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WEEKLY INVESTOR RESEARCH

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Emerging Markets headlines provide fig leaf for developed market problems

By Jan Dehn

Global market sentiment is weak, allegedly due to Russia and China. However, we think tapering, bad technicals, and weak data are a big part of the reason for poor performance of global stocks. Emerging Markets (EM) sell-offs are becoming less violent and shorter lived as technicals, valuations, and fundamentals prove resilient despite negative EM sentiment.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	941	–	-1.47%
MSCI EM Small Cap	1,022	–	-0.59%
MSCI FM	605	–	-0.73%
GBI-GD	7.08%	–	-0.25%
ELMI+	4.15%	–	-0.09%
EMBI GD	5.77%	327 bps	-0.04%
EMBI GD IG	4.86%	220 bps	-0.11%
EMBI GD HY	7.98%	580 bps	0.12%
CEMBI BD	5.56%	331 bps	-0.37%
CEMBI BD HG	4.63%	239 bps	0.00%
CEMBI BD HY	7.49%	524 bps	-0.38%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1841	-1.88%
VIX Index	17.82	25.49%
5 year UST	1.56%	-6 bps
10 year UST	2.67%	-10 bps
DAX	9111	-1.66%
10 year Bund	1.56%	-6 bps
EURUSD	1.3890	0.12%
USDJPY	101.81	-1.37%
Brent	107.64	0.03%
Copper	301.73	-6.16%
Gold	1379.37	2.79%

Additional benchmark performance data is provided at the end of this document.

Emerging Markets

Global stock markets tumbled this week. Allegedly, this was due to Russia and China. China, so the story goes, is having a hard landing, this time due to softer than expected data, a lone domestic corporate bond default, and the unwinding of copper positions used by Chinese corporates as finance collateral. If these factors are really the cause of the weakness in US and Japanese stocks it is impressive how sensitive developed economies have suddenly become to events in EM. Sure, China's share of global GDP and – more importantly – its share of global growth are no doubt important, but there is a problem with this theory: China is not having a hard landing (see our 'Emerging View' out last week) and we don't think that hard landing fears have caused stock market weakness in developed countries.

Rather, Chinese hard landing fears are a convenient vehicle for revving up negative sentiment to support a broader unwind of pregnant positions in developed equity markets.

The same can be said about the Russia story. The story here is that Russia is holding the entire civilised world hostage over Crimea, threatening the very foundations of global security. This is of course a bit ridiculous. For one, West Texas Intermediate crude would not be trading below USD 100 per barrel if there was a real risk to Russian energy exports. Russia accounts for 12% of global oil exports and is by far the world's largest producer of gas. Russia and the West have overwhelming incentives to compromise, but only after a suitably public row. For now, this row too has become a great vehicle for amplifying the technical unwinding of positions in stock markets.

But behind the juicy China and Russia stories lie other – real – reasons for the continuing weakness in developed stock markets. And these reasons are both more fundamental and far closer to home: The US Fed has been sitting at the very top of the world's profligacy rankings, but is now slowing its bond purchases. QE policies in the US and Japan supported stock markets in both countries for years, to the point that technicals and valuations in both markets rose far in excess of what is justified by still relatively weak fundamentals. Add into the equation not particularly encouraging US data and growing pessimism about Abenomics in Japan and you begin to get at the real reasons for the ongoing pessimism in developed market equities – it is justified by developed market fundamentals, developed market technicals, as well as developed market valuations.

EM fundamentals have largely been immune to the hugely negative sentiment about EM over the past twelve months. Sure some countries had to do some macro adjustment, But this is normal and not the same as crisis.

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Emerging Markets

But EM asset prices have never ever escaped fallout from outbreaks of broader pessimistic sentiment in developed countries and this time around EM asset prices have absolutely not been immune either. Having said that, EM markets have responded less adversely in each sell-off. The Fed's first attempt at tapering last year induced a violent sell-off in Emerging Markets. Local bond yields for example rose from 5.5% to 7%, inflicting losses of 7% in bonds plus the associated losses from the fall in currencies. And EM markets took a very long time to stabilise. The second sell-off in December-January was noticeably shallower – local bond yields rose from 7% to 7.2% and the recovery was swifter. By the end of February, EM bond markets were beating developed market bonds YTD and EM small cap and frontier equities were beating the S&P 500.

What this shows is that each successive sell-off in EM is shallower and shorter. This is due to three reasons: First, the valuations are becoming more attractive with each sell-off. Second, there are fewer sellers left as technicals improve with each sell-off. And thirdly, as EM fails to deliver a genuine crisis with each successive sell-off investors slowly come around to the view that EM is perhaps not as fundamentally vulnerable after all.

