Back in black

By Jan Dehn

Brazil is back in the black as growth turns positive for the first time since Q4 2014. The central bank signalled a slower pace of cuts in recognition of the lower likelihood of pension reform in the near-term. Maldives joins the family of EM sovereign issuers, but the bond will not be in the index and we explain why. Maduro offers a referendum on a new constitution: what does it mean? Zuma survives an attempt to unseat him, but his problems are not over. Ecuador's Moreno surprises with a number of market friendly announcements. The Lower House in the Philippines approves a tax reform. India's growth dips in Q1 2017. Peru promises to unlock infrastructure spending using funds from the Fiscal Stabilisation Fund. The US data last week was not directional enough to warrant a major shift in market expectations with respect to the Fed or recent market dynamics, in our view.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	-0.12%
MSCI EM Small Cap	11.8	–	0.57%
MSCI Frontier	10.8	–	1.34%
MSCI Asia	12.3	–	0.63%
Shanghai Composite	12.1	–	1.41%
Hong Kong Hang Seng	7.8	–	1.06%
MSCI EMEA	9.4	–	-1.39%
MSCI Latam	12.4	–	-1.56%
GBI-EM-GD	6.24%	–	0.78%
ELMI+	3.68%	–	0.30%
EM FX spot	–	–	0.34%
EMBI GD	5.22%	306 bps	0.40%
EMBI GD IG	4.07%	186 bps	0.47%
EMBI GD HY	6.50%	442 bps	0.33%
CEMBI BD	5.03%	300 bps	0.26%
CEMBI BD IG	4.09%	207 bps	0.26%
CEMBI BD Non-IG	6.44%	441 bps	0.28%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.8	–	1.05%
1-3yr UST	1.31%	–	0.09%
3-5yr UST	1.74%	–	0.19%
7-10yr UST	2.18%	–	0.76%
10yr+ UST	2.84%	–	1.84%
10yr+ Germany	0.29%	–	0.54%
10yr+ Japan	0.05%	–	-0.16%
US HY	5.42%	362 bps	0.31%
European HY	3.02%	353 bps	0.22%
Barclays Ag		248 bps	0.50%
VIX Index*	10.16	–	0.35%
DXY Index*	96.90	–	-0.54%
EURUSD	1.1251	–	0.78%
USDJPY	110.60	–	0.61%
CRY Index*	177.26	–	-4.74%
Brent	49.5	–	-5.43%
Gold spot	1281	–	1.03%

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

Emerging Markets

- **Brazil:** The Central Bank cut the policy rate by 100bps to 10.25% and the Brazilian economy expanded 1.0% in the first quarter of 2017 relative to the last quarter of 2016. This first quarter of positive growth in Brazil since Q4 2014 lifts the country out of one of it's longest and deepest self-inflicted recessions. The statement accompanying the decision to cut rates was more hawkish than expected as the Central Bank intimated that the pace of cuts will be reduced to 75bps per meeting going forward. It is tempting to think that this is due to the more benign growth outlook in Brazil. However, while the economic fortunes of Brazil are certainly brightening, it is wrong to conclude that better economic prospects lie behind the Central Bank's hawkishness.

The Central Bank is perfectly well aware that Brazil will only grow very sluggishly for the foreseeable future due to numerous drags, including a heavy debt load, political noise and the uncertainty presented by the 2018 election. It also knows that there is a lot of spare capacity and that inflation, which is currently 4.08% yoy, is falling with unabated velocity. Rather, the Central Bank's sudden hawkish bent has to be understood in the context of Brazil's current political situation and the marginally improving growth outlook merely provides a fig leaf for the Central Bank to exert pressure on politicians to refocus on reforms. The real reason behind the Central Bank's hawkish stance is that the Temer Administration last week announced that a vote on a critically important pension reform has been postponed to July instead of June. This delay reflects the ongoing political pressure on President Michel Temer following alleged impropriety on his part. If the political noise further delays the reform or even renders it impossible to pass during Temer's time in office then Brazil's fiscal adjustment will simply not be sufficient to ensure sustained macroeconomic stability. This is why the Central Bank feels it must err on the side of caution, i.e. push down demand in the rest of the economy by maintaining higher interest rates than would have been the case if the pension reform was heading for passage this month. The Central Bank's hawkishness thus socialises the cost of the failure of Brazil's politicians to keep

