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WEEKLY INVESTOR RESEARCH

Ashmore

The Icarus Index

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We construct a new index of macroeconomic risk, which we name the Icarus Index in reference to the son of Daedalus, who fell victim to hubris while trying to fly between the sea and the sun. The Icarus Index suggests that the US is precariously close to a negative macroeconomic event, such as inflation, recession, or possibly both. Much like Icarus we think the Fed will find it difficult to steer clear of problems, in this case tightening enough to manage inflation without causing a recession. This problem is caused by the late start and extremely easy starting point for the tightening cycle and the overvalued level of the real effective exchange rate. We also provide an update about default rates for EM high yield bonds and explain why we are not afraid of the four most frequently cited risks in China: debt, slower growth, stock market volatility and capital flight. Finally, we present views on the most recent political developments in both South Korea and India.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.3	–	1.01%
MSCI EM Small Cap	11.9	–	0.67%
MSCI Frontier	9.9	–	-0.55%
MSCI Asia	12.0	–	1.24%
Shanghai Composite	12.2	–	1.50%
Hong Kong Hang Seng	7.9	–	0.97%
MSCI EMEA	9.5	–	0.05%
MSCI Latam	12.8	–	0.86%
GBI-EM-GD	6.63%	–	0.24%
ELMI+	3.75%	–	0.20%
EM FX spot	–	–	0.20%
EMBI GD	5.48%	306 bps	0.48%
EMBI GD IG	4.30%	184 bps	0.50%
EMBI GD HY	7.00%	468 bps	0.47%
CEMBI BD	5.18%	291 bps	0.37%
CEMBI BD IG	4.31%	203 bps	0.39%
CEMBI BD Non-IG	6.60%	433 bps	0.35%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	1.12%
1-3yr UST	1.22%	–	0.17%
3-5yr UST	1.90%	–	0.34%
7-10yr UST	2.41%	–	0.72%
10yr+ UST	3.03%	–	0.94%
10yr+ Germany	0.27%	–	1.58%
10yr+ Japan	0.08%	–	0.09%
US HY	5.67%	370 bps	0.38%
European HY	3.29%	387 bps	0.26%
Barclays Ag	–	241 bps	0.56%
VIX Index*	11.62	–	-0.35%
DXY Index*	101.37	–	0.93%
EURUSD	1.0546	–	-1.20%
USDJPY	113.20	–	0.04%
CRY Index*	191.23	–	-1.05%
Brent	56.6	–	1.71%
Gold spot	1238	–	-0.11%

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

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Global markets are rightly focusing on the outlook for Fed interest rate hikes. We do not think Fed hikes pose a major threat to most Emerging Markets (EM) countries, because EM bond yields are already roughly at the same level as before the Developed Markets Crisis of 2008/2009, while EM currencies are competitive enough to give EM economies considerable room to grow. On the other hand, we think the US and other developed economies are far more vulnerable to Fed hikes. Take the US, for example. The US dollar is so expensive in real terms that the competitiveness of US businesses is severely compromised. Yet, despite the fact that the economy is at or very close to full employment the Fed's monetary policy stance remains extremely easy, so easy, in fact, that inflation could rise sharply if the Fed does not hike. On the other hand, if the Fed does go ahead with significant rate hikes the risk of recession rises sharply due to the overvalued state of the real effective exchange rate (REER). It is precisely this combination of an overvalued REER and a very easy policy stance, which creates a conundrum for the Fed. We have summarised the conundrum in the table below, which we call the Icarus Square in reference to the tragic hero of Greek mythology, who, during his flight from Crete between the sea and the sun fell victim to hubris and crashed to his demise.

The US economy today finds itself in Quadrant B, the most risky segment of the Icarus Square. Quadrant B is a high risk quadrant, because the economy has very little room to grow yet the policy stance is still extremely stimulatory. Recession may be close due to extreme REER overvaluation, yet policy remains far too easy, so only very significant hikes will avoid inflation.[1] In classic Icarus fashion, Quadrant B does not leave much room between recession and inflation.

[1] By contrast, we believe most EM economies find themselves in Quadrant C with room to grow due to competitive REERs and room to ease on account of high real interest rates.

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Fig 1: **'Icarus Square'**

		State of economic competitiveness	
		Room to grow	No room to grow
Policy stance	Easy	**A** REER < Equilibrium REER FFR < Taylor Rule*	**B** REER > Equilibrium REER FFR < Taylor Rule*
	Tight	**C** REER < Equilibrium REER FFR > Taylor Rule*	**D** REER > Equilibrium REER FFR > Taylor Rule*

FFR = Fed funds rate.