Undoubtedly, there will be further EM sell-offs because the market still operates from the mistaken assumption that EM is more vulnerable to tapering than developed economies. But, as the price action is telling us, the conviction behind this assumption is beginning to be challenged. EM valuations, technicals, and fundamentals are beginning to make EM look good at the margin. Meanwhile technicals and valuations and fundamentals are beginning to make developed markets more dubious at the margin. This is how markets begin to turn.

Turning to country specific news:

- Russia: While the Western reaction to Crimea's referendum decision to join Russia will grab the headlines, Russia has itself contributed to raising the rhetorical temperature by warning of Iran-style sanctions on account of the annexation of Crimea. In reality, US sanctions on Russia have been extremely modest, involving mainly economically irrelevant measures such as visa bans and asset freezes on those involved in Crimea and suspension of talk about a more simplified visa regime. Whatever the outcome of today's meeting of EU foreign ministers, the EU's appetite for meaningful sanctions also appears limited. We believe a major diplomatic tussle between Russia and Western powers serve the purpose of masking de facto Western impotence in the face of Russia's actions.
- Ukraine: The list of Western backers for Ukraine continued to grow last week. The European Commission offered USD 700m in tariff cuts. Based on the verdict of a recent IMF mission which is likely to support assistance for Ukraine we expect substantial support for Ukraine as EU/US seek to make a success out of Ukraine after Russia's annexation of Crimea.
- China: People's Bank of China (PBOC) this weekend widened the trading band for USDCNY from +/- 1% to +/- 2%. This is part of China's big shift from exchange rate targeting to using interest rates as the main policy tool. This shift in policy is in turn part of a broader preparation for a world of greater inflation and associated currency weakness in those developed countries that are printing money via QE policies. Band widening will increase the volatility of the currency in the near-term, but this move has to seen as a step in the direction of capital account opening. This will be extremely positive for global investors, who will get access to China's domestic bond market. For more details on our view of China's reform path please refer to *"Bull in a China shop",* The Emerging View, published last week. In a related development, MSCI, the index provider, announced that it intends to include China's A-shares into the MSCI Emerging Markets Index by June, subject to Chinese government approval.
- Brazil: Retail sales rose by a hefty 2% mom in January (3.5% yoy). The main driver of consumption in Brazil is strong labour markets. The employment situation has not been adversely affected by a loss of confidence in the macroeconomic management of the country by market participants and segments of the business community. Industrial production bounced back sharply (2.9% mom sa) and inflation in January was 5.68% yoy, marginally higher than December at 5.59% yoy. We expect sub-trend growth in Brazil due to poor supply-side policies, the coming election, and weak macroeconomic leadership.
- Policy decisions: Bank Indonesia left the main policy rate unchanged at 7.5% and the deposit facility rate unchanged at 5.75%. Chile's central bank reduced the policy interest rate by 25bps to 4.0%. Bank of Thailand cut rates by 25bps to 2.00%. Russia's central bank left policy rates unchanged at 7%.
- Venezuela: The World Bank's arbitration panel (ICSID) rejected an appeal by the Venezuelan oil company PDVSA against a ruling in favour of Conoco, a US oil company. The case dates back to former President Hugo Chavez's nationalisation of foreign oil companies in 2007. Other cases against Venezuela are pending and potential liabilities run into billions of Dollars. Settlement is often negotiated between parties after ICSID rules. Meanwhile, protests against the government continue in Venezuela.

