Down but far from out in Brazil

By Jan Dehn

Down but far from out in Brazil. Iranians want more pragmatism and reform. The US puts eight Venezuelan judges on the OFAC sanctions list. S&P upgrades Indonesia to investment grade. Mexico welcomes NAFTA talks. China takes another step towards capital account liberalisation. India formally launches GST. Malaysia and a very large number of other EM economies are growing materially faster than expected so far in 2017 – see the Snippets section. In the global backdrop, it is still all about political noise in the US as Trump goes abroad to divert attention away from his domestic political woes.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.3	–	-0.63%
MSCI EM Small Cap	0.0	–	-0.88%
MSCI Frontier	10.4	–	0.21%
MSCI Asia	12.0	–	0.35%
Shanghai Composite	11.9	–	0.27%
Hong Kong Hang Seng	7.7	–	-0.10%
MSCI EMEA	9.5	–	0.49%
MSCI Latam	12.2	–	-7.32%
GBI-EM-GD	6.44%	–	0.16%
ELMI+	3.86%	–	0.34%
EM FX spot	–	–	0.27%
EMBI GD	5.31%	308 bps	0.06%
EMBI GD IG	4.14%	186 bps	0.33%
EMBI GD HY	6.65%	450 bps	-0.19%
CEMBI BD	5.07%	297 bps	0.04%
CEMBI BD IG	4.14%	204 bps	0.28%
CEMBI BD Non-IG	6.50%	440 bps	-0.32%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	-0.32%
1-3yr UST	1.29%	–	0.10%
3-5yr UST	1.79%	–	0.19%
7-10yr UST	2.24%	–	0.83%
10yr+ UST	2.90%	–	1.85%
10yr+ Germany	0.36%	–	-0.09%
10yr+ Japan	0.05%	–	0.63%
US HY	5.57%	367 bps	0.25%
European HY	3.17%	361 bps	-0.09%
Barclays Ag	–	246 bps	0.39%
VIX Index*	12.30	–	1.88%
DXY Index*	97.37	–	-1.54%
EURUSD	1.1174	–	1.81%
USDJPY	111.22	–	-2.27%
CRY Index*	185.08	–	3.39%
Brent	54.0	–	4.19%
Gold spot	1256	–	2.03%

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

Emerging Markets

- **Brazil:** Political uncertainty re-emerged in Brazil last week, when O Globo, a local newspaper, published accusations, based on audio tape recordings, that President Michel Temer endorsed bribes to Eduardo Cunha, former speaker of parliament. Temer rejected the accusations and said that the tapes had been doctored. He appealed to the Supreme Court to verify the integrity of the tapes. Pending the Supreme Court's assessment, which is expected on Wednesday of this week, this is a classic case of one side's word against another. However, it seems clear that even if the audio tapes have integrity the content may not be strong enough to prove anything against Temer. Even so, the tapes wound Temer, because he comes across as someone who has been too responsive to powerful oligarchs, who requested special favours from BNDES (local development bank), the Finance Ministry and Brazil's equivalent of SEC, the CVM. As president Temer should not even be listening to such requests and should not have conceded to 1-to-1 meetings.

What are the possible outcomes from here? One scenario is that Temer resigns quickly, which opens the door for the parliament to select a new leader via indirect election. Rumours are mentioning Finance Minister Henrique Meirelles or former president Fernando Henrique Cardoso as contenders to serve out the remainder of the Temer's term which ends in October 2018. In this case, the political parties that make up the current coalition (PMDB, PSDB and DEM) would resume reforms. This scenario would be very bullish.

The other main scenario is that Temer remains in office and regains legitimacy after proving his innocence. Reforms would be back on track with good prospects for final passage of the labour reform, which still needs to pass in the Senate. The pension reform, however, would be called into question given that this requires two thirds support in order to pass. The market is currently pricing in zero chance of pension reform plus the possibility that Lula comes back through direct elections. This seems excessively bearish. There is no doubt that the pension reform is important for the long-term fiscal outlook, but the reform is not time-critical. Brazil's public finances will easily be able to cope with a delay to the pension reform until the next

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Emerging Markets

administration takes office. The next administration would not have much choice in the matter though. The recently approved constitution reform limits public spending growth in real terms to zero over the next two decades, so unless the pension reform is passed statutory contributions to pensions will eventually eat up 7-9% of GDP and leave very little room for discretionary spending. Politicians do not like this.

Temer could also be forced from office if the Electoral Court, in June of this year, rules that the 2014 Dilma/Temer presidential election was illegitimate. If this happens then Temer's replacement will also be elected indirectly, i.e. by Congress, provided that Temer is removed more than six months ahead of the next election. The market fears that Temer will be removed and direct elections held leading to the election of former President Lula before he is tried for corruption, but we think this is unlikely due to the six months rule.

