**Issued:** 19 December 2016



Ashmore

# 2016 – a year of contrasting fortunes in EM and DM

By Jan Dehn

This last Weekly of 2016 asks why EM fixed income in particular outperformed DM fixed income markets in 2016. In addition to reviewing the underlying economic, political and market developments that brought about this outcome the report also concludes that there is more good news in the pipeline for EM investors in 2017. In addition to covering the main events across individual EM countries from the past week this report also offers a reaction to the Fed decision to hike 25bps. Ashmore's 2017 outlook for EM fixed income and equities will be published later this week.

| Emerging Markets | Next year forward PE/Yield | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| MSCI EM | 11.7 | – | -2.43% |
| MSCI EM Small Cap | 12.0 | – | -0.88% |
| MSCI Frontier | 9.7 | – | 0.19% |
| MSCI Asia | 12.2 | – | -2.39% |
| Shanghai Composite | 13.1 | – | -3.40% |
| Hong Kong Hang Seng | 7.7 | – | -4.03% |
| MSCI EMEA | 9.8 | – | -1.28% |
| MSCI Latam | 13.4 | – | -4.36% |
| GBI-EM-GD | 6.82% | – | -0.93% |
| ELMI+ | 4.08% | – | -0.64% |
| EM FX spot | – | – | -0.71% |
| EMBI GD | 5.92% | 332 bps | -0.33% |
| EMBI GD IG | 4.63% | 199 bps | -0.46% |
| EMBI GD HY | 7.56% | 504 bps | -0.19% |
| CEMBI BD | 5.53% | 307 bps | -0.21% |
| CEMBI BD IG | 4.54% | 209 bps | -0.29% |
| CEMBI BD Non-IG | 7.12% | 467 bps | -0.09% |

| Global Backdrop | Next year forward PE/Yield/Price | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| S&P 500 | 16.9 | – | -0.03% |
| 1-3yr UST | 1.24% | – | -0.26% |
| 3-5yr UST | 2.05% | – | -0.65% |
| 7-10yr UST | 2.58% | – | -0.92% |
| 10yr+ UST | 3.17% | – | -0.43% |
| 10yr+ Germany | 0.32% | – | 1.52% |
| 10yr+ Japan | 0.08% | – | 0.22% |
| US HY | 6.25% | 405 bps | -0.06% |
| European HY | 3.59% | 415 bps | 0.58% |
| Barclays Ag | – | 237 bps | -0.18% |
| VIX Index* | 12.20 | – | 0.45% |
| DXY Index* | 102.60 | – | 1.57% |
| EURUSD | 1.0463 | – | -1.61% |
| USDJPY | 117.22 | – | 1.91% |
| CRY Index* | 191.43 | – | -0.55% |
| Brent | 55.5 | – | -0.41% |
| Gold spot | 1141 | – | -1.79% |

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

## Emerging Markets

The Financial Times ran a story last week about how Chinese scientists have successfully implanted 3D printed blood vessels made from stem cells into rhesus monkeys, marking an important step towards printing blood vessels and other organs for human transplants.[1] It is difficult not to contrast this development with President-elect Donald Trump's contemplation of tariff increases to protect inefficient old-world steel and apparel industries. Indeed, in many ways this little anecdote sums up 2016, which was a year that marked important turnings points for Emerging Markets (EM) and developed economies alike.

For developed countries 2016 was the year when mainstream politicians were finally ejected from power in favour of populists. This triumph of populism had been in the works ever since the Developed Market Crisis (DMC) of 2008/2009. It is a direct consequence of years of failure on the part of mainstream politicians to address the concerns of voters – stagnation and rising inequality.