How big is the risk of a 'macroeconomic accident' in the US? To answer this question we calculated what we call the Icarus Index. The Icarus Index can be thought of as an indicator of the likelihood that something will go wrong in macroeconomic terms, whether a recession, say, due to loss of competitiveness, or inflation due to over-easy monetary policies. The Icarus Index combines measures of US competitiveness and the monetary policy stance. US competitiveness is measured as the difference between the US Real Effective Exchange Rate (REER) and the equilibrium REER, while the monetary policy stance is calculated as the difference between where the Taylor Rule[2] would predict the policy rate to be and the actual policy rate. The variables are then divided by their respective standard deviations and added together to make up the index. The units are standard deviations from equilibrium.[3] The Icarus Index for the US from 1971 to 2017 is shown in the chart below.

Fig 2: **Icarus Index for the US**

Source: Ashmore, BIS, Bloomberg.

The chart shows that risk of something going wrong in macroeconomic terms in the US is now close to three standard deviations from the mean, which is higher than before the 1985 Plaza Accord and the Dotcom Stock Market Crash. The risk has only been higher in the 1970s.

It is against this high-risk backdrop that investors need to examine the potential risks from Fed hikes. After the likely 25bps rate hike this week the Fed will still be more than six hikes away from even reaching neutral. Yet, six hikes would trigger a recession, but if the Fed does not bridge the gap to neutral the US economy will almost certainly have a major inflation problem. The Fed is, in other words, impaled on the horns of a dilemma. All this has to be placed within the broader policy agenda of the Trump Administration, which is proposing further fiscal stimulus via infrastructure spending and tax cuts. A border adjustment tax is also under consideration, which would push both prices and the Dollar higher and thus shunt the REER even further into overvalued territory. In the backdrop loom US stock prices at all-time highs.

[2] Taylor's rule is a proposed guideline for how central banks, such as the Federal Reserve, should alter interest rates in response to changes in economic conditions (www.investopedia.com).
[3] The REER data is from BIS and the Taylor Rule data is from Bloomberg. All the calculations are Ashmore's own.

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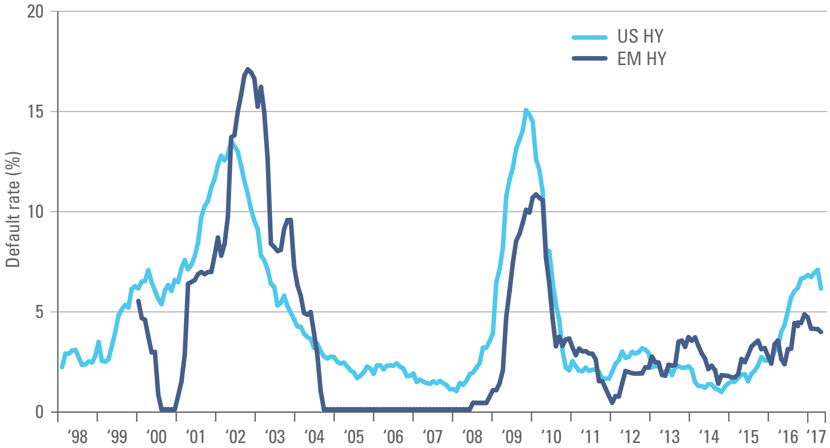
- **Corporate debt:** Stronger growth and gradually easing financial conditions in EM countries are the most likely reasons why default rates are now declining within the most risky part of the EM corporate universe, namely Dollar-denominated High Yield (HY) bonds. The rate of default dropped to 3.93% in February after peaking at 4.96% in October last year. For comparison, the rate of default for US HY corporate bonds is currently substantially higher at 6.11%, though also down a bit from the peak of 7.06% last month. The more rapid decline in default rates for EM HY corporates make them a superior investment proposition compared to more leveraged US high yield corporates, which also happen to pay a lower yield. The long-term default rate for EM high yield corporate bonds of 3.7% is lower than that of US high yield corporate bonds (4.6%). We expect EM corporate HY default rates to continue to decline gradually as financial conditions ease in EM in the years ahead.

Fig 3: **Default rates for high yield bonds**



Source: BAML, Ashmore.

Four Chinese problems and four explanations:

The global financial community is almost uniform in its scepticism about China, which is rooted in the perception that China has four major economic problems, which will guarantee the long-awaited hard landing of the Chinese economy. China's most serious problem, the narrative goes, is debt. The debt load is so excessive that China's economy is slowing. The slowdown in growth in turn explains why the stock market is so beset with volatility and frequent speculative frenzies. Finally, all the aforementioned problems in turn give rise to the final problem: terminal capital flight. Since all the problems are interlinked, but ultimately rooted in the debt problem, which, everyone knows, is notoriously intractable it follows that China's outlook is permanently bearish.

