now fallen to USD 22.3bn, or 1.3% of GDP. As recently as 2015 the current account deficit was close to 4.5% of GDP. The improvement is driven by the trade balance, but at USD 8.4bn FDI flows were also much stronger than expected (USD 6.5bn). The 12 months FDI flow has now reached USD 75.1bn, up from USD 73.4bn in September. Annual FDI is now more than 4% of GDP, nearly three times larger than the current account deficit.

The primary fiscal balance in October swung into a large surplus well above market expectations (BRL 40.8bn versus BRL 35.1bn expected). The surplus was due to BRL 45.1bn received from a program of repatriation of capital kept overseas, therefore should be considered a one-off. Ex-capital repatriation, the primary deficit would have been BRL 4.3bn, which is still better than expected due to strong expenditure discipline (-15.5% yoy).

Credit creation by the financial sector in Brazil continues to shrink, but there are interesting developments taking place beneath the surface. Brazilian banks are forced to lend by the government (so-called earmarked lending), but can also extend credit independently of mandated lending. The Dilma years saw dramatic increases in mandated lending at the expense of credit to the private sector, a phenomenon known as crowding out. This is now changing, however. Data released last week shows that non-earmarked loans rose 5.3% mom, while earmarked lending declined 3.0% mom.

The central bank will take great pleasure in the continuing decline in inflation. The November mid-month inflation rate was 0.26% mom, which took the yoy rate down sharply from 8.3% yoy to 7.6% yoy. Brazil's electricity pricing regulator signalled last week that electricity tariffs will not be raised following good recent rainfall, so inflation will continue to fall for this and other reasons, including a policy rate of 14%.

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- Cuba: Fidel Castro's death has more emotional significance than economic or political importance. Opinionated people the world over either admired or hated him, while most other people simply did not care much. Fidel Castro had been ill for many years and Cuba embarked on market reforms long before his death. The real tragedy in Cuba is that the romantic image that Cuba itself cultivated about Fidel Castro and the revolution and the intransigence of Cuba's detractors kept Cuba locked in a Cold War time warp, which meant that Cuba's development stagnated for the past 30 years during which time other EM countries made spectacular economic and political advances.

- Mexico: Mexican real GDP growth accelerated to 2.0% yoy sa in Q3 2016 from 1.5% yoy sa in Q2 2016. At USD 23.1bn, or 2.9% of period GDP, the current account deficit also narrowed in the first three quarters of the year compared to the same period las year (USD 25.7bn, or 3.0% of period GDP. Within the current account, the trade deficit narrowed to USD 5.3bn from USD 6.7bn over the same period. On the other hand, the rapid weakening of MXN on fears about draconian action against Mexico by Donald Trump pushed up inflation in the first half of November. Core inflation was higher than expected at 3.3% yoy versus 3.1% in the second half of October. Headline inflation rose from 3.0% yoy to 3.3% yoy. Banxico, the central bank, appears to have anticipated the increase in inflation, because it raised rates by 50bps to 5.25% earlier in the week. Domestic consumers in Mexico did not care much about the election, however, as retail spending increased at a rate of 8.1% yoy in September, accelerating versus August even in seasonally adjusted terms

- Turkey: The central bank raised the 1-week repo rate from 7.5% to 8% and the marginal funding rate from 8.25% percent to 8.5% last week. This was a surprise to the market, but falls short of the action required to bring about macroeconomic stability, in our view. Meanwhile, tensions with the European Union have escalated following a non-binding vote to freeze Turkey's EU accession in response to President Erdogan's post-coup clamp-down on the opposition. Erdogan in turn has threatened to let refugees enter Europe again. Europe's open borders under the Schengen Agreement practically collapsed when one million refugees entered the European Union, because the European Union was incapable of controlling its borders and distributing the refugees evenly across member states. Turkey has great bargaining power. Europe is turning increasingly xenophobic and Turkey houses some 3 million refugees from the conflicts in Iraq and Syria. A renewed influx of refugees from Turkey would seriously threaten mainstream politicians in Europe, who are under attack from populists from both the extreme left and the extreme right.

- Colombia: The economy expanded at a rate of 1.2% yoy in Q3 2016, which was slower than anticipated (1.5% yoy). The central bank left rates unchanged at 7.75%. To put the policy rate in context, inflation expectations for the next year and the year after are currently 4.2% and 3.6%, respectively. The government's focus on reaching a peace accord with the FARC rebel group has impacted the economy negatively, because the government delayed a necessary adjustment to lower oil prices. This means that Colombia's economic slowdown is still in full swing, whereas growth is picking up in a number of other countries that undertook adjustment more promptly. The Colombian slowdown is, however, just a classic cyclical one, which will be reversed in due time. In fact, the best evidence of the ongoing adjustment is the improvement in Colombia's external balances. The trade deficit was just USD 1.1bn in September, which means that the 12-month trade deficit has narrowed from USD 15.9bn at the end of 2015 to USD 13.9bn now. In other positive news, the government announced that it has now completed a new peace accord with the FARC, which will be put to parliament for approval at some time yet to be specified. The other task on the agenda of parliament is to pass a tax reform.