How did developed economies end up here? Unwilling or incapable of tackling the true causes of stagnation – debt and declining productivity – mainstream politicians have for years relied solely on short-term stimulus measures ranging from zero interest policies, massive debt-fuelled fiscal spending and Quantitative Easing (QE). Unfortunately, these policies have not worked. Instead, it has become more evident every year, even to voters with next to no interest in matters macroeconomic, that these 'cures' were making the disease even worse. In addition to not raising living standards, for example, QE clearly contributed significantly to rising income inequality, thus underlining the universal truth that administering the wrong drugs can destroy rather than heal.

The lurch into populism in developed economies should worry all investors, especially those with large exposures in developed markets. Not only are valuations in these markets excessive after years of QE, but the underlying political conditions are now such that economic health may be jeopardised significantly. Clearly, closing borders, stoking geopolitical tensions, withdrawing from international economic and trade partnerships, persecuting immigrants and other minorities are not good for trend growth rates.

[1] https://www.ft.com/content/3e86b47a-c1fd-11e6-9bca-2b93a6856354

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## Emerging Markets

By contrast, EM countries tend to respond to economic downturns much more robustly than developed economies. Firstly, EM countries do not have the luxury of printing money or engaging in reckless borrowing. Secondly, they tend to inhabit a domestic political reality, which affords little tolerance for macroeconomic shenanigans. Huge numbers of people in EM live at or below the poverty line without access to social security, unemployment benefit or inflation hedges and they have no patience with politicians who mess around with the economy. Hence, if politicians in EM countries screw up they often face impeachment or other means of ex-communication very quickly. This is then followed by rapid and often deep reforms to fix the underlying economic problems. It is precisely this feedback loop from economic shocks to better politics to better economics, which keeps EM countries fundamentally healthier and which is missing in developed economies.

2016 was a good year for most EM countries, because EM countries were able once again to move forward after a few years of adjustment to much tighter financial conditions. Investors have pulled money from the EM asset class for several years in order to chase returns in QE-sponsored developed markets. This triggered sharp cyclical slowdowns in EM, although EM economies never grew less than twice as fast as developed economies. However, EM countries undertook prudent macroeconomic management and reforms, which made it possible for them to weather the storms with surprisingly few casualties. By late 2015 the combination of cheaper currencies and declining inflation rates had rendered them competitive and in 2016 the IMF revised EM growth rates higher twice, while growth rates were revised lower in developed economies.

There was also an important change in global currency markets in 2016. After declining by about 10% per year over the previous five years EM currencies were broadly unchanged against the Dollar in 2016. While the Dollar rallied strongly against all currencies in late 2016, including EM FX, EM currencies had racked up strong returns prior to Q4 and outperformed both EUR and JPY in the Dollar rally going into year-end. The fact that EM currencies are ending the year broadly flat against the Dollar is significant. Even local currency bonds, the world's most despised asset class, have dramatically outperformed developed market bonds of the same duration in Dollar terms in 2016.

Indeed, valuations were extremely compelling – and remain so. In February 2016 the average bond yield across all EM fixed income themes was higher than before the DMC when the Fed had rates at 5.25%! Moreover, in local markets yields were high in real terms too, while Dollar-bond spreads sat well above fair value. As investors in developed markets were piling into the longest duration bonds they could find – a phenomenon we dubbed the 'last QE' trade[2] – only to suffer horrific losses in H2 2016 EM local bonds steadily clocked up positive high single digit returns in Dollar terms. Dollar sovereign bonds did the same and Dollar corporate bonds had even better returns. There is little prospect of a turn-around in developed market bonds, barring, perhaps, under a recession, but there is still plenty of value in EM fixed income.

Finally, technicals were and remain strong in EM. By 2016, positioning had become so light in EM fixed income that even major risk-off events, such as the Brexit vote, the Turkish coup attempt and Fed hike fears no longer had the power to cause big EM sell-offs. There were, in other words, very few sellers left: retail and cross-over investors, hedge funds and banks were largely out of the market and real money investors were – and remain – underweight. In fact, institutional investors continued to pull money from the asset class throughout 2016 albeit at a slowing pace. ETF inflows to EM equity and fixed income briefly spiked to USD 50bn after Brexit, but left immediately after Trump was elected, with little overall long-term consequence for an asset class of USD 18.5trn. The implication of light positioning and quality hands is simple, but powerful: prices respond asymmetrically to global events. The downside risks are smaller, while the upside is larger when investors return to the asset class.

