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WEEKLY INVESTOR RESEARCH

Ashmore

Strong Q1 across the board for EM assets

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The strong performance of Emerging Markets in Q1 2017 is based on a strong value proposition, which has been in the making for several years and waning profitability in developed markets. EM risks are mainly idiosyncratic and can be mitigated with active management. South Africa and Venezuela are two cases in point. In most cases, investors should buy into bouts of volatility, especially when it is imparted by events in developed economies.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.3	–	-1.07%
MSCI EM Small Cap	12.1	–	-0.06%
MSCI Frontier	10.3	–	-0.96%
MSCI Asia	12.0	–	-0.37%
Shanghai Composite	12.1	–	-1.43%
Hong Kong Hang Seng	7.6	–	-1.95%
MSCI EMEA	9.1	–	-4.49%
MSCI Latam	12.3	–	-0.38%
GBI-EM-GD	6.55%	–	-0.93%
ELMI+	3.73%	–	0.00%
EM FX spot	–	–	-0.91%
EMBI GD	5.47%	307 bps	-0.03%
EMBI GD IG	4.28%	184 bps	0.12%
EMBI GD HY	6.99%	467 bps	-0.20%
CEMBI BD	5.22%	295 bps	0.27%
CEMBI BD IG	4.32%	204 bps	0.19%
CEMBI BD Non-IG	6.65%	438 bps	0.40%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	0.82%
1-3yr UST	1.26%	–	0.11%
3-5yr UST	1.92%	–	0.17%
7-10yr UST	2.39%	–	0.24%
10yr+ UST	3.01%	–	0.15%
10yr+ Germany	0.33%	–	0.58%
10yr+ Japan	0.07%	–	-0.02%
US HY	5.84%	383 bps	0.89%
European HY	3.56%	401 bps	0.10%
Barclays Ag	–	242 bps	0.18%
VIX Index*	12.37	–	-0.59%
DXY Index*	100.35	–	0.72%
EURUSD	1.0653	–	-1.34%
USDJPY	111.39	–	0.04%
CRY Index*	185.88	–	2.42%
Brent	53.5	–	5.37%
Gold spot	1249	–	0.47%

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

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- **Performance:** At the end of Q1 2017 it is clear that Emerging Markets (EM) continue to outperform developed markets by a considerable margin. EM currencies are up more than 3% versus the Dollar so far this year compared to an outperformance of 50bps last year. Local currency bonds have returned 6.5% in Dollar terms ytd compared to just 67bps for similar duration US government bonds. EM stocks are up nearly 11.50% compared to 6% for the S&P 500 and high yield bonds in EM are up close to 4% compared to 2.6% for US HY bonds. Of course, EM fixed income also outperformed DM fixed income last year, but the outperformance is accelerating this year compared to last year. What is behind this profound change from the 2010-2015 period during which EM assets struggled, particularly in local markets?

There are two basic reasons for the improving performance of EM assets. The first reason is the most natural of all, namely that valuations in EM markets have become very attractively priced. In this respect, EM markets are of course like all other markets, except that due to deeply held prejudices about the asset class, EM assets often have to move far deeper into value territory before investors pay attention. On the other hand, when sentiment then changes the upside is that much higher with very handsome rewards to those who bought when everyone else sold.

EM is clearly attractive in its own right at current valuations and fundamentals. Yields are very high both in real and nominal terms. At this particular time the high yields represent value, because growth is improving across EM countries, led by improving external balances while inflation has declined significantly in recent years and remains at multi-year lows. In addition, EM currencies are trading at close to 13 year lows in real terms. Finally, technicals are strong, because foreign investors in particular have been reducing exposure to EM for several years and most have so far missed the turning point in the market, which took place more than a year ago.

The holding structure of local bonds is now heavily skewed towards locals and this bodes well for economic growth in EM countries as flows return. Local currency denominated instruments – both stocks and bonds – were particularly out of favour during the widespread selling of EM assets in the last few years, which means these assets are now mainly held by local institutions such as banks, pension funds and insurance companies.

