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Argentina joins the EM local currency bond index

By Jan Dehn

We applaud JP Morgan for including Argentina in the GBI EM GD local currency government bond index, although the main benchmark indices in EM fixed income still remain woefully unrepresentative of the overall opportunity set. Mexico intervenes in the currency market to stabilise MXN in response to a series of threats by US President-elect Donald Trump against US and foreign companies with plans to produce cars in Mexico. The Speaker of the Lower House in Brazil's parliament is optimistic that pension reform will be passed in H1 2017. Venezuela's President Nicholas Maduro reshuffles his cabinet to surround himself with friends as his party hits new lows in the polls. China's recent oversight and regulatory measures are broadly similar to provisions that exist in Western capital markets and should not be regarded as capital controls. US payrolls did not change the immediate economic outlook, while the December FOMC minutes suggested discomfort in Fed circles at prospect of major fiscal stimulus at a time of full or near-full employment.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	2.65%
MSCI EM Small Cap	10.6	–	2.22%
MSCI Frontier	9.5	–	2.71%
MSCI Asia	11.5	–	3.25%
Shanghai Composite	11.8	–	1.88%
Hong Kong Hang Seng	7.2	–	3.20%
MSCI EMEA	9.3	–	1.29%
MSCI Latam	12.0	–	1.55%
GBI-EM-GD	6.75%	–	0.48%
ELMI+	3.77%	–	0.33%
EM FX spot	–	–	0.15%
EMBI GD	5.61%	318 bps	1.40%
EMBI GD IG	4.40%	194 bps	1.25%
EMBI GD HY	7.14%	480 bps	1.56%
CEMBI BD	5.32%	304 bps	0.74%
CEMBI BD IG	4.39%	210 bps	0.64%
CEMBI BD Non-IG	6.85%	457 bps	0.90%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	1.29%
1-3yr UST	1.22%	–	-0.05%
3-5yr UST	1.93%	–	0.02%
7-10yr UST	2.42%	–	0.23%
10yr+ UST	3.00%	–	1.28%
10yr+ Germany	0.31%	–	-1.57%
10yr+ Japan	0.06%	–	-0.30%
US HY	5.81%	383 bps	0.98%
European HY	3.36%	390 bps	0.56%
Barclays Ag	–	240 bps	0.29%
VIX Index*	11.32	–	-2.05%
DXY Index*	102.35	–	0.14%
EURUSD	1.0537	–	0.73%
USDJPY	117.36	–	-0.16%
CRY Index*	193.54	–	0.64%
Brent	56.8	–	-0.09%
Gold spot	1174	–	1.92%

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

Emerging Markets

• **Indices developments:** The decision by JP Morgan to include Argentina in the EM local currency bond market index (GBI EM GD) is an important and positive development, although it was widely expected. The inclusion takes effect from 28 February 2017. Argentina used to be the largest issuer of bonds in the EM universe and the country has the potential to once again become a major issuer in Latin America and beyond. Having said that, it will take several years to grow the local market and Argentina will never be able to fully regain its former pre-eminence within the EM fixed income universe. This is not just due to the country's bad reputation, which will take years to live down. It is also because the world has moved on. There are now many more EM countries that regularly tap into global capital markets, so no single country will ever again dominate the indices the way Argentina used to do. South Africa, Turkey and Malaysia will give up part of their weights in the GBI-EM GD index in order to make room for Argentina, which will have an initial weighting of 1.16%. The market cap of the index is currently just under USD 1trn.

Benchmark providers, notably JP Morgan, are constantly working to improve the EM fixed income benchmark indices. Enormous progress has been made in a very short span of time. However, the most commonly used benchmark indices are still very far from representing the EM fixed income asset class. We estimate that the four main fixed income benchmark indices – three provided by JP Morgan and one from Bank of America Merrill Lynch – only represent some 9% of the total EM fixed income, which means that passive investors are excluding themselves from 91% of the opportunities in the asset class.

There are many reasons for the poor index representation, including low liquidity, various barriers to entry and the index providers' own business considerations. Most institutional investors still insist on benchmarking.