As the start of 2017 approaches the outlook for EM fixed income is brighter than in many years. EM economies are demonstrably healthier, while the deterioration in politics should lead to genuine concern about the economic health in many developed economies. EM assets are already delivering better returns due to deep value, yet still look attractive in price terms compared to the over-bought and technically vulnerable markets in rich countries. Finally, EM positioning is light, so could improve significantly. Inflows typically respond to performance and should help EM growth to improve further. For those eager to learn more about the outlook for EM in 2017 look out for the December 'Emerging View', which will be published later this week.

- Argentina: The weighted average of inflation across the country declined from 2.6% mom in October to 1.4% mom in November. The monthly rate of inflation declined in all major provinces. In a positive development, the government managed to derail a counter-productive fiscal bill at the committee stage in the Senate. The eventual outcome is now likely to be a consensus bill, which wreaks less havoc on the public finances than the original bill would have done.

- Brazil: The government passed a raft of measures to cut red tape for Brazilian businesses. Similar supply-side measures have been implemented in India under Modi's administration. Like India, Brazil is notoriously bureaucratic, so the marginal benefits of even moderate changes in red tape could be substantial. Meanwhile, the committee responsible for vetting the constitutionality of reforms last week approved the pension reform, a successor bill to the fiscal reform, which was passed the week before last. The pension bill now goes to the economic committee stage in the Lower House and then to a vote in the plenary. If passed, the reform then goes to the Senate for two further approvals. Meanwhile, retail sales remained weak.

[2] For more details see http://www.ashmoregroup.com/insights/research/last-qe-trade

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**Emerging Markets**

- China: There is no sign of a let-up in the pace of reforms. China's top leadership re-iterated its commitment to reforms across a broad range of areas at the Central Economic Work Conference (14-16 Dec 2016). In addition, the government will continue to employ fiscal and monetary policy tools to stabilise the economy during the reform process and focus more on measures to increase financial stability. China is in the fortunate position to have both fiscal and monetary room to support its economy during reforms and to have the vision to execute long-term reforms. However, a combination of very high savings rates and insufficient financial instruments, notably fixed income instruments, means that financial market volatility has been high. Both credit and money supply growth numbers were solid in November, however, and the economy gained momentum with better than expected activity data too. The PBOC tightened monetary policies by hiking the 7-days repo rate. Yields rose sharply in the Chinese bond market, marking the possible end of a strong rally that began in late 2014.

- Colombia: High frequency indicators of economic activity consolidated in October, which suggests the economic downturn brought about by adjustment to lower oil prices may now be nearing the end. Colombia's central bank cut the policy rate by 25bps to 7.5%. Juan Jose Echavarria was named to replace Jose Dario Uribe as governor of the central bank. Echavarria is an experienced former central bank board member, whose policies are not likely to change materially versus the policies under Uribe. Echavarria's term begins on 4 January 2017.

- India: The overall balance of payments surplus rose to USD 8.5bn in Q3 2016 from USD 7.0bn in the previous quarter resulting in a rise in reserves to just below 10 months of import cover. The current account narrowed on the back of strong imports, but FDI jumped to USD 17.2bn in Q3 2016 from USD 4.1bn in Q1 2016 and portfolio inflows rose to USD 6.1bn from USD 2.1bn in the previous quarter. Indian inflation in November declined to 3.6% yoy from 4.2% yoy in October.

- Russia: The Central Bank of Russia left the policy rate unchanged at 10% despite its expectation that inflation will converge to the 4% target by the end of next year. This underlines the reassuring hawkish bent of CBR and bodes well for receivers in the Russian local currency bond market in 2017. Industrial production meanwhile accelerated to 2.7% yoy in November from -0.2% yoy in October. This was much stronger than expected (0.3% yoy).