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There are very few local currency denominated assets left in foreign hands. Hence, as foreign investors come back to local markets they have to turn to local players for securities instead of buying them from investment banks in New York or London. The result is that capital flows back into EM countries, which then begins to reverse the financial tightening of recent years which contributed so much to the slowdown in growth in EM (though without creating widespread defaults or balance of payments crises due to strong, deeper fundamentals).

A benign cycle is therefore now underway, whereby capital inflows help to unleash faster growth rates. This is only possible, because EM countries are severely capital constrained. For example, EM countries account for nearly 60% of global GDP, but less than 20% of global fixed income. By contrast, developed economies account for just 40% of global GDP, but more than 80% of global fixed income. No wonder then that capital inflow to EM will revamp growth. Nor is it a mystery why bonds and stocks in developed economies offer so little value, since too much money is chasing these assets.

Capital flows back to EM will stimulate growth and thus help to kick into motion a benign cycle of better returns and better growth too. In practise, this happens as follows: A pension fund awards Ashmore a mandate to invest in local currency bonds. The only way to hold local bonds is to buy them from a local financial institution. As the bonds are lifted from the local bank's balance sheet the yield is pushed down and the bank will find that lending to households and companies now becomes relatively more lucrative. The bank then starts to provide credit to the wider economy and growth rises. This effect is specific to local bond markets and makes them special, though declining spreads for foreign currency denominated bonds in offshore markets may also encourage issuance at the margin.

The second reason why EM is outperforming is that the global backdrop has changed. It is not a great exaggeration to say that most of the recovery in developed economies since their crisis in 2008/2009 has been driven by monetary stimulus, conventional and otherwise. Very, very few developed economies indeed have undertaken any meaningful reforms or even seriously attempted to deleverage their economies. Indeed, most governments have dramatically increased their debt burdens. The problem they face now is that inflation is rising, especially in the US. This means that central banks have to tighten policy, however reluctantly. The resulting tightening of financial conditions removes the fuel which has propelled developed markets in recent years. While most developed economies ought to have become self-propelling by now in terms of growth the sad fact remains that their failure to deal with the underlying debt and productivity issues has rendered their growth rates extremely tepid despite enormous financial tailwinds due to zero interest rate policies, QE and capital inflows from all over the rest of the world.

Governments are therefore turning back to fiscal stimulus, but this will only increase debt burdens further and thus undermine long-term trend growth rates even more. The return to fiscal policy also has very undesirable consequences for bond markets. Fiscal means net supply of bonds, where QE was net demand for bonds. Combined with the roll-back of QE and the return of inflation, the increase in supply of bonds through fiscal stimulus now means a triple whammy of head winds for developed market bonds.

Investors are rightly switching from bonds into stocks, because although stocks are also overvalued at least they rise with inflation rather than lose money as prices rise. But to the extent that investors also want to have some fixed income in their portfolios and not just stocks they are also now forced to reverse the QE fixed income trades of recent years by putting money back into EM bonds. Of course, this is not a bad trade for reasons given above, provided, of course, investors can get over the widely held quasi-religious view that EM is somehow too risky.

This switch from developed market bonds into both stocks and EM fixed income has already restored the positive correlation, which has traditionally existed between developed markets stocks and EM local bond market performance. Correlation was temporarily turned on its head by the temporary fear of deflation and massive QE purchases, but as these conditions are reversed, so are EM's fortunes.

Needless to say, positive correlations with US stocks render EM markets vulnerable to US equity market corrections, but with few other easing options at its disposal the US government would probably welcome a lower Dollar if the stocks markets were to correct meaningfully lower. This should support EM currencies and thus make local bonds extra attractive, even if US stocks correct lower (as they should do in the not so distant future).