We disagree with this narrative. We do not accept that China has a fundamental debt problem to begin with. We do not believe that the other three problems are linked to debt. We do not even see China's alleged 'problems' as necessarily problematic, because they are mostly symptoms of other developments many of which are actually fundamentally positive. We now explain these views:

1) **Debt:** China's debt stock is large compared to other EM countries. China's stock of domestic credit to GDP is 256% of GDP. While this compares favourably to the 290% credit to GDP average for developed economies it is nevertheless noticeably higher than the 155% average for EM countries ex-China. However, it makes no sense to look only at the lending side without also looking at the funding side. In China, the stock of deposits to GDP is truly massive: 197%. This means that the banking system is only leveraged to the tune of 30% (=256% divided by 197%). The high level of deposits is a direct consequence of China's enormously high saving rate (49%). With such a high savings rate even if China's banks used zero leverage they would still extend credit worth nearly 200% of GDP. The high level of deposits is actually a strength: deposits are the single most stable source of funding for banks. Moreover, China's banks have extended most of their credit to infrastructure investment, which is likely to offer a higher return over the long term than, say, consumer loans in Western banks. Finally, China's debt stock is entirely sustainable given current growth and interest rates. In sum, debt is not a systemic problem and should therefore not be regurgitated endlessly as the source of China's alleged economic problems.

2) **Slower growth:** If debt is not the problem why is China's growth rate slowing? The primary reason for slower growth is that China is implementing an extremely ambitious reform programme. The reforms include interest rate liberalisation, price liberalisation and capital account liberalisation. They are part of a broader reform programme designed to rotate the entire economy away from state control to market forces and away from an export-led focus towards a domestic demand-led growth strategy. The magnitude of these reforms is such that consumers and investors have become far more cautious pending better

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information about the success (or otherwise) of the reforms. The postponement of investment and consumption is the principal reason for slower growth. Investors should not be overly concerned, however. China's reforms are the right ones and are very likely to succeed. Longer-term, China will naturally grow more slowly, since a consumption-led growth model implies lower savings, lower investment and therefore lower real GDP growth rates. However, consumption will rise, so there will not political unrest.

3) Stock market volatility: Chinese retail investors tend to invest in two types of assets (other than cash): property and equities. Both are bull-market instruments. There is no obvious bear market instrument such as bonds available to retail investors, because nearly all the bonds in China are held by banks, pension funds and other institutional investors. Where, in fully developed financial markets, investors would switch into bonds in China the only way to trade a bear market is to sell stocks... and then to sell them again, that is, to short sell them. China's stock market therefore tends to generate twice the volatility of developed economies with more broadly held fixed income markets. Broadening the ownership structure of bonds in China is an important policy objective and China is making strides in this area with the development of the municipal bond market and rolling out mutual funds. Soon China's onshore bonds will also feature in the most important global bond indices. For now, however, it should be recognised that the volatility in the Chinese stock market is more a reflection of an underdeveloped fixed income market rather than a symptom of some deeper macroeconomic malaise.

4) Capital flight: Chinese investors are infinitely better informed about the rest of the world than the rest of the world is about China. While Chinese investors have the same home biases as investors in other markets, which means that their investments will always predominantly be domestic they are nevertheless ready immediately to allocate some of their savings to foreign assets. With the exception of foreign central banks, which are already invested onshore in China other institutional investors overseas have generally not yet allocated to China, especially not commensurately with the size of the Chinese market. One significant obstacle to further foreign involvement is that China's onshore stock and bond markets are not yet represented in the main benchmark indices. This gives rise to a stark asymmetry between Chinese appetite for foreign assets and foreign appetite for Chinese assets, which in turn poses a problem for China's reformers at a time of capital account liberalisation: for a time at least outflows will be larger than inflows. This pressure should ease, however, as China is included in the main indices and until that happens it seems likely that China will only gradually relinquish capital controls if only to ensure an orderly liberalisation of the capital account.

In conclusion: China's growth is slowing due to reforms, not excessive debt. Stocks are volatile due to a combination of large volumes of savings and inadequate access to both bonds and foreign assets. China's reforms are the right ones and the debt stock is sustainable. There is no reason to expect a hard landing. China's growth rate will continue to slow as consumption gradually becomes the dominant driver of the economy and savings rates decline. China's financial markets will continue to deepen and, as they become more integrated with global markets, will also become more stable. Finally, as Chinese savers will gradually get their fill of foreign assets and as foreigners are brought into China on the back of index inclusion so the capital flight 'problem' will fade way.