- Turkey: Real GDP growth turned sharply negative in Q3 2016 (-1.8% yoy versus +0.3% yoy expected). Recent terror attacks and the attempted coup in July weighed heavily on the result. The central bank has also been under pressure from the government to pursue excessively dovish monetary policies throughout the entire economic upswing. Hence, the downturn in growth is bad news. While a revision of Turkey's past GDP numbers also added an impressive 15.7% to the size of the economy between 2012 and 2015 the market is likely to focus more on the most recent numbers. An upcoming referendum to approve greater power to President Erdogan next year means that the pressure on the central bank to keep policies too easy will remain, in our humble opinion.

Snippets:

- Chile: The central bank left the policy rate unchanged at 3.5% with a dovish bias.
- Ecuador: Ruling party candidate Lenin Moreno expanded his lead in polls from 28.1% in November to 31.3% in December. Ecuador's next election will be held on 19 February and incumbent President Rafael Correa will not stand.
- Indonesia: Bank Indonesia left the 7-days reverse repo rate unchanged at 4.25%.
- Mexico: The central bank hiked rates by 50bps to 5.75% and maintained a hawkish bias. We think MXN is cheap and the decision to hike twice as much as the Fed makes Mexican bonds increasingly attractive too. Senior Chinese and Mexican government officials agreed to deepen ties in response to Donald Trump's election in the US.
- Peru: The central bank left the policy rate unchanged at 4.25% with a hawkish bias in the accompanying statement. The monthly growth indicator slowed to 2.1% yoy in October from 4.2% yoy in September.
- Poland: Inflation was 0% in November, up from -0.2% yoy in October.
- Singapore: Non-oil domestic exports rose 11.5% yoy in November versus -2.7% yoy expected. Biomedical exports performed particularly well.
- South Africa: Retail sales were weaker than expected in October.
- South Korea: The Bank of Korea left rates unchanged at 1.25%.
- Ukraine: The government has nationalised Privatbank, the largest private lender in Ukraine. The bank will be sold once it has been recapitalised, according to the government, which coordinated the take-over of the bank with the IMF. Privatbank had nearly USD 6bn in deposits, which made it too big to fail in the Ukrainian context.

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## Global backdrop

The 25bps December Fed hike was widely expected, but Fed Chairwoman Janet Yellen's commentary in the subsequent press conference was more hawkish than expected. One of her comments in particular stood out: she said that she did not see much room for further fiscal stimulus in the US. We see two reasons for this statement: firstly, further fiscal stimulus right now would be inflationary, since the economy is close to or at full employment already and core CPI inflation is already higher than the 2% Fed inflation target. Secondly, this was Yellen's first opportunity to respond to attacks by Donald Trump during the election campaign. She reminded the president-elect that she represents the Federal Reserve of the United States, an immensely powerful institution, and that the Fed is independent and that Yellen herself, despite her diminutive stature, can swing a mighty big stick if she chooses to do so.

Herein resides a broader point with relevance to EM investors too: Donald Trump is going to have to learn very quickly that the US is a country with mature institutions. While he has important powers he will be hemmed in from many sides. Trump has already run into resistance from the State Department over his comments about the One China Policy, from the CIA over Russian hacking, from Congress over fiscal spending and, now, from the Fed over macroeconomic management.

As for the market reaction to Yellen's hawkish comments they immediately became a pretext for a further leg higher in what increasingly looks like an irrationally exuberant Trump rally that may well be reversed soon. The big rise in bond yields is a particularly concern for an indebted economy such as the USA. Indeed, Freddie Mac last week issued a clear warning about the impact of higher yields on mortgage markets and housing starts fell (somewhat worryingly builders have never been happier). Industrial production also declined 0.4% in November and retail sales were disappointing. Q4 GDP growth expectations were therefore revised down by most analysts despite a narrower current account deficit. We are not convinced that the Fed will be able to deliver the three hikes implicit in the 'dots' for 2017, but even if they did it would not be a major shock to EM, where rates are already at levels last seen before 2008/2009.