What, then, are the remaining risks to EM investors? The risks fall into three broad categories: EM specific risks, shocks emanating from the global backdrop and valuations. Consider each in turn:

a) EM specific risks: The truth is that only a very small percentage of the 66 countries in the EMBI GD index mess up every year. When this happens it is either because electorates elect an idiot to power (a phenomenon not confined to EM countries) or they make a big policy mistake (again, not an EM-only phenomenon) or they simply experience an external shock, which they struggle to manage (this risk is greater in EM countries than in developed economies because EM countries are less diversified, though they tend to make up for this by having far less debt and more FX reserves, etc.). In that past week South Africa and Venezuela have both inflicted some damage onto themselves mainly for political reasons

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(more on these two stories below). Such idiosyncratic risks, however, do not detract from the attractiveness of other credits in the asset class, so they are best mitigated with active management. The majority of EM countries are managed prudently and well and even those that are not sometimes offer great value propositions, even when they mess up, say, if markets over-react to events.

b) Risks arising from the global backdrop: These tend to be plentiful and typically impart considerable volatility onto EM asset prices in the short term, but rarely impact fundamentals meaningfully. Sadly many investors still confuse such bouts of globally induced volatility with EM risk. Such mistakes can be extremely costly. The reality is that the vast majority of developed markets crises have had no material implications for EM fundamentals and the associated bouts of volatility have actually presented excellent buying opportunities. We estimate, for example, that if investors had rigorously stuck to a rule to only buy EM during months in which the VIX index (US equity options volatility index) spiked by 10 points or more – i.e. when most investors actually sell EM – they would have outperformed the respective benchmark indices by between 178bps and 486bps per annum, depending on the specific EM asset class. This is meaningful alpha, especially taking into account that the benchmark EM external debt index has outperformed the S&P 500 handsomely since inception. Irrational fear can be expensive.

c) Valuations: There will come a day when investors are once more overweight EM, when bond yields are much lower in both real and nominal terms and when EM currencies have rallied far beyond the current levels. At that point it will be prudent to take profits, provided that there are other opportunities elsewhere. But that day is not today. Maybe it is two years away, maybe three or more. We estimate that investors are likely to make a return of about 50% in EM local bonds over the next five years, not in a straight line, obviously, but the prize is big enough that EM local bonds will handsomely beat any other bond market with 4.5 years of duration over this period. This is not the time to sell. It is the time to buy.

- Venezuela: Venezuelan bonds took a hit last week due to political developments combined with quarter-end profit-taking, but the event may turn out to be a buying opportunity, in our view. The Supreme Court started the furore by usurping powers hitherto vested with the opposition-controlled parliament. This immediately sparked accusations of a descent into dictatorship in Venezuela. Strong reactions both from overseas and from within the Maduro Administration eventually prompted a U-turn by President Nicholas Maduro over the weekend. At the President's prompt, the Supreme Court immediately rescinded its decision. How much should investors read into this development?

In reality, the Supreme Court in Venezuela has been a tool of the Maduro Administration for some time. Ever since the last parliamentary election, which saw the Opposition take overall control of the Legislature, the Supreme Court has nullified every single piece of legislation passed by the Opposition and approved every decision taken by the Maduro Administration. Hence, in practice nothing much has changed. It is also unlikely, in our view, that this episode will motivate sufficient numbers of Venezuelans to rise in anger against the corrupt and inept Maduro Administration.

It has proven extremely difficult to rouse the Venezuelan people in the past despite the dire economic conditions which prevail in the country and the Opposition has spectacularly failed to capitalise on the worst events in the past in order to mount a sustained attack on the government. Venezuela simply appears to have very little social capital. The controversial Supreme Court decision may, however, have some consequences for bond holders in that the decision related specifically to powers to engage in joint ventures with foreign oil companies. Since such joint ventures are often accompanied by fresh financing it follows that the reversal of the Supreme Court's ruling could actually make it a bit more difficult for the Maduro Administration to raise new funding.

