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Ashmore

EM growth up-turn confirmed

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EM growth is back and the future looks bright. Going forward, we expect even stronger EM growth due to a number of gentle tail winds, including gradually rising commodity prices, capital inflows, rate cuts and the fruits of the reforms undertaken by many EM countries in recent years.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.2	–	0.97%
MSCI EM Small Cap	11.8	–	1.06%
MSCI Frontier	9.9	–	0.07%
MSCI Asia	11.9	–	0.93%
Shanghai Composite	12.2	–	0.17%
Hong Kong Hang Seng	7.8	–	2.32%
MSCI EMEA	9.4	–	1.05%
MSCI Latam	12.4	–	1.03%
GBI-EM-GD	6.65%	–	0.07%
ELMI+	3.73%	–	0.23%
EM FX spot	–	–	0.14%
EMBI GD	5.53%	311 bps	-0.07%
EMBI GD IG	4.33%	186 bps	-0.12%
EMBI GD HY	7.08%	475 bps	-0.01%
CEMBI BD	5.21%	292 bps	0.21%
CEMBI BD IG	4.33%	204 bps	0.24%
CEMBI BD Non-IG	6.63%	436 bps	0.16%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.2	–	1.60%
1-3yr UST	1.19%	–	0.02%
3-5yr UST	1.90%	–	0.00%
7-10yr UST	2.42%	–	0.00%
10yr+ UST	3.02%	–	-0.36%
10yr+ Germany	0.32%	–	0.37%
10yr+ Japan	0.10%	–	-0.62%
US HY	5.75%	377 bps	0.20%
European HY	3.31%	385 bps	0.30%
Barclays Ag	–	241 bps	0.14%
VIX Index*	11.49	–	0.64%
DXY Index*	100.86	–	-0.10%
EURUSD	1.0615	–	0.16%
USDJPY	113.14	–	-0.52%
CRY Index*	192.12	–	-1.91%
Brent	56.0	–	0.81%
Gold spot	1235	–	0.78%

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

Emerging Markets

Emerging Markets (EM) are growing again. In a report published last week, the *Institute of International Finance* pointed out that EM countries grew at a rapid rate of 6.4% on a quarter on quarter basis in January, seasonally adjusted.[1] Actually, the EM growth story is not new. EM growth bottomed out in 2015, when EM countries 'only' grew twice as fast as developed economies. In the preceding five years the EM growth premium had declined as financial conditions tightened due to a giant rotation of global capital out of EM into QE-sponsored financial markets in Europe and the US. However, EM countries survived with surprisingly few casualties. For example, EM high yield corporate default rates were lower than those for US high yield companies and there were only a very small number of sovereign defaults (with surprisingly small losses). In addition, EM had almost no balance of payments crises and hardly any IMF programmes. Indeed, rather than going under most EM countries emerged from the financial drought stronger due to dramatically improved competitiveness on the back of lower currencies and reforms. This enabled EM countries to begin to re-accelerate in 2016 due to strong net exports.

What is the EM growth outlook from here? In a recent update of its 'Global Economic Prospects' the World Bank indicated that on average EM countries will grow more than 3% faster than developed economies within the next three years.[2] This seems conservative. After all, so far EM countries have been able to retake the global growth initiative mainly on the back of extremely competitive real exchange rates, while commodity prices have merely stabilised and EM countries have certainty not experienced sustained positive capital inflows yet. Looking ahead, these conditions are likely to change in ways that will be supportive for growth in EM countries. Firstly, EMs will benefit from a gentle upswing in commodity prices as developed economies stimulate fiscally and EM countries continue to accelerate. Secondly, falling real interest rates in EM will support growth as central banks will cut rates from extremely high real levels. Thirdly, capital flows to EM should resume in a gentle fashion on the back of clear outperformance of EM fixed income and equity markets compared to developed markets. In addition, many EM countries should be able to grow faster due to the serious reforms they have undertaken in recent years, especially in Latin America. These factors have most likely not yet been factored into World Bank and other projections for EM growth in the years ahead.

[1] https://www.iif.com/publication/em-growth-tracker/january-2017-em-growth-tracker
[2] http://pubdocs.worldbank.org/en/255181481727526594/Global-Economic-Prospects-January-2017-Highlights-Chapter-1.pdf

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Emerging Markets

Needless to say, the return to stronger growth in EM is important. Above all, it will give global investors the option to put money into EM as an alternative to the overbought QE markets. Returns in EM look promising. History, while no guide to the future, shows a strong positive correlation exists between the EM growth premium and EM currencies. As such, we think EM local markets could do particularly well.