Finally, there is a scenario where Temer stays, but with no or very little legitimacy. In this case no reforms will be approved, but we think the damage would be relatively limited, because the market is already beginning to look to the 2018 elections. Clean politicians are likely to do far better in 2018 than dirty politicians. As such, the odds that Dilma and Lula return to office are very small, in our view. Lula and Dilma are alleged to have stolen USD 50m and USD 30m, respectively. Another old timer, Aecio Neves of the PSDB, is also alleged to have performed major misdeeds and may yet go to jail. Hence, the election in 2018 looks set to offer a bunch of newcomers to the political stage, such as Sao Paulo's mayor Joao Doria (PSDB), who is currently in a strong position to challenge for the presidency. He would want Temer to stay, so that reforms can be completed before he takes office.

In short, we think the market has priced in too much fear. The odds that Lula comes back are low. The reform agenda is not hugely time sensitive. And the outlook beyond 2018 looks positive. And then there is the economy: Ratings agencies have so far chosen to withhold judgement pending availability of further information. This makes sense. Brazil's willingness to service debt is unaffected by the scandal and the ability to pay is improving on account of better news about the economy. After a long recession Brazil's economy is now slowly picking up and should record positive growth this quarter. The central bank's economic activity indicator was up 1.05% yoy in March. This was higher than the median market expectation of 0.2% yoy. Net payroll job creation was also better in April with 60K new jobs created, again much higher than the market expectation. Meanwhile, inflation is falling and the central bank will continue to cut rates, albeit possibly at a slower speed if the pension reform is derailed. Bouts of political noise tend to generate over-reactions in the markets and very few such events have a meaningful impact on the riskiness of investing in public debt. Past bouts of political volatility have been excellent buying opportunities. In 2016 Brazil's domestic government fixed income returned a whopping 60% in Dollar-terms to those who bought bonds on the back of the bout of political noise surrounding Dilma's impeachment. We think Brazil continues to offer a compelling fixed income proposition, now with an even more attractive entry point.

- Iran: Pragmatism and more reform, please. That was the message from Iranian voters in last week's presidential election, which saw incumbent President Hassan Rouhani's rack up a convincing victory against hard-line candidate Ebrahim Raisi. Rouhani's victory is good news for Iran and for those who would like to avoid a military confrontation between Iran and the West, particularly the US, although President Donald Trump, currently touring Saudi Arabia and Israel, has predictably made hostile remarks about Iran. Aside from the rhetoric, we think Rouhini's victory makes conflict in Lebanon less likely and even offers some hope for a peaceful resolution of the conflict in Syria and Iraq, provided the US and others are willing to work towards peace. Rouhani's victory is at least as important for Iran itself. Iranian politics has in the past lurched between reform and populism. While the 2014 drop in oil prices has made it difficult for Iran's reformers to achieve much in the last few years Iranians were clearly not inclined to gamble politically by voting in an extremist. Rouhani was the safe choice. In this case, safe means reforms, safe means progress. In our view, the West should recognise this and seek to work towards normalising relations.

- Venezuela: The Office of Foreign Assets Control of the US Department of the Treasury last week placed eight Venezuelan Supreme Court judges on its list of sanctioned individuals. The judges are therefore banned from entering the US, while their US assets are frozen. Americans are also barred from doing business with them. We do not think this will have any macroeconomic implications for Venezuela. There were already thirty Venezuelans on the OFAC list, including President Maduro's Vice-President Tareck El Aissami Maddah.

- Indonesia: Reflecting improving economic performance and rising markets in EM, the main ratings agencies are now beginning to upgrade individual EM countries again. Last week Standard and Poor's upgraded Indonesia's sovereign credit rating to investment grade (BBB-, with a stable outlook) from sub-investment grade (BB+). This means that all three of the main international ratings agencies now assign an investment grade rating to Indonesia. In other news, the central bank left the policy rate unchanged at 4.75%, while the trade surplus was USD 1.2bn in Q1 2017 versus USD 0.9bn expected.

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Emerging Markets

- **Mexico:** Mexico's main opposition parties (PRD and PAN) announced last week that they will run jointly in the June 2018 presidential election. This is positive, in our view. It reduces the odds that Andres Manuel Lopez-Obrador, a populist, becomes president. In other news, the Mexican government welcomed the US Administration's invitation to renegotiate the North American Free Trade Agreement (NAFTA). The early tone adopted towards Mexico by the Trump Administration has receded and has been replaced by a more respectful tone. This bodes well for talks and we expect the NAFTA renegotiation to be relatively benign. The central bank hiked the policy rate by 25bps to 6.75%.