- Indonesia: New data show that the public finances are strong. The fiscal numbers from the end of October reveal that Indonesia's fiscal deficit stands at IDR269tn, which is equivalent to 2.1% of GDP. This compares favourably to the fiscal deficit at the same time last year (2.5% of GDP). The strong performance at this stage in the budget year suggests that Indonesia will beat expectations for the year as a whole.

- Venezuela: PDVSA, the national oil company, was late in paying coupons on a few bonds last week, but we do not think this reflects binding limitations on the company's ability to pay. Indeed, the coupons were paid soon after the news hit the wires. Rather, we think the company missed the deadline for logistical reasons, which, at root, reflect manpower and management issues at PDVSA, where finance officials have recently been busy with a swap of the company's maturities into longer-dated maturities. Clearstream confirmed that the coupons had been paid. While it is unusual for EM issuers to miss payment deadlines, it is not abnormal. This is indeed why bond prospectuses usually include grace periods. In PDVSA's case the grace period is 30 days.

- South Africa: Fitch revised the outlook for South Africa's sovereign external debt credit rating to negative from stable, but left the rating unchanged at BBB-. Moody's also reviewed the country's credit rating and left both rating and outlook unchanged (Baa2, negative). S&P (BBB-, negative) is due to publish the results of its own review on 2 December. Currently all three ratings agencies have South Africa on investment grade. An immediate downgrade to sub-investment grade – and excommunication from IG sub-indices – would require downgrades by at least two or more agencies. This is now impossible in the near-term even if S&P downgrades the credit on Friday. South Africa's ratings will continue to remain vulnerable, however, amidst an ongoing power struggle within the ruling ANC party, which is hurting business confidence and preventing reforms. In other news, the central bank left rates unchanged at 7.0% against a backdrop of headline CPI inflation of 6.4% yoy and core inflation of 5.7% yoy.

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Snippets:

- **Argentina:** The central bank cut the 35-Lebac interest rate to 25.25%, 50bps lower than last week. Finance Minister Prat Gay announced that the government has already met its USD 20bn tax amnesty target for this year.
- **China:** The government has expanded the regulatory oversight to include very large transactions abroad by state-owned enterprises and certain types of highly speculative transactions, which may have been used to disguise capital flight. The economy continues to improve with industrial profits rising at a rate of 9.8% yoy in October compared to 7.7% yoy in September.
- **Ghana:** The central bank cut interest rates by 50bps to 25.5%, but public finances revealed that the government deficit is wider than anticipated. This implies that Ghana is likely to have to implement further measures in order to continue to receive support from the IMF.
- **India:** The Reserve Bank of India prudently hiked reserve requirements temporarily in order to control excess liquidity in the banking system created as a result of a recent de-monetarisation effort. Failure to do so would have increased the risk of a suddenly and possibly irresponsible burst in lending.
- **Malaysia:** The rate of inflation declined to 1.4% yoy in October from 1.5% yoy in September. Bank Negara left rates unchanged at 3.0%.
- **Mongolia:** Fitch downgraded Mongolia's sovereign credit rating to B- with a stable outlook.
- **Nigeria:** The central bank left rates unchanged at 14% despite the fact that inflation is running at 18.3% yoy. This will maintain the downwards pressure on the Naira, but probably also government capital controls that are preventing the FX market from clearing. Unlike many other EM currencies that now look cheap the Naira is overvalued due to the government's poor macroeconomic policies.
- **Peru:** Real GDP growth accelerated sharply to 4.4% yoy in Q3 2016 compared to 3.7% yoy in the previous quarter. The pickup in growth was driven by net exports, which contributed a whopping 3.8 percentage points to the overall growth print.
- **South Korea:** Consumer confidence declined sharply in November to 95.8 from 101.9 a month previously. The drop reflects an outbreak of political noise following revelations of influence peddling by people close to President Park. Park now looks increasingly likely to become the target of an impeachment attempt, which could usher in a more stable government.

Global backdrop

The global backdrop continues to be dominated increasingly by irrational exuberance about the US outlook following the election of Donald Trump to the US presidency, although, at the margin, the momentum appears to be waning. This makes a great deal of sense and we think that many of the market moves of the last couple of weeks may well turn out to be excessive given the little attention paid to the actual economic and political backdrop in the US. Indeed, the advance estimate of the US trade gap was much wider than expected at USD 62bn (USD 59bn expected) on the back of falling exports and rising imports. A Trump financed fiscal expansion would only widen the deficit further, given that the USD is already about 20% overvalued, while productivity growth has been outright negative for two consecutive quarters. A decline in US home sales also bears watching closely – the sharp rise in long bond yields clearly poses a risk to housing.

