

# Gee Vix!

By Jan Dehn

Historically it has been very profitable to buy EM during major risk-off episodes in developed economies, i.e. events that push the VIX index up by 10 points or more. Brexit was such an event and EM's performance following Brexit was no different from the past with strong positive performance across the board. We find that all EM sub-asset classes performed better than their historical averages in the ten months since Brexit. The only exception was the least risky Investment Grade sub-asset classes. This suggests that investors can do better by investing in high yield credit, stocks and local currency, when the sources of risk are explicitly due to events in developed markets (as opposed to EM).

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)	Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	1.18%	S&P 500	16.6	–	1.47%
MSCI EM Small Cap	11.8	–	0.51%	1-3yr UST	1.29%	–	0.03%
MSCI Frontier	10.7	–	1.24%	3-5yr UST	1.78%	–	0.03%
MSCI Asia	12.2	–	1.02%	7-10yr UST	2.24%	–	0.12%
Shanghai Composite	12.2	–	0.69%	10yr+ UST	2.90%	–	0.10%
Hong Kong Hang Seng	7.9	–	2.41%	10yr+ Germany	0.30%	–	1.45%
MSCI EMEA	9.7	–	0.68%	10yr+ Japan	0.04%	–	0.15%
MSCI Latam	12.6	–	2.64%	US HY	5.49%	361 bps	0.32%
GBI-EM-GD	6.38%	–	0.67%	European HY	3.09%	356 bps	0.32%
ELMI+	3.63%	–	0.21%	Barclays Ag	–	246 bps	0.12%
EM FX spot	–	–	0.16%	VIX Index*	9.81	–	-1.12%
EMBI GD	5.25%	301 bps	0.52%	DX Index*	97.61	–	0.26%
EMBI GD IG	4.12%	182 bps	0.30%	EURUSD	1.1137	–	-0.41%
EMBI GD HY	6.54%	438 bps	0.74%	USDJPY	110.86	–	-0.82%
CEMBI BD	5.05%	294 bps	0.22%	CRY Index*	182.00	–	-3.07%
CEMBI BD IG	4.13%	202 bps	0.17%	Brent	52.0	–	-3.97%
CEMBI BD Non-IG	6.48%	436 bps	0.28%	Gold spot	1268	–	1.36%

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

## Emerging Markets

Many investors develop almost irresistible urges to sell all their EM assets every time Greece's economy makes headlines. This also occurs when the Fed hikes, and when the French go to the polls, and when the Bureau of Labour Statistics releases US non-farm payroll data, and when Donald Trump tweets. Risk events in developed markets whether of the known or the unknown variety tend to become pretexts for delaying allocations to or even outright selling EM. Empirically, however, this behaviour is quite irrational. As we show below, most risk events emanating from developed countries tend to have far bigger impacts on the sentiment of fast money investors than on EM fundamentals, when the smart thing to do in response to such events would be to buy rather than to sell.

It is now nearly a year ago since the last 10+ point spike in the VIX index, the US S&P 500 equity options volatility index, also known as the 'fear gauge'. On 23 June 2016 the British people voted to leave the European Union. Brexit pushed the VIX from a low in May of 13.5 to a high of 25.5 in June. Shortly afterwards Ashmore issued a report to remind investors that VIX spikes have historically been excellent buying opportunities and recommended that investors buy into the noise.<sup>1</sup> With ten months of monthly data at our disposal we are now in a position to make a preliminary assessment of the performance of EM assets after the Brexit VIX spike. The table overleaf summarises the findings.

<sup>1</sup> See [VIX spiked 10 points in June – it is a good time to allocate to EM](#), Weekly Investor Research, 11 July 2016.

## Emerging Markets

Fig 1: Annualised returns since Brexit

Asset class	EM Equities	EM Small Cap Equities	Frontier Equities	Corp High Yield	Local Currency Bonds	Sov High Yield	FX fwds	Corporate Debt	External Debt	Corp High Grade	Sov High Grade
Performance relative to average return since index inception	<b>25.5%</b>	<b>17.2%</b>	<b>10.9%</b>	<b>3.8%</b>	<b>2.5%</b>	<b>1.9%</b>	<b>1.2%</b>	<b>0.3%</b>	<b>-1.1%</b>	<b>-2.3%</b>	<b>-3.2%</b>
Return since Brexit	28.1%	20.2%	15.9%	13.4%	9.8%	12.8%	6.8%	7.8%	8.3%	4.4%	4.5%
Return since index inception	2.6%	3.0%	5.0%	9.6%	7.3%	10.9%	5.6%	7.5%	9.4%	6.7%	7.7%
Index	MSCI EM	MSCI MXEF SC	MSCI MXFM	JPM CEMBI BD HY	JPM GBI EM GD	JPM EMBI GD HY	JPM ELMI+	JPM CEMBI BD	JPM EMBI GD	JPM CEMBI BD HG	JPM EMBI GD IG

Source: Ashmore, JP Morgan, MSCI, Bloomberg.