- **China:** The central banks of China (PBOC) and Hong Kong (HKMA) have linked the bond markets in their respective territories. So far, the Bond Connect only permits northbound investment, i.e. investment into China's onshore bond market from Hong Kong. However, it is only a question of time before this will be complemented by southbound trades, in our view. The Bond Connect is another one of China's many incremental reforms that will ultimately lead to full capital account liberalisation. We estimate that by 2050 China's economy will be some 2-3 times larger than the US economy, wherefore China's markets – bonds, stocks and currency – will naturally become the largest in the world. This, in turn, implies that they will become the global benchmarks too, although we expect the US markets to continue to be important as well.

- **India:** The government has finalised the tax rates to be applied under the GST reform. The new tax rates apply to 1,211 goods and major services and 81% of these will fall under the 18% GST rate, while the remaining 19% will be taxed at 28% and above. The introduction of GST may create a one-off increase in inflation, but the GST reform is a huge step forward in economic terms. GST replaces state-based taxation and therefore reduces trade barriers between states. In other news, the April merchandise trade deficit widened to the highest level in 2.5 years (USD 13.2bn) on the back of rapidly rising non-gold imports.

- **Malaysia:** The Malaysian economy expanded in real terms at a rapid rate of 5.6% yoy Q1 2017. The consensus expectation was for growth to be about 4.8% yoy in the quarter. Last quarter the economy expanded at a rate of 4.5% yoy. Domestic demand was the main driver of growth, but investment demand was also very healthy (both public and private investment). Meanwhile, consumer prices fell by 0.3% mom (sa) in April, which left the headline inflation rate at 4.4% yoy (consensus was 4.5% yoy). A number of other EM countries also racked up stronger than expected growth in Q1 2017, including Hungary, Peru, Poland, Pakistan, Romania, Russia and Thailand. See Snippets section below.

Snippets:

- **Chile:** The central bank cut the monetary policy rate by 25bps to 2.5% as the economy expanded at a rate of 0.2% qoq in Q1 2017.
- **Colombia:** The real economy expanded at a pace of 1.1% yoy in Q1 2017 in line with expectations. The March trade deficit, at USD 726m, was lower than a year ago (USD 1.1bn).
- **Dominican Republic:** The current account surplus increased marginally to USD 391m in Q1 2017 from USD 386m in the same quarter last year.
- **Hungary:** Q1 2017 real GDP growth accelerated to 1.3% qoq from 0.7% qoq in Q4 2016. The market had expected 1.2% qoq growth.
- **Ivory Coast:** The government reached agreement with mutinous soldiers on pay, ending a few days of heighted media speculation about political instability.
- **Pakistan:** Preliminary government data points to real GDP growth of 5.3% in the year to June 2017 compared to 4.5% yoy growth in the previous fiscal year. Agriculture and services led the improvement in growth.
- **Panama:** The government has turned a fiscal deficit of 0.3% of GDP in Q1 2016 into a surplus of 0.3% of GDP in Q1 2017.
- **Peru:** Peru racked up the highest trade surplus since 2013. The trade surplus was USD 3.6bn in the 12 months through March, equivalent to roughly 1.7% of GDP. Real GDP expanded at a rate of 0.7% yoy in March versus 0.0% expected by the market consensus.
- **Poland:** The government's preliminary estimate of the Q1 2017 GDP growth rate was 4.0% yoy versus 2.5% yoy in Q4 2016. The central bank left the policy rate unchanged at 1.5%.
- **Philippines:** The real economy expanded 6.4% in Q1 2017 relative to last year, a marginal slowdown compared to last quarter.
- **Romania:** The economy expanded 5.7% in real terms in the year to Q1 2017 versus 4.5% yoy expected.
- **Russia:** Q1 real GDP growth was 0.5% yoy versus a consensus expectation of 0.4% yoy. In March industrial production expanded at a much higher rate than anticipated. Industrial output was up 2.3% yoy compared to 0.8% yoy in February and the Bloomberg consensus expectation of just 0.6% yoy.
- **Singapore:** Non-oil domestic exports were much weaker than expected (-0.7% yoy versus +13% yoy expected). The negative surprise was due to pharmaceuticals, but followed five months of higher than expected net exports.