- Brazil: The current account deficit in January was USD 5.1bn, which was better than expected (-USD 5.4bn). Foreign direct investment in particular surprised strongly to the upside at USD 11.5bn versus USD 9.5bn expected. Chief-of-Staff Eliseu Padilha indicated last week that the government may submit a tax reform to Congress by the middle of April. Details of the reform are yet to be revealed, but it is expected to involve simplification of the current tax code, with the unification of some taxes and other measures to make Brazil less bureaucratic. The government will also push forward legislation to enable foreign investors to buy land, which could boost farming – an area of enormous potential in Brazil. These are unexpected and positive pieces of news, in our view. Meanwhile, the pace of contraction of real economic activity continues to slow. The economy contracted -1.8% yoy in December, down from -2.2% yoy in November.

- Mongolia: The government appears to have staved off default following a last minute agreement with the IMF and other creditors, including China, South Korea, Japan, the Asian Development Bank and the World Bank. Between them, they will provide up to USD 5.5bn in fresh financing for the country. On Sunday the government launched an exchange offer for USD 580m of maturing bonds from the Development Bank of Mongolia in exchange for new sovereign bonds.

- Ecuador: Government candidate Lenin Moreno holds a lead in the presidential election after 81.4% of polling stations have reported, according to Reuters. Moreno, who was picked by President Rafael Correa as his successor, has secured about 39% of the vote compared to 29% for Guillermo Lasso, the opposition candidate. Moreno must obtain 40% of the votes plus secure a margin of 10% over Lasso in order to avoid a second-round run-off. Ecuador has been stable under Correa, but the change of president could usher in a return to greater instability depending on the new president's ability to control parliament.

Snippets:

- Chile: The Chilean central bank left rates unchanged at 3.25% with an easing bias.
- China: The pace of increase of total social financing – a broad measure of credit – was unchanged at 12.8% yoy in January. In absolute terms total social financing was RMB 3.74trn versus RMB 3.0trn expected. In other news, the Chinese securities regulator has relaxed restrictions on daily trading volumes in stock index futures (from 10 contracts to 20 contracts per day). Margin requirements and trading fees will also be reduced.
- Colombia: Retail sales jumped 6.2% yoy in December versus 4.0% expected, aided in part by purchases ahead of a hike in VAT rates.
- El Salvador: November saw the trend growth rate increase to 2.2% yoy from 2.1% in October and 1.2% yoy in November 2015.
- India: The trade deficit narrowed to USD 9.8bn in January compared to USD 10.3bn expected with exports rising at a pace of 4.3% yoy. Wholesale prices rose at a greater than expected rate of 5.25% in January due to higher energy prices.
- Indonesia: The trade surplus increased to USD 1.3bn in January from USD 1.0bn in December. The consensus expectation was the trade surplus would narrow to USD 800m. The central bank left the policy rate (reverse repo) unchanged at 4.75% and indicated that it sees no room for further cuts this year.
- Malaysia: Real GDP expanded at a rate of 4.5% yoy in Q4 2016, up from 4.3% yoy in Q3 and above expectations (4.4% yoy). The current account surplus increased to MYR 12.2bn (3.7% of GDP) compared to MYR 10bn expected.
- Oman: In Q4 2016 the government generated the first fiscal surplus for nearly three years, mainly due to big cuts in public spending.
- Panama: Real GDP expanded at a rate of 4.2% yoy in November versus 3.7% yoy in the same month last year.
- Peru: Real GDP increased at a pace of 3.3% yoy in December versus 3.1% you expected.
- Philippines: Overseas remittances reached USD 2.56bn in December, taking the annual total for 2016 to USD 26.9bn, or nearly 9% of GDP.
- Singapore: Strong growth. Real GDP in Q4 2016 expanded at a pace of 2.9% yoy compared to 2.5% yoy expected.
- South Africa: ANC parliamentary party whip Jackson Mthembu threw his support behind Cyril Ramaphosa to be South Africa's next president. The future of President Zuma will likely be decided at this year's ANC party conference.
- South Korea: The unemployment rate inched up by 0.1% to 3.6% in January.
- Thailand: GDP growth slowed to 3.0% yoy in Q4 2016 from 3.2% yoy in q3 2016.

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Global backdrop

Fed Chairwoman Janet Yellen and US President Donald Trump face the same problem: the economy is very close to full employment and hitting the Fed's inflation target, but the growth rate is still far lower than in past expansions, while voters are demanding more than the economy can deliver. What can be done to satisfy them? The real solution would be to fix all the supply-side issues, including the excessive volume of debt, but this would be painful at first and there are no signs that anyone wants to go there.

Yellen, of course, has no powers to reform anything. She only sets monetary policy and all the signs are that her Fed is incredible dovish. Not only has it allowed the US economy to reach full employment with the lower bound of the Fed funds rate at a mere 50bps, but as core inflation is already at 2.3 the real policy rate is currently *minus* 180bps. Moreover, it seems unlikely that the Fed would allow rates to rise to anywhere near neutral, not least because it would likely trigger an almighty recession. In fact, the Fed still seems to be in two minds about whether inflation is a good or a bad thing.