The oil market remains glued to every headline emanating from OPEC. Saudi Arabia and Iran are struggling to agree on who should cut and by how much, but even if OPEC agree there is the still the thorny problem of how to ensure that Russia, a non-OPEC country, does not simply respond to a cut in OPEC output by expanding its own production. Oil analysts believe that OPEC activism alone justifies a premium regardless of whether OPEC actually manages to effectuate a cut in output and so far they have been proven right judging by the enormous focus on and market sensitivity to all OPEC related headlines. We think oil prices are range bound. Fiscal spending will increase demand in developed economies in the next couple of years, while EM growth is also accelerating gently due to real competitiveness and reforms. The resulting rise in demand should put a floor on oil prices. On the other hand, a material rise in oil prices, say, to USD 60 per barrel, would likely bring in higher cost producers such as US shale.

The UK government's autumn statement pointed to weaker growth, higher inflation and a lot more borrowing. This is also the likely direction of travel in most other developed economies with a few nuances. The US will have more inflation than, say, Europe, while growth in Japan will be weaker than in the US. Bond issuance, however, will add to already world beating debt levels in all the developed economies as they run out of room to ease monetary policies.

Francois Fillon's victory in the French Conservative Party's presidential nomination race will be seen as a positive for market sentiment at the margin. The main focus this week will be the referendum on political reform in Italy on 4 December, which the Italian government may lose. Analysts are already frothing at the mouth over the potential consequences, but we think they are already exaggerating the significance of a loss. The ECB is unlikely to taper at its next meeting on 8 December and, finally, the Fed looks likely to hike on 14 December. This hike has been fully priced for some time following the last set of FOMC minutes and recent comments to that effect by Fed Chairwoman Janet Yellen.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-5.39%	10.29%	5.14%	-2.79%	2.31%
MSCI EM Small Cap	-5.45%	1.74%	0.20%	-1.18%	3.91%
MSCI Frontier	-1.09%	0.71%	-1.07%	-2.02%	4.54%
MSCI Asia	-3.73%	6.89%	4.26%	0.83%	6.19%
Shanghai Composite	5.21%	-5.94%	-8.73%	16.91%	9.18%
Hong Kong Hang Seng	2.43%	5.71%	0.84%	-1.23%	4.84%
MSCI EMEA	-5.18%	12.04%	0.80%	-8.99%	-1.58%
MSCI Latam	-11.91%	28.29%	17.40%	-8.60%	-4.64%
GBI EM GD	-7.89%	6.93%	3.27%	-5.35%	-1.45%
ELMI+	-3.66%	2.66%	0.88%	-4.18%	-1.45%
EM FX Spot	-5.52%	-0.81%	-3.40%	-11.14%	-7.68%
EMBI GD	-4.15%	8.63%	6.92%	5.77%	5.97%
EMBI GD IG	-4.63%	6.08%	4.59%	4.76%	4.39%
EMBI GD HY	-3.63%	11.43%	9.41%	6.64%	8.09%
CEMBI BD	-2.28%	8.57%	7.05%	4.95%	5.84%
CEMBI BD IG	-2.67%	5.28%	4.56%	4.52%	5.08%
CEMBI BD Non-IG	-1.68%	14.19%	11.19%	5.33%	7.38%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	4.33%	10.45%	8.29%	9.35%	16.26%
1-3yr UST	-0.51%	0.94%	0.93%	0.54%	0.54%
3-5yr UST	-1.76%	1.32%	1.20%	1.39%	1.20%
7-10yr UST	-4.00%	1.32%	1.19%	3.30%	2.21%
10yr+ UST	-7.26%	1.97%	2.11%	7.98%	2.90%
10yr+ Germany	-1.72%	9.72%	7.03%	11.03%	8.68%
10yr+ Japan	-1.49%	9.43%	11.29%	6.99%	6.22%
US HY	-0.75%	14.69%	12.01%	4.18%	7.64%
European HY	-0.72%	7.66%	5.41%	5.50%	11.26%
Barclays Ag	-2.16%	5.33%	4.72%	4.12%	5.04%
VIX Index*	-27.67%	-32.24%	-18.39%	-4.93%	-61.59%
DXY Index*	2.43%	2.24%	0.82%	25.14%	27.22%
CRY Index*	-0.30%	5.44%	1.36%	-32.09%	-39.69%
EURUSD	-2.98%	-1.86%	0.84%	-21.70%	-20.02%
USDJPY	6.81%	-6.75%	-9.05%	9.41%	43.58%
Brent	-2.92%	25.78%	4.53%	-57.70%	-56.98%
Gold spot	-6.58%	12.43%	12.07%	-4.08%	-30.31%

*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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