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Emerging Markets

Our view is that index providers should not require EM bond markets to meet the same exacting standards of liquidity and access that apply to fully mature bond markets in developed economies. After all, EM fixed income markets are – almost by definition – works in progress. Hence, by imposing too stringent requirements the index providers are stifling rather than encouraging large swathes of EM from entering global capital markets. It is also entirely reasonable to expect active EM asset managers to make some effort on their own to overcome barriers to entry, such as applying for quotas when those are available; countries should not be excluded from indices just because asset managers are lazy.

The 'elephant in the room' with respect to index inclusion remains China. China is on the cusp of granting foreign institutional asset managers full access to the China Interbank Bond Market (CIBM). This multi-trillion Dollar local currency bond market is extremely liquid, so access should result in the removal of the last remaining excuses for not including the market in the indices, in our view. Inclusion of the CIBM in Barclays Global Ag and the Citi WGBI indices would be particularly important, though EM specific mandates will also benefit from China's inclusion in the GBI EM GD index.

- Mexico: President-elect Donald Trump's *ad hoc* tweets with threats of border taxes for US and other companies that invest in Mexico are putting considerable pressure on the MXN. This prompted the Mexican central bank to intervene in currency markets last week to stabilise the MXN. Mexico has USD 170bn in FX reserves plus access to various credit lines, including a Flexible Credit Line with the IMF. However, there is no serious threat to Mexico's ability to manage the currency, which is likely to be allowed to decline if the market wishes it to do so, while the central bank will intervene to limit volatility, but not the trend. Mexico has been a model neighbour to the US – almost like a 53rd State. Mexico has engaged with successive US administrations in areas ranging from monetary, trade, capital account policies to fighting drug crime. Due to this good neighbourliness Mexico has come to depend heavily on US markets, although trade between the two countries is actually very balanced. Other than short-term political point scoring with a section of American voters it is difficult to see how hurting Mexican business can improve the American economy. Mexico is not a real threat to American prosperity compared, say, to the overvalued US real exchange rate. We expect Mexico to continue to pursue civilised policies in the face of Trump's attacks. Indeed, the appointment of former finance minister Luis Videgaray to the position of foreign minister testifies to the importance Mexico now attaches to maintaining good economic and financial relations with the US. Amidst the gloom, however, one positive sign: CNN reported last week that the US Congress, not Mexico, will pay for Trump's wall.[1] No one in Mexico ever doubted this, but still...

- Brazil: Lower House speaker Rodrigo Maia indicated that pension reform, which plays a central role in Brazil's medium term fiscal outlook, will be approved during the first half of 2017. The pension reform, which complements an already approved fiscal reform, aims to bring statutory payments into line with the lower overall spending ceiling going forward. In turn, this will free up more spending for discretionary purposes. Brazil's twin reforms of the public finances are among the most radical ever implemented and will change the fiscal outlook for Brazil completely. In other news, industrial production recovered marginally following a dip in October. Petrobras also raised diesel prices, while keeping gasoline prices unchanged. This news was positive for bonds, because the market had expected a rise in gasoline prices as well. Short term inflation can now be expected to be lower than anticipated. The central bank meets to decide on rate cuts this week.

- Venezuela: Tomorrow is an important day in Venezuela, because according to the country's constitution the president can now be replaced by the vice-president if removed from office, say, though a recall referendum. The rest of the government would remain in place. Until tomorrow, a recall of the president would also have required the rest of the government to step down. This change naturally makes Maduro's tenure a great deal more tenuous. Maduro has therefore wasted no time reshuffling his cabinet in order to fill it with good friends. The reshuffle included changes in economic ministries and the energy ministry, but is unlikely to result in any material changes in the overall policy direction, in our view. A poll published last week by Datanalisis, the most credible pollster in the country, showed that Venezuela's opposition coalition now commands an approval rating of 27% compared to just 18% for the ruling PSUV. This is the first time since 2004 that the ruling socialist party has not been the most popular political party in the country. Julio Borges of the Primera Justicia party has been appointed to head the National Assembly. He is strongly opposed to Maduro, but more pragmatic in his approach than his predecessor.