Meanwhile, Trump's agenda seems hell bent on stimulus with no signs of deeper reform. Trump and the Republicans in Congress are in agreement about the need to pass major tax cuts in the coming months. With the US economy already at or close to full employment this strategy clearly risks sacrificing overall macroeconomic stability on the altar of tax cuts.

The combination of easy money *and* loose fiscal policy should push inflation higher in the coming years. Last week's surprise spike in headline inflation to 0.6% mom versus 0.3% mom expected is clearly a harbinger of things to come as Yellen and Trump both try to keep the party going the time-honoured way: by extending the stimulus a little bit longer.

Most excesses lead to hangovers and macroeconomic hangovers are no different. In the last few years while the US economy had significant spare capacity it was possible to stimulate without apparent cost (except rising debt levels, bubble-like valuations and therefore growing challenges in reversing monetary easing), but today additional stimulus would cause inflation.

This begs the question: is inflation good or bad for America? As a debtor nation, higher inflation in the US would inflict costs on foreign creditors. Certainly, the market actually seems to be strongly in favour of inflation. A bit of inflation means that nominal bond yields can drift higher without causing major economic pain, since higher inflation will help to keep real yields low, though if inflation gets higher it may be necessary to introduce more financial repression in order to keep term yields low too. Inflation would also help to keep the rally in the US stock market going even if (whisper whisper) the source of the rally were to change slowly from higher growth to higher inflation.

That is not to say that there are no domestic costs associated with higher inflation. In addition to the pain inflicted on overseas holders of US assets, future generations would also get robbed as inflation eats away pensions and other domestic savings pools. But perhaps that is acceptable from a political perspective, because neither foreigners nor future generations vote in today's elections. The Fed would also lose credibility, but does Yellen really care? Trump has made it quite clear that he hates her and she is retiring next year anyway and probably just wants to make sure the economy does not cave in on her watch. In light of all these considerations, it seems policies that push up inflation and weaken the Dollar are the easy options, a bit like pushing on an open door.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.31%	8.96%	31.06%	1.86%	0.32%
MSCI EM Small Cap	4.49%	9.39%	24.04%	1.73%	2.11%
MSCI Frontier	0.62%	7.32%	15.64%	-1.02%	6.20%
MSCI Asia	2.98%	9.36%	27.41%	4.42%	3.89%
Shanghai Composite	1.36%	3.17%	13.98%	17.10%	8.99%
Hong Kong Hang Seng	5.67%	10.27%	36.27%	4.75%	1.46%
MSCI EMEA	2.41%	4.57%	29.19%	-3.54%	-2.70%
MSCI Latam	4.38%	12.34%	52.34%	-1.15%	-6.37%
GBI EM GD	1.28%	3.56%	11.78%	-2.56%	-2.34%
ELMI+	0.99%	2.85%	7.10%	-2.75%	-1.80%
EM FX Spot	0.82%	1.97%	2.96%	-9.26%	-8.25%
EMBI GD	1.18%	2.64%	12.86%	6.88%	5.86%
EMBI GD IG	1.14%	2.46%	8.14%	5.38%	4.34%
EMBI GD HY	1.22%	2.83%	18.46%	8.51%	7.87%
CEMBI BD	0.95%	2.19%	12.20%	5.55%	5.65%
CEMBI BD IG	0.88%	1.67%	7.30%	4.76%	4.91%
CEMBI BD Non-IG	1.05%	3.00%	20.66%	6.51%	6.92%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	3.36%	5.32%	24.67%	10.81%	13.94%
1-3yr UST	0.07%	0.19%	0.34%	0.61%	0.58%
3-5yr UST	0.13%	0.44%	-0.22%	1.60%	1.24%
7-10yr UST	0.32%	0.54%	-2.39%	3.18%	2.11%
10yr+ UST	0.65%	1.13%	-4.68%	6.94%	3.50%
10yr+ Germany	1.34%	-1.49%	0.08%	9.64%	7.19%
10yr+ Japan	-0.85%	-2.17%	1.88%	5.22%	5.20%
US HY	0.74%	2.20%	23.80%	4.88%	6.94%
European HY	0.66%	1.31%	13.94%	5.69%	9.79%
Barclays Ag	0.54%	0.66%	6.98%	4.10%	4.48%
VIX Index*	-4.17%	-18.16%	-44.03%	-22.31%	-35.38%
DXY Index*	1.35%	-1.32%	4.41%	25.63%	27.14%
CRY Index*	0.05%	-0.20%	20.35%	-36.22%	-39.47%
EURUSD	-1.69%	0.90%	-3.75%	-22.63%	-19.84%
USDJPY	0.30%	-3.30%	0.19%	10.62%	42.08%
Brent	0.61%	-1.37%	69.77%	-49.19%	-53.32%
Gold spot	1.99%	7.15%	2.16%	-6.67%	-28.83%

*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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