## Benchmark performance

| Emerging Markets | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| MSCI EM | -0.71% | 10.42% | 11.31% | -2.11% | 1.71% |
| MSCI EM Small Cap | -0.22% | 2.37% | 6.00% | -0.58% | 3.95% |
| MSCI Frontier | 1.53% | 1.54% | 2.91% | -2.03% | 4.75% |
| MSCI Asia | -1.52% | 6.18% | 7.53% | 1.06% | 5.48% |
| Shanghai Composite | -3.91% | -9.94% | -9.35% | 15.67% | 9.71% |
| Hong Kong Hang Seng | -3.74% | 2.26% | 3.57% | -0.98% | 3.13% |
| MSCI EMEA | 3.30% | 16.11% | 17.41% | -6.69% | -1.01% |
| MSCI Latam | -3.66% | 25.42% | 22.68% | -8.45% | -6.12% |
| GBI EM GD | 0.27% | 8.21% | 8.75% | -5.01% | -1.57% |
| ELMI+ | 0.05% | 3.08% | 2.96% | -4.13% | -1.40% |
| EM FX Spot | -0.15% | -0.52% | -0.59% | -10.95% | -7.73% |
| EMBI GD | 0.30% | 9.04% | 9.49% | 5.86% | 5.80% |
| EMBI GD IG | -0.18% | 6.21% | 6.46% | 4.78% | 4.17% |
| EMBI GD HY | 0.84% | 12.15% | 12.89% | 6.82% | 7.99% |
| CEMBI BD | 0.18% | 9.00% | 9.33% | 5.08% | 5.87% |
| CEMBI BD IG | -0.12% | 5.27% | 5.43% | 4.52% | 5.02% |
| CEMBI BD Non-IG | 0.65% | 15.35% | 15.99% | 5.64% | 7.52% |

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## Benchmark performance

| Global Backdrop | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| S&P 500 | 2.78% | 12.84% | 11.33% | 10.41% | 15.54% |
| 1-3yr UST | -0.28% | 0.70% | 0.82% | 0.46% | 0.47% |
| 3-5yr UST | -0.75% | 0.57% | 0.66% | 1.38% | 0.98% |
| 7-10yr UST | -1.46% | -0.31% | -0.01% | 3.10% | 1.65% |
| 10yr+ UST | -2.29% | -0.92% | -1.08% | 7.34% | 2.01% |
| 10yr+ Germany | -1.22% | 7.64% | 7.57% | 10.58% | 6.92% |
| 10yr+ Japan | -1.51% | 8.21% | 9.25% | 6.68% | 5.83% |
| US HY | 1.25% | 16.44% | 16.78% | 4.57% | 7.47% |
| European HY | 1.48% | 9.38% | 8.82% | 5.86% | 11.23% |
| Barclays Ag | -0.40% | 5.03% | 5.24% | 4.07% | 4.66% |
| VIX Index* | -8.48% | -33.00% | -41.06% | -13.78% | -51.04% |
| DXY Index* | 1.08% | 4.02% | 3.95% | 27.25% | 27.85% |
| CRY Index* | 1.12% | 8.68% | 11.19% | -31.97% | -35.29% |
| EURUSD | -1.18% | -3.62% | -4.13% | -23.41% | -19.50% |
| USDJPY | 2.41% | -2.37% | -3.28% | 12.44% | 50.19% |
| Brent | 9.89% | 48.77% | 50.38% | -49.71% | -46.49% |
| Gold spot | -2.71% | 7.54% | 5.85% | -3.98% | -28.41% |

*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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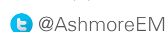 @AshmoreEM

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