- China: Recent measures introduced by China in the area of cross-border capital flows have been portrayed as capital controls, but we think this characterisation is misleading and represents another example of the strange double-standards that are usually applied when it comes to China. Most of China's new measures are entirely normal and prudent regulatory changes. They include: (a) increased oversight of companies' overseas direct investment and greater compliance of such deals. This is clearly prudent, since much of this money is public money; (b) scrutiny of overseas mergers and acquisitions in excess of USD 10bn. This too seems entirely reasonable practice, which is also matched in Western financial markets; (c) overseas lending in RMB above a certain threshold will require registration with SAFE. Clearly this makes sense for the obvious reason that the monetary authorities need to monitor the money base for purposes of conducting monetary policy; (d) bringing cross-border Renminbi business within the overall remit of China's macro-prudential assessment.

[1] http://edition.cnn.com/2017/01/05/politics/border-wall-house-republicans-donald-trump-taxpayers/index.html

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Emerging Markets

Macro-prudential assessments too are standard practice in the West; (e) increased monitoring of cross-border flows for purposes of curbing money laundering and preventing terrorism financing. As every asset manager in the West knows, this practice is rife in the West too. Finally, China announced that, contrary to expectations, the quota limit for individuals' FX purchases of USD 50,000 per person would not be reduced. Note that most countries, including the US, require declaration of cross-border transactions – both in and out – beyond USD 10,000.[2] In other news, China's FX reserves were marginally higher than expected at USD 3.01trn.

Snippets:

- Argentina: The central bank has unified the 35-day LEBAC rate with the 7-day repo rate and thus completed an important technical step towards inflation targeting.
- Botswana: The Bank of Botswana has adjusted the basket for the Botswana Pula (BWP) to give greater weight to the Special Drawing Right (SDR) and less weight to ZAR. However, ZAR will remain the main driver of BWP.
- Chile: Inflation declined 0.2% during December. Markets had expected a rise of 0.1% during the month.
- Colombia: Yoy inflation slowed by 0.21% in December to 5.75% yoy.
- Costa Rica: The year-to-date fiscal deficit narrowed to 4.3% of GDP in November from 4.9% of GDP in the same month during the previous year.
- India: The Central Statistics Office issued an advance estimate of full fiscal year GDP growth of 7.1% yoy. This was a downwards revision from last year's growth rate of 7.6% yoy. The growth forecast may be revised lower in coming months as the full ramifications of the recent de-monetisation process are fully incorporated in the numbers.
- Indonesia: Inflation was 3.0% yoy in December versus 3.1% yoy expected.
- Malaysia: Exports were much stronger than expected in November, rising 7.8% yoy compared to a market consensus of 2.5% yoy.
- Romania: The National Bank of Romania left the policy rate unchanged at 1.75%.
- Taiwan: Headline inflation declined to 1.7% yoy in December from 2.0% in November.
- Thailand: Core inflation was unchanged at 0.7% yoy in December. Headline inflation rose to 1.1% yoy from 1.0% yoy.

Global backdrop

The FOMC minutes contained two messages: first, they echoed Fed Chairwoman Janet Yellen's concerns expressed during her December press conference that the fiscal stimulus proposed by the Trump administration may push inflation higher and require further Fed hikes. Second, the FOMC noted that the Dollar is a downside risk to US growth. On the data front, US payrolls were a bit softer than expected and the unemployment rate increased to 4.7% from 4.6%. However, this does not materially change the outlook for the Federal Reserve, in our view. The outlook remains extremely uncertain mainly due to President-elect Donald Trump's promises of import tariff increases and fiscal stimulus. The problem, of course, is that the US economy is already at or near full employment with hourly earnings rising 0.4% (much more than expected). Fiscal stimulus right now would therefore risk pushing inflation higher.