The bigger picture remains unchanged, however. The Maduro Administration is extremely weak and Chavismo is riven with deep internal divisions. Behind the scenes, the military is the real power broker and will act if things get too messy. The military in Venezuela has traditionally not sought to take power directly, but it has proven willing in the past to intervene to restore order if things get too messy, even if this means a change of government. For now, if things calm down after the Supreme Court's U-turn and if the government finds the means to make the upcoming PDVSA bond payments then the Venezuelan bond market could bounce significantly.

- South Africa: President Zuma fired Pravin Gordhan (his finance minister) and a bunch of other ministers last week in an attempt to shore up support for himself ahead of the ANC's main party conference later this year. The ANC conference will likely replace Zuma as head of the party, which in turn could trigger his premature dismissal as president unless he manages somehow to limit the fallout, say, by ensuring that a friendly person takes over the leadership of the ANC. The market understandably did not like the decision to fire Gordhan, who had become an anchor for policy credibility. Zuma is clearly sacrificing the South African economy for his private gain. Now that Gordhan is gone Zuma has better odds of implementing his game plan by dishing out jobs in state-owned companies and awarding lucrative (but potentially ethically questionable) public sector procurement contracts. The new Finance Minister, Malusi Gigaba, offered reassurances about macroeconomic policy at his first press conference, but major doubts now remain about the integrity of economic policy at microeconomic level going forward. The silver-lining is that Zuma does not have much time left in office and

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Gigaba may simply not have enough time to inflict much damage. The next few weeks will also reveal the extent of the backlash against Zuma within the ANC. Cyril Ramaphosa, a known opponent of Zuma's and Deputy President of South Africa and the ANC, remains within the Administration and he may be too strong to be removed. As long as he is there Zuma may find it hard to put his former wife into the job of party chairperson. In short, the political conflict is not over by any stretch of the imagination. Taking a step back, the wider picture remains negative. South Africa's fundamental political problem is that ANC is weakening from the inside, because it has been in power for far too long. Yet, there is still no viable alternative to the ANC. Zuma is currently deftly exploiting the divisions within the party and benefitting from the fact that no other party is big enough to take power. The decline in South African politics will continue until the ANC changes, or perhaps splits. Indeed, it may take a corrupt president like Zuma to destroy the party before political renewal can take place in South Africa. In other news, the South African Reserve Bank left the policy rate unchanged at 7.0%.

- Brazil: The government implemented a public spending freeze in order to ensure that the 2017 fiscal target will be met. This is clearly positive for bond holders, but also underlines the continuing weakness of the economy following years of severe economic mismanagement under the Lula and Dilma administrations. As if to hammer home the point about economic weakness, the real economy contracted 0.26% mom in January. Still, we expect the fiscal picture to become brighter in 2017 as the Brazilian economy returns to positive growth, albeit slowly and with plenty of spare capacity for years to come. In other news, the government announced an important financial reform last week. The National Monetary Committee lowered the loan rate for the BNDES development bank from 7.5% to 7.0% starting in Q2 2017 and said that starting in January 2018 the BNDES loan rate will gradually be replaced over a five year period by a fully market determined interest rate (the NTN-B 5 year rate plus inflation). This is extremely positive, because it significantly reduces subsidies for BNDES leading to savings of up to BRL 40bn per year, according to analysts' estimates. Finally, we note that Credit Suisse reported that the foreign share of Brazilian local bonds has fallen to just 13.7%, which is the lowest share since 2012. Clearly, most investors totally missed the 60% rally (in Dollar terms) in government bonds last year and are likely to miss meaningful returns this year too unless they start putting money to work.

- China: The official index of manufacturing activity (PMI) accelerated to 51.8 in March from 51.6 in February. This was better than the market had expected. New orders improved to 53.3. The Caixin PMI index was also above 50 yet again. The market suffers from collective cognitive dissonance when it comes to China. Most observers, especially in the media, but also among some bank analysts, categorically believe that China is either have having a hard landing or overheating with nothing in between. Yet, for years it has had neither. China announced over the weekend the establishment of a number of new free trade zones to promote more open trade and technological progress. This clearly shows that China's leadership recognises the critical importance of free trade and globalisation for future prosperity, unlike some Western governments.