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Emerging Markets

- **South Africa:** Retail sales in March were significantly stronger than expected, up at a rate of 0.8% yoy compared to -1.0% yoy expected.
- **South Korea:** Export growth normalised to 3.4% yoy in May from an unusually high 28.6% yoy in April.
- **Thailand:** Real GDP expanded faster than expected in Q1 2017 (5.2% qoq saar, or 3.3% yoy versus 3.1% yoy consensus).
- **Turkey:** President Erdogan was formally re-appointed leader of the ruling AKP in an official ceremony yesterday. Erdogan's appointment is a formality, which has no impact on the power balance in Turkey.
- **Ukraine:** The real GDP growth rate slowed to 2.4% yoy Q1 2017 from 4.8% yoy in Q4 2016.
- **Zambia:** The central bank cut the main policy rate to 12.5% from 14% and dropped the statutory reserve ratio to 14% from 15.5%.

Global backdrop

The political outlook in the US deteriorated significantly last week due to the launch of an independent investigation into President Donald Trump's links to Russia during last year's election campaign. The decision to conduct an investigation followed in the wake of revelations that Trump had applied pressure on other government officials to discourage such an investigation. Using a time-honoured tactic to distract attention away from his domestic problems Trump promptly flew to the Middle East to strike a few arms deals with key allies. Political noise is, of course, universal. Unlike Brazil, however, political noise in the US poses more danger to investors. Political risks are always expected in EM and therefore priced in, even if one can debate whether they are correctly priced. By contrast, political risks are rarely priced at all in developed economies. Besides, US markets remain the main global benchmarks for currency and bonds with many investors still extremely heavily invested. We think valuations, technicals and the fundamental outlook – both political and economic – today favour EM compared to the US. We note in passing that the price of the Brent first future contract has reached USD 54 per barrel, up nearly 12% since early April 2017.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.92%	16.13%	30.83%	1.41%	4.71%
MSCI EM Small Cap	-0.33%	13.95%	20.94%	1.49%	5.67%
MSCI Frontier	2.84%	13.11%	12.96%	-2.35%	7.62%
MSCI Asia	2.74%	19.04%	31.89%	5.17%	8.33%
Shanghai Composite	-1.96%	-0.29%	12.39%	18.19%	8.34%
Hong Kong Hang Seng	0.53%	9.36%	29.98%	5.09%	5.40%
MSCI EMEA	1.47%	8.91%	25.03%	-4.05%	0.98%
MSCI Latam	-2.99%	8.83%	25.56%	-6.66%	-3.01%
GBI EM GD	0.85%	8.66%	11.17%	-3.01%	-0.44%
ELMI+	0.77%	6.34%	7.04%	-2.50%	-0.49%
EM FX Spot	0.71%	4.13%	3.00%	-9.41%	-6.80%
EMBI GD	0.29%	5.72%	9.56%	5.74%	6.28%
EMBI GD IG	0.49%	5.10%	5.97%	4.39%	4.59%
EMBI GD HY	0.10%	6.41%	13.74%	6.93%	8.55%
CEMBI BD	0.31%	4.45%	8.46%	5.10%	5.87%
CEMBI BD IG	0.55%	3.78%	5.30%	4.28%	5.02%
CEMBI BD Non-IG	-0.05%	5.49%	13.63%	6.11%	7.42%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.08%	7.24%	19.23%	10.40%	15.37%
1-3yr UST	0.10%	0.68%	0.83%	0.73%	0.65%
3-5yr UST	0.17%	1.48%	0.73%	1.74%	1.39%
7-10yr UST	0.52%	2.74%	-0.41%	3.28%	1.98%
10yr+ UST	1.20%	4.58%	-2.43%	5.81%	2.71%
10yr+ Germany	-1.29%	-2.75%	-3.04%	7.34%	5.41%
10yr+ Japan	-0.20%	-0.20%	-4.10%	5.82%	5.03%
US HY	0.45%	4.35%	14.46%	4.68%	7.19%
European HY	0.55%	2.88%	9.19%	4.94%	9.71%
Barclays Ag	0.54%	2.70%	4.65%	3.87%	4.53%
VIX Index*	13.68%	-12.39%	-19.08%	2.24%	-45.28%
DXY Index*	-1.70%	-4.74%	2.13%	21.32%	19.48%
CRY Index*	1.84%	-3.86%	0.47%	-39.84%	-35.40%
EURUSD	2.54%	6.22%	-0.41%	-18.18%	-11.90%
USDJPY	-0.29%	-4.94%	1.81%	9.32%	39.09%
Brent	4.37%	-4.98%	10.82%	-51.08%	-50.20%
Gold spot	-1.00%	8.97%	0.52%	-2.96%	-19.95%

*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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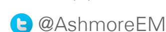 @AshmoreEM

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