Other Chinese news, Citi announced last week that China's onshore bond market will be eligible for inclusion in a newly constructed WGBI+ index plus Citi's EM and regional indices. We expect JP Morgan to follow suit by including Chinese bonds in the GBI EM GD index later this year. Between them, these benchmark inclusions could result in USD 65bn in inflows. When China is included in the main WGBI and Barclays Ag indices next year the resulting inflows could reach USD 200bn. FX reserves increased marginally to USD 3.0trn in February. CPI inflation dropped sharply in February to 0.8% yoy from 2.5% yoy in January. Exports accelerated to 4.0% yoy in the first two months of 2017 compared to -5.2% yoy in Q4 2016, while imports increased at a pace of 26.4% yoy compared to 2.5% yoy in Q4 2016. The higher rates of both imports and exports points to an economic upswing in China.

- South Korea: President Geun Hye Park was impeached following a verdict of influence-meddling by the Constitutional Court. South Korea will now go to the polls on 9 May to elect a new president. The polls show opposition leader Moon Jae-in with a large lead (32% of voting intentions versus 17% for his nearest rival, according to a recent Gallup poll). Moon has urged caution over the deployment of an anti-missile defence system the news of which recently raised tensions between the US and China. Moon also favours a less confrontational approach to North Korea and he is more positively disposed towards China. It is therefore possible that South Korea follows the Philippines out of the US orbit, further eroding American influence in Asia. This would also make sense strategically, since the US is becoming protectionist, while the Chinese economy is opening up and will in any case be four times larger than the US economy by the middle of this century. In related news, the countries that signed up to the Trans-Pacific Partnership – a free trade agreement once sponsored by the US – plus China and South Korea are due to meet in Chile this week to work towards a regional trade pact that excludes the US. Trade is good for economic efficiency and growth.

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- **India:** It is difficult not to be impressed by Modi and the BJP party. Despite tackling some of the most difficult reforms that any government can undertake, including GST and demonetisation, BJP swept to victory in the critical state of Uttar Pradesh. The result will strengthen BJP to continue a reform-intensive economic programme. In practice, this may mean more asset sales, more reduction in red tape, more rationalisation of laws, further improvements in the GST regime and, perhaps, improving prospects for financial sector reform. Many India banks are saddled with unrecognised bad debts, which act like a blanket on economic activity by restricting credit to the private sector and the broadening of access to finance among lower income groups. Stronger banks would also put India in a better place to open its bond markets to the rest of the world. In other news, industrial production expanded at a rate of 2.7% yoy in January versus 0.5% yoy expected.

Snippets:

- **Argentina:** Moody's placed the outlook for Argentina's sovereign debt rating to positive from stable. Inflation was 2.5% mom in February versus 2.1% mom expected, partly due to seasonal effects and changes in regulated prices. The central bank left the policy rate unchanged at 24.75% in March.
- **Brazil:** Industrial production increased at a rate of 1.4% yoy in January versus -0.1% yoy in December. Real GDP growth was -0.9% in Q4 2016, weaker than expected, but possibly the last negative quarter for growth in this cycle.
- **Chile:** The trade surplus was USD 236m in February, which was down from USD 809m in the same month last year. Economic activity increased to 1.7% yoy in January from 1.2% yoy in December.
- **Colombia:** The yoy rate of inflation declined to 5.18% in February from 5.47% in January. Fitch revised the outlook for the sovereign credit rating of BBB from negative to stable.
- **Kazakhstan:** S&P affirmed Kazakhstan sovereign credit rating of BBB- with negative outlook.
- **Mexico:** CPI rose by 0.58% in the month of February compared to 0.55% expected. This pushed up the yoy rate of inflation to 4.86% from 4.72% in January. Private consumption accelerated at the strongest pace in more than four years in December (4.7% yoy).
- **Peru:** The central bank left the policy rate unchanged at 4.25%.
- **Philippines:** Exports rose much faster than expected in January (22.5% yoy versus 10.5% yoy expected). The rate of core inflation rose to 2.7% yoy in February from 2.6% yoy in January.
- **Poland:** The central bank left the policy rate unchanged at 1.5%.
- **Romania:** The rate of inflation increased to 0.2% yoy in February from 0.05% in January.
- **Russia:** Inflation slowed sharply to 4.6% yoy in February from 5.0% yoy in January.
- **Singapore:** The government eased mortgage restrictions after having successfully deflated a potential property bubble over the last few years. A reduction of stamp duty and other easing measures bodes well for the evolution of property prices and therefore consumption going forward.
- **South Africa:** Real GDP contracted 0.3% in Q4 2016 versus 0.0% qoq expected.
- **Taiwan:** Export growth accelerated to a rate of 27.7% yoy in February versus 16.4% yoy expected. Inflation was zero yoy in February versus +0.7% yoy expected.
- **Venezuela:** The World Bank's ICSID arbitration court has ruled in favour of Venezuela by overturning a USD 1bn award to Exxon Mobil.