- Argentina: The current account deficit declined to USD 15.0bn in 2016 from USD 16.8bn in 2015. However, due to the weak performance of the economy in GDP terms the current account barely improved (the deficit is roughly 2.8% in GDP terms). This is clearly disappointing. The underlying problem is the particular policy mix adopted by the Macri Administration. The government is liberalising the capital account but not doing enough to liberalise the current account. At the same time, the government is running lose fiscal policy alongside tight monetary policy. This combination is a recipe for hot money inflows and bubble risks without generating real benefits to the economy. The policy mix may continue to push ARS higher, but the risk of violent capital flight episodes only rises under the current policy mix. The central bank continues to argue for more fiscal restraint and more reform, especially of the current account, but the mid-term election beckons and on a deeper level there is simply no appetite for deep economic reform in Argentina.

- Mexico: Economic indicators mainly improved over the past week. Credit growth to the private sector was up 7.8% yoy in real terms in February. Also in February, the primary fiscal balance was in surplus to the tune of MXN 33bn on a 12 months rolling basis, which was an improvement from the surplus of MXN 12.6bn in January. The central bank hiked the policy rate by 25bps to 6.5% and announced a MXN 535bn operating surplus for 2016 of which a substantial chunk (equivalent to 1.5% of GDP) will be transferred to the Treasury (the transfer last year was 1.2% of GDP). The trade surplus was USD 684 million in February versus an expected deficit of USD 350 million.

- Ecuador: With 94.1% of the votes counted, the candidate supported by the current government, Lenin Moreno leads by 51.2% vs. 48.9% for reformist centre-right Guilhermo Lasso. This comes as a surprise after the most credible exit poll gave Lasso a 6% winning margin with 53% support. Lasso is strongly contesting the result in all 24 states citing election fraud in order to influence the result of the election. As in many other countries, a vicious campaign led to a large divide in the country with Moreno's supporters celebrating on the streets while thousands of Lasso supporters broke down metal barricades in Quito in an attempt to break into the electoral council's headquarters before being held by the police. Protests were also observed in Guayaquil. Moreno's party has so far gained 74 out of 130 seats in the congress, giving him a better platform to govern should victory be confirmed.

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Snippets:

- **Chile:** Unemployment ticked higher to 6.4% in February. This is 0.5% higher than in February 2016.
- **El Salvador:** Remittances from workers overseas were 10.2% higher than a year ago in the January-February period.
- **Hungary:** The central bank left the policy rate unchanged at 90bps.
- **Mongolia:** Moody's removed Mongolian sovereign debt from credit watch negative and affirmed the Caa1 rating due to abating liquidity pressures following a recent debt exchange.
- **Paraguay:** A senate vote to amend the constitution to allow President Horacio Cartes to seek re-election triggered protests in Asuncion.
- **Poland:** CPI inflation was 2.0% yoy in March versus 2.3% yoy expected.
- **Russia:** The official GDP growth rate in Q4 2016 was confirmed at 0.3% yoy, which means that Russia returned to positive growth after - 0.4% yoy in Q3 2016. Full year growth in 2016 was -0.2% compared to -2.8% yoy in 2015.
- **South Korea:** Industrial production increased at a rate of 6.6% in February compared to 1.4% yoy in January. Exports rose at an impressive rate of 13.7% yoy in March versus 12.8% yoy expected.
- **Turkey:** Real GDP growth rebounded in Q4 2016 to 3.5% yoy after a severe contraction in Q3 2016 following the attempted coup. The economy thus grew 2.9% yoy in 2016, which was less than half of the growth rate in 2015 (6.1% yoy).
- **Thailand:** The trade surplus rose to USD 4bn in February from USD 1.9bn in January.