The red numbers show the difference between the annualised index performance since Brexit and the average annual index return since the inception of the respective index (i.e. the longest period for which data is available). The main conclusions are that following the Brexit VIX spike:

1. All EM asset classes produced positive absolute returns, so selling would have been a mistake.
2. EM stocks (large cap, small cap and frontier markets) strongly outperform their own past performance as well as EM bonds.
3. High yield bonds (both sovereign and corporate) strongly outperformed IG bonds.
4. Local currency bonds and FX both beat their own historical average returns after VIX spikes. Note that local currency markets racked up this strong performance despite a material wobble in the immediate aftermath of US President Donald Trump's election in November 2016.
5. The only sub-asset classes to perform worse than their historical average since the Brexit vote were IG corporate, IG sovereign and external sovereign debt. These are 'less risky' Dollar-denominated fixed income themes, where investors often seek shelter, when they are scared. This result suggests this may not be the most efficient way to play risk-off events specifically in developed economies, though this does not invalidate them as a way of reducing exposure to risk events within EM itself.

The performance of EM sub-asset classes following Brexit confirms past experience. The table below shows how broad EM asset classes performed following all the VIX spikes, which have occurred since 1993.<sup>2</sup> The table shows that investors who bought into EM during VIX spikes outperformed respective benchmarks by between 174bps per year and 462bps per year, depending on the asset class.

Fig 2: EM performance after VIX spikes relative to passive investing

Annualised return	External debt (EMBI GD)	Corporate debt (CEMBI BD)	Local currency bonds (GBI EM GD)	Equities (MSCI EM)
Excess return (bps)	<b>174</b>	<b>295</b>	<b>335</b>	<b>462</b>
Buying during VIX spikes	11.1%	10.4%	10.6%	7.2%
Passive timing	9.4%	7.5%	7.3%	2.6%
Years of index	23	15	14	23

Source: Ashmore, JP Morgan, MSCI, Bloomberg.

## Conclusion

All spikes in the US VIX index since 1998 have been due to crises in developed markets, not in EM. Yet, markets continue to sell EM assets whenever developed markets screw up. This is one of the great inefficiencies in global finance, because, as we have shown, investors are able to make excellent returns by investing in EM precisely at such times.<sup>3</sup> While a rule-based approach to investing is never advisable we believe investors should stand ready to buy EM assets whenever the VIX index spikes. The reason is simple: Even if the past is no guide to the future statistically speaking, buying EM in VIX spikes has been one of the highest probability trades available anywhere in global finance.

<sup>2</sup> The longest-running EM indices were launched in 1993.

<sup>3</sup> For an excellent and comprehensive exposition of why EM markets are so inefficient see Jerome Booth's "Emerging Markets in an upside down world", Wiley Finance Series, 2014.

## Emerging Markets

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.96%	18.45%	29.02%	1.93%	4.75%
MSCI EM Small Cap	0.36%	14.73%	19.08%	1.22%	5.45%
MSCI Frontier	4.11%	14.51%	12.92%	-3.53%	7.96%
MSCI Asia	4.79%	21.41%	29.51%	5.57%	8.36%
Shanghai Composite	-1.29%	0.39%	12.50%	17.72%	8.59%
Hong Kong Hang Seng	4.03%	13.17%	28.91%	5.16%	5.46%
MSCI EMEA	2.71%	10.24%	21.81%	-4.16%	0.90%
MSCI Latam	-1.06%	10.99%	28.10%	-5.65%	-2.91%
GBI EM GD	1.81%	9.69%	11.80%	-2.81%	-0.11%
ELMI+	1.41%	7.01%	7.18%	-2.26%	-0.23%
EM FX Spot	1.22%	4.65%	3.25%	-9.20%	-6.56%
EMBI GD	0.81%	6.27%	9.72%	5.84%	6.44%
EMBI GD IG	0.79%	5.42%	5.95%	4.46%	4.71%
EMBI GD HY	0.84%	7.20%	14.06%	7.00%	8.75%
CEMBI BD	0.53%	4.68%	8.45%	5.10%	5.91%
CEMBI BD IG	0.72%	3.96%	5.33%	4.27%	5.06%
CEMBI BD Non-IG	0.23%	5.78%	13.52%	6.08%	7.44%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.54%	8.81%	18.03%	10.59%	15.30%
1-3yr UST	0.12%	0.71%	0.87%	0.74%	0.65%
3-5yr UST	0.18%	1.49%	0.79%	1.68%	1.39%
7-10yr UST	0.49%	2.72%	-0.52%	3.05%	2.00%
10yr+ UST	1.05%	4.42%	-2.51%	5.37%	2.83%
10yr+ Germany	-0.24%	-1.71%	-2.45%	7.59%	5.19%
10yr+ Japan	-0.23%	-0.23%	-4.97%	5.74%	5.18%
US HY	0.77%	4.69%	13.63%	4.79%	7.30%
European HY	0.87%	3.21%	8.68%	5.07%	9.77%
Barclays Ag	0.66%	2.83%	4.49%	3.77%	4.57%
VIX Index*	-9.33%	-30.13%	-25.23%	-15.21%	-53.35%
DXY Index*	-1.45%	-4.50%	2.19%	21.45%	17.58%
CRY Index*	0.15%	-5.46%	-2.22%	-40.78%	-34.94%
EURUSD	2.20%	5.87%	-0.01%	-18.31%	-9.95%
USDJPY	-0.61%	-5.25%	-0.24%	8.92%	40.19%
Brent	0.52%	-8.48%	4.50%	-52.47%	-49.74%
Gold spot	-0.01%	10.06%	5.19%	1.47%	-18.88%

\*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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