Global backdrop

Last week global markets were firmly focused on the increasing probability of Fed hikes as both the ADP and the non-farm payroll numbers were stronger than expected. A 25bps Fed hike in March is now 100% priced and the odds of three hikes this year are close to 70%.

In other global news, the US may hit the so-called debt ceiling on 15 March. A failure by Congress to raise it will force Treasury Secretary Steven Mnuchin to cut spending in other areas of government in order to continue to service debt. The Atlanta Fed has reduced its estimate for US Q1 real GDP growth to just 1.2% (annualised) based on the data released year to date. The widening US trade deficit – a casualty of an overvalued real exchange rate – has contributed significantly to weak growth. The weak start suggests that 2017 could be yet another poor year for real GDP growth. This suggests that the US stock market is desperately holding out for a tax cut. To help, the Republicans are rushing a hatchet job of a health reform through Congress, since a tax reform is difficult to quantify unless the regime governing health care has been clearly defined. The consensus is that a tax reform will be on the statute books sometime this year.

Meanwhile, in Europe ECB President Mario Draghi was in a more neutral frame of mind after much improved recent growth data in the Eurozone, including stronger industrial production in Germany. He left it up to the market to decide if his more bullish statements about growth should also be construed as hawkish. The market firmed up EUR versus the Dollar. Oil prices on the other hand took a tumble on the back of higher inventory data in the context of heavy speculative positioning skewed to the long side.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.65%	10.37%	30.30%	2.46%	0.54%
MSCI EM Small Cap	5.27%	10.20%	22.09%	2.00%	2.09%
MSCI Frontier	0.49%	7.18%	14.31%	-0.98%	5.94%
MSCI Asia	4.24%	10.69%	26.29%	4.84%	4.06%
Shanghai Composite	3.23%	5.08%	13.71%	18.20%	8.96%
Hong Kong Hang Seng	7.48%	12.16%	33.67%	5.92%	1.61%
MSCI EMEA	2.78%	4.95%	28.24%	-2.99%	-2.54%
MSCI Latam	6.74%	14.88%	51.29%	-0.19%	-5.96%
GBI EM GD	1.95%	4.25%	11.79%	-2.26%	-2.24%
ELMI+	1.39%	3.26%	7.36%	-2.52%	-1.74%
EM FX Spot	1.31%	2.46%	2.95%	-9.00%	-8.20%
EMBI GD	1.54%	3.00%	12.49%	6.87%	5.82%
EMBI GD IG	1.39%	2.72%	7.80%	5.35%	4.33%
EMBI GD HY	1.70%	3.32%	18.05%	8.50%	7.77%
CEMBI BD	1.15%	2.40%	11.98%	5.51%	5.60%
CEMBI BD IG	1.03%	1.83%	7.20%	4.71%	4.89%
CEMBI BD Non-IG	1.32%	3.28%	20.18%	6.48%	6.80%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	3.88%	5.85%	24.08%	11.05%	14.11%
1-3yr UST	0.10%	0.22%	0.28%	0.62%	0.59%
3-5yr UST	0.15%	0.46%	-0.34%	1.61%	1.24%
7-10yr UST	0.36%	0.58%	-2.84%	3.18%	2.11%
10yr+ UST	0.61%	1.09%	-6.10%	6.89%	3.49%
10yr+ Germany	1.56%	-1.27%	-1.23%	9.65%	7.14%
10yr+ Japan	-0.57%	-1.89%	1.33%	5.39%	5.34%
US HY	1.07%	2.54%	23.35%	4.82%	6.94%
European HY	0.79%	1.45%	13.26%	5.62%	9.65%
Barclays Ag	0.69%	0.82%	6.49%	4.10%	4.45%
VIX Index*	-3.09%	-17.24%	-44.61%	-20.84%	-30.83%
DXY Index*	1.87%	-0.82%	3.99%	26.34%	28.61%
CRY Index*	-0.42%	-0.67%	19.19%	-36.59%	-40.87%
EURUSD	-2.33%	0.28%	-4.30%	-23.28%	-21.14%
USDJPY	-0.35%	3.32%	-0.97%	-9.44%	-29.33%
Brent	1.62%	-0.39%	70.12%	-48.48%	-54.21%
Gold spot	2.23%	7.86%	0.88%	-6.54%	-30.50%

*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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