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Emerging Markets

- **Argentina:** In a very positive development the Paris Club has approved repayment in instalments of debt owed to it by Argentina. In another development, Chief of the Cabinet Jorge Capitanich last week confirmed that the government will halve energy subsidies from 4.5% to 2-2.5% of GDP. This will have a direct positive effect on the fiscal balances and help to reduce inefficiency in the economy. A raft of recent economic policy measures suggests that Argentina is aware that adjustment is necessary to avoid a balance of payments crisis before the end of President Cristina Kirchner's term. The Paris Club agreement re-opens potential access to official sector and bilateral funding. Argentina is pursuing two tracks to regain access to international financing. The other is via bond markets. On that front, US Secretary of State, John Kerry, said last week that the US will not submit an opinion supporting Argentina in the US Supreme Court as the court decides whether or not to hear the holdout case. A Supreme Court decision on this question is likely within months. If the court refuses to hear the case then the ruling against Argentina in the New York second district court would stand. This would require payment agents to channel some of the cash flows intended for holders of performing New York law bonds to holdout investors.
- **India:** The improvement in India's fundamentals continues after last year's macroeconomic adjustment. CPI inflation declined to 8.1% in February from 8.8% in January. Wholesale prices inflation fell to 4.7% versus 4.9% expected, and down from 9.8% in November. The RBI and fiscal authorities have engineered a gentle, yet effective, correction to India's excess demand problem from last year. The economy has continued to grow nearly 5% in real terms, while inflation has fallen and the external balances have improved significantly.
- **South Africa:** South Africa's current account deficit narrowed to 5.1% of GDP in Q4 from 6.4% of GDP in the previous quarter. South Africa was among the so-called 'fragile five' last year. In our view, the term 'fragile' was highly inappropriate. None of the five economies in question (Brazil, South Africa, Turkey, India, and Indonesia) are particularly fragile. Most faced some kind of macroeconomic adjustment challenge, which they have now largely addressed (Turkey belatedly). But their deeper fundamentals are strong due to low debt, high reserves, and stronger growth rates than in developed economies. It is the rule rather than the exception that EM analysts dumb down EM by lumping them together into dubious categories based on exaggerated and in many cases irrelevant criteria. The existence of current account deficits is one such irrelevant criterion. EM countries should import capital and run deficits. The problem is not having a deficit; it is having one that cannot be financed.
- **Turkey:** Turkey's current account narrowed to a smaller than expected USD 4.8bn in January. The expectation was for a deficit of USD 5.3bn. Turkey's external balances are likely to improve sharply this year due to falling import demand as interest rate hikes take effect and recent currency weakness stimulates exports. Turkey, like the other so-called 'fragile five' is likely to adjust quickly due to economic flexibility and the absence of the structural impediments to growth that dog developed economies. However, lingering election noise and problems of corruption will probably keep investment demand muted and therefore points to a sluggish recovery.
- **Indonesia:** Joko Widodo aka Jokowi, Governor of Jakarta, has announced his intention to run for president in Indonesia's presidential election slated for July 2014. This is very positive news. Jokowi's popularity rating is high and his policies are likely to be market friendly, in our view. Jokowi's ability to govern effectively will depend on his support in parliamentary elections scheduled for next month. 15 parties will take part and a Jokowi-led administration's coalition building will be critical to the quality of governance.
- **Malaysia:** Industrial production accelerated to 3.7% yoy in January from 2.3% yoy in December.

Global backdrop

US data was mixed and did not change the broader picture that the US economy is in the grip of an inventory correction, which is unlikely to ease until Q2. The key data release was February retail sales, which were broadly in line, but significant negative revisions to both January and December point to soft consumer demand. This is consistent with the observation that deleveraging for US households is still only about 75% complete. Weak consumer demand does not bode well for an imminent US bounce back, especially since US firms accumulated further inventories in January, which added to large inventories of goods in Q3 and Q4 2013. This explains why the US economy has experienced manufacturing-led softness, which should continue until excess inventories have been worked off. The US economy is now tracking between 1.5% and 2.0% real GDP growth in Q1. Fed official, Jerome Powell, indicated that there are risks in removing accommodative measures too quickly. We would agree. On the plus side initial claims for unemployment declined to 315K, lower than expected, although the 4-week rolling average is still within recent 330K-350K ranges.

The other major global development was continuing strength in EUR. As EUR last week approached 1.40, the ECB engaged in verbal intervention. A stronger EUR – as opposed to economic weakness or deflation – is the most likely trigger of further monetary policy easing by the ECB, although for now the ECB will hope verbal intervention is enough. Essentially, the ECB sees itself as the defender of the EUR, in the strictest sense possible. Thus if the EUR strengthens the ECB will interpret this to mean that there is enough credibility in the currency that the ECB can cut the rate it pays to induce people to hold it.

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.6%	-6.3%	-7.9%	-2.9%	15.3%
MSCI EM Small Cap	0.4%	1.4%	-1.4%	-0.4%	22.1%
MSCI FM	-1.2%	2.1%	18.4%	6.1%	14.5%
GBI-EM-GD	-0.29%	-1.18%	-10.17%	0.69%	9.71%
ELMI+	0.08%	-0.72%	-2.95%	-0.96%	4.30%
EMBI GD	-0.33%	1.99%	-1.51%	6.63%	11.94%
EMBI GD IG	-0.42%	2.47%	-2.67%	5.39%	9.41%
EMBI GD HY	-0.15%	1.07%	0.73%	8.75%	15.46%
CEMBI B	-0.94%	1.05%	-0.86%	5.26%	12.47%
CEMBI BD HG	-0.21%	2.25%	0.57%	5.98%	10.70%
CEMBI BD HY	-0.48%	0.85%	-0.36%	5.12%	19.69%

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Beijing
T: +86 10 5764 2601

Bogota
T: +57 1 347 0649

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Sao Paulo
T: +55 11 3556 8900

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

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