Global backdrop

Rising inflation and slowing spending reduced the tracking rate for the US economy to just 0.9% qoq annualised in real terms, according to the Atlanta Fed's GDPnow GDP tracking tool. This should ensure that there will not be any major surprises from the Fed in terms of the market's expectation of 2-3 hikes this year. Inconveniently, inflation expectations and core PCE inflation both ticked higher, but the Fed is likely to keep the real Fed funds rate deep within negative territory to avoid a hard landing for the US economy and the stock market. Growth in recent years has been driven almost exclusively by monetary stimulus. On the other hand, the most likely and least painful exit from the US economy's debt problem is inflation, so maybe a bit more work needs to be done to make everyone understand that inflation – along with currency weakness – is a good thing if you are an indebted country and foreigners own a huge part of the debt. As such, the outlook for Europe is less appealing. After all, Europe will struggle to generate inflation on account of the failure to recapitalise European banks. Last week the Eurozone delivered lower than expected inflation in March (1.5% yoy headline after a 0.2% mom print).

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.54%	11.45%	17.63%	1.52%	1.15%
MSCI EM Small Cap	2.64%	13.03%	14.73%	1.87%	3.10%
MSCI Frontier	2.37%	8.80%	12.94%	-1.69%	5.65%
MSCI Asia	3.27%	13.37%	17.79%	4.94%	5.04%
Shanghai Composite	-0.57%	3.85%	9.50%	19.29%	10.03%
Hong Kong Hang Seng	-0.24%	9.35%	19.00%	4.55%	3.25%
MSCI EMEA	0.60%	2.83%	9.74%	-4.71%	-3.04%
MSCI Latam	0.57%	12.12%	23.60%	-3.74%	-5.89%
GBI EM GD	2.31%	6.50%	5.47%	-2.68%	-1.62%
ELMI+	1.60%	5.18%	3.27%	-2.37%	-1.43%
EM FX Spot	0.90%	3.17%	-1.90%	-9.38%	-7.90%
EMBI GD	0.38%	3.87%	8.92%	6.23%	5.82%
EMBI GD IG	0.51%	3.66%	4.97%	5.09%	4.33%
EMBI GD HY	0.24%	4.09%	13.56%	7.10%	7.80%
CEMBI BD	0.32%	2.97%	8.69%	5.30%	5.50%
CEMBI BD IG	0.27%	2.39%	4.89%	4.52%	4.81%
CEMBI BD Non-IG	0.40%	3.87%	15.02%	6.23%	6.65%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.12%	6.07%	17.16%	10.35%	13.28%
1-3yr UST	0.27%	0.40%	0.33%	0.67%	0.66%
3-5yr UST	0.30%	0.67%	-0.55%	1.83%	1.33%
7-10yr UST	0.39%	1.13%	-2.47%	3.40%	2.49%
10yr+ UST	0.15%	1.89%	-5.04%	6.23%	4.30%
10yr+ Germany	-1.64%	-1.69%	-2.29%	8.85%	6.86%
10yr+ Japan	-0.28%	-1.09%	-2.54%	5.77%	5.43%
US HY	-0.32%	2.60%	16.57%	4.56%	6.81%
European HY	-0.12%	1.44%	8.89%	5.05%	9.07%
Barclays Ag	-0.20%	1.13%	4.17%	4.00%	4.40%
VIX Index*	0.00%	-11.89%	-5.57%	-7.48%	-21.01%
DXY Index*	0.00%	-1.82%	6.09%	25.28%	27.02%
CRY Index*	0.00%	-3.44%	10.63%	-38.67%	-40.18%
EURUSD	0.00%	1.26%	-6.39%	-22.64%	-20.17%
USDJPY	0.00%	-4.79%	-1.05%	7.90%	34.42%
Brent	1.33%	-5.79%	35.18%	-50.32%	-56.44%
Gold spot	0.00%	8.43%	1.35%	-2.70%	-25.11%

*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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