In other news, the US Congress is considering the introduction of an audit of Fed policy, which could seriously interfere with Fed independence. The Congressional measure would require the Fed to benchmark its policy stance against a Taylor Rule, which would have exactly the same effect as benchmarking has on, say, a fixed income fund. By requiring the manager, i.e. the Fed, to 'perform' versus a benchmark the Fed's focus will naturally shift toward 'benchmark risk', i.e. the Fed's stance versus the benchmark, from longer-term considerations and underlying economic fundamentals. This is clearly not good. While there would be no specific requirement for the Fed to be 'market-weight' versus the Taylor Rule benchmarking would clearly introduce a lot more pressure on the Fed, especially during extreme economic conditions, thus forcing the Fed to become more myopic. The other problem is that a Taylor Rule benchmark cannot be a complete representation of the underlying economy and therefore makes it hard for the Fed to act on factors that are not captured in the benchmark. For example, the Fed would struggle to take into account problems such as excessive debt in the economy. This factor has probably been one of the main reasons why the Fed has been so dovish in this cycle versus the Taylor Rule.

[2] https://help.cbp.gov/app/answers/detail/a_id/195/~/currency-and-monetary-instruments---amount-that-can-be-brought-into-or-leave

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.20%	2.20%	18.84%	-0.62%	1.75%
MSCI EM Small Cap	1.67%	1.67%	7.07%	-0.26%	3.85%
MSCI Frontier	2.09%	2.09%	6.95%	-1.85%	5.52%
MSCI Asia	2.53%	2.53%	12.77%	2.11%	5.37%
Shanghai Composite	1.63%	1.63%	-4.24%	18.19%	10.54%
Hong Kong Hang Seng	2.30%	2.30%	9.72%	1.53%	3.18%
MSCI EMEA	1.31%	1.31%	27.39%	-4.85%	-0.63%
MSCI Latam	1.85%	1.85%	39.77%	-5.86%	-5.57%
GBI EM GD	0.48%	0.48%	12.20%	-3.61%	-1.16%
ELMI+	0.33%	0.33%	5.50%	-3.54%	-1.16%
EM FX Spot	0.15%	0.15%	2.44%	-9.97%	-7.48%
EMBI GD	1.40%	1.40%	11.57%	6.58%	6.25%
EMBI GD IG	1.25%	1.25%	7.83%	5.50%	4.57%
EMBI GD HY	1.56%	1.56%	15.83%	7.37%	8.46%
CEMBI BD	0.74%	0.74%	10.23%	5.44%	5.98%
CEMBI BD IG	0.64%	0.64%	6.31%	4.89%	5.15%
CEMBI BD Non-IG	0.90%	0.90%	16.88%	5.95%	7.59%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.76%	1.76%	16.93%	9.91%	14.65%
1-3yr UST	-0.05%	-0.05%	0.90%	0.56%	0.54%
3-5yr UST	0.02%	0.02%	0.92%	1.79%	1.16%
7-10yr UST	0.23%	0.23%	0.39%	3.82%	2.10%
10yr+ UST	1.28%	1.28%	0.75%	8.43%	3.21%
10yr+ Germany	-1.57%	-1.57%	5.91%	10.90%	6.97%
10yr+ Japan	-0.30%	-0.30%	7.20%	6.50%	5.69%
US HY	0.97%	0.97%	18.28%	4.88%	7.38%
European HY	0.56%	0.56%	10.53%	5.73%	10.91%
Barclays Ag	0.13%	0.13%	5.84%	4.37%	4.83%
VIX Index*	-19.37%	-19.37%	-58.09%	-12.18%	-46.27%
DXY Index*	0.14%	0.14%	3.87%	26.35%	26.28%
CRY Index*	0.53%	0.53%	14.81%	-28.92%	-37.87%
EURUSD	0.16%	0.16%	-2.97%	-22.57%	-17.45%
USDJPY	0.31%	0.31%	-0.34%	11.96%	52.71%
Brent	-0.09%	-0.09%	69.21%	-46.64%	-49.52%
Gold spot	1.90%	1.90%	7.31%	-4.38%	-27.14%

*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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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

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
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