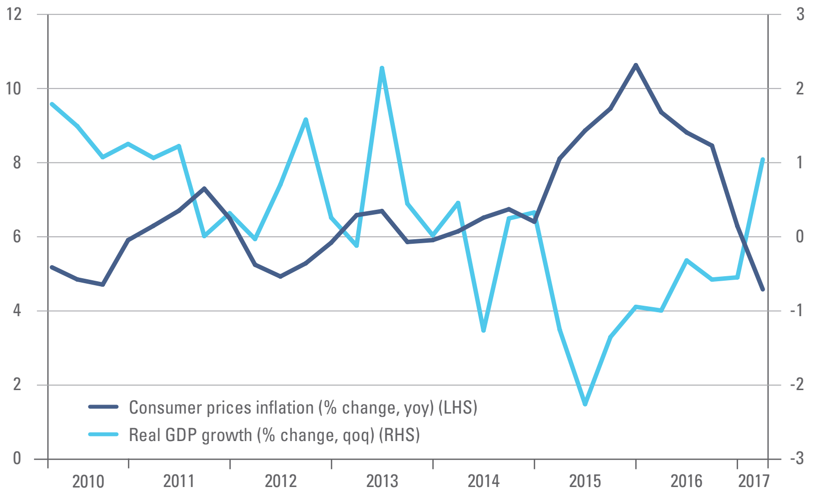
Continued overleaf

Emerging Markets

their noses out of the trough. The Central Bank is obviously right to be prudent. There are silver-linings, however. The Central Bank's hawkish stance should help to focus the minds of the politicians in Brasilia on the subject of reform. Even in a scenario, where Temer – or his replacement – fails to implement pension reform we think it is inevitable that the reform will be passed shortly after the next administration takes office in 2018 for the simple reason that without the pension reform the room for discretionary fiscal spending shrinks at an alarming rate, a reality that very few governments would find comfortable. Following the signal from the Central Bank most of the fallout from Temer's problems – including reduced odds of passage of the pension reform, political uncertainty and the slower pace of cuts – should now be more or less fully priced in. The big political event coming up starting next week is the electoral court's ruling on the legitimacy of the 2014 election result. This ruling could require Temer to step down as president. In other news, Moody's changed the outlook on Brazil's Ba2 issuer rating to negative from stable. Going forward, we expect the 'goldilocks' evolution of Brazil's economy with gradually improving growth rates and still declining inflation to be the main driver of Brazil's fixed income market. Finally, on the economy the news is unambiguously positive albeit unspectacular:

- Brazil's PMI index rose to 52 in May from 50.1 in April
- The trade surplus in May was USD 7.7bn, which took the 12-month rolling trade surplus to USD 57.1bn
- The unemployment rate dropped to 13.6% in April from 13.7% in March.
- Industrial production rose at a rate of 0.6% mom versus 0.1% mom expected in April with 0.5% mom upward revision for March.

Fig 1: **Brazil: Growth and inflation**



Source: Ashmore, Bloomberg.

- **Maldives and the EM index problem:** The government of the Maldives issued an inaugural sovereign Dollar-denominated bond last week, thus entering into global financial markets for the first time. The five-year non-sinking bond was issued with a coupon of 7% fixed. However, at USD 200m the bond is too small to enter JP Morgan's EMBI GD benchmark index, which imposes a minimum size restriction of USD 500m. This means that Maldives' bond joins a growing universe of bonds, which fall outside the scope of the main EM fixed income benchmark indices. Across the whole EM fixed income universe the main benchmarks cover only 8% of outstanding securities (see table below). Index coverage is so pathetically poor, because of a basic market-failure. The investment banks, which provide benchmark indices tend only to include securities in their indices if they trade the markets in question. Hence, if the investment bank does not have a market making operation in a particular EM country then that market will quite simply not be covered. This is a pure business decision on the part of the banks: as long as the bank trades the market in question the index groups can get free daily pricing data. There is no appetite to provide index coverage for markets that the bank does not trade, since the index group would have to buy the pricing data without the means to recoup the cost through trading operations. The problem is particularly acute in local bond markets. This is not a criticism of the investment banks for serving their own private interests. That is, after all, what businesses are supposed to do. Still, the resulting very limited index coverage is clearly not in the interest of the broader investor community, which would be far better off if the benchmarks covered the whole investment universe (more diversification, wider set of opportunities, etc.). Like all market failures, this one is ultimately a government failure: international financial institutions (IFCs), such as the World Bank, IFC or the IMF have consistently failed to address this problem, for example, by incentivising investment banks to cover all EM markets properly, or simply by providing proper indices themselves. The problem can be solved extremely cheaply. It is therefore a travesty that it has not been done, illustrating the enormous gulf that still exists between what goes on in these ivory towers and the day to day reality in the financial markets.

Continued overleaf

Emerging Markets

Fig 2: **EM fixed income benchmarks**

Asset class	Index market cap (USD bn)	Asset class (USD bn)	Index as % of asset class
All EM fixed income	1,494	18,507	8%
External sovereign debt	397	835	48%
External corporate debt	376	2,627	14%
Local currency government debt	599	7,003	9%
Local currency corporate debt	122	8,043	2%

Source: Ashmore, BAML, JP Morgan, BIS, Bloomberg.

- Venezuela: President Nicholas Maduro has promised to hold a referendum on a new constitution once it has been written by a Constituent Assembly (CA) due to be convened next month. This offer is a concession to the opposition and members of Maduro's own administration, who have expressed concerns about the erosion of institutions in the country, but Maduro's offer does not solve the political impasse. The opposition is concerned about what it sees as biased rules governing the composition of the CA and the process of writing a new constitution can in any case drag out for a very long time. In other news, the government launched a new system for auctioning FX with a sale of USD 24m. Both the price and the volume of FX are restricted under the new auction system, so it will not clear the market. Finally, we note that the Organisation of American States failed to agree to oust Venezuela from the organisation due to opposition from Bolivia and Nigeria.
- South Africa: The ANC National Executive Committee decided to maintain its support for President Jacob Zuma on the grounds that the party needs to be unified going into next year's election. The ANC is obviously far from unified and the scandals surrounding Zuma are not ending. For example, on Thursday last week a number of new emails were leaked, which show improper dealing with respect to public sector contracts. Yet, there is still not critical mass within the ANC to remove Zuma. Instead of ousting Zuma the party has formed a judicial commission to investigate allegations of undue influence by private business interests on the state. The commission will undoubtedly look upon the leaked emails with considerable interest. Ratings agency Fitch kept South Africa's sovereign credit rating at BB+ with stable outlook.
- Ecuador: Newly elected President Lenin Moreno impressed the market with a number of market-friendly announcements pertaining to economic policy. He emphasised private sector initiatives and included a number of business people in his administration. He promised to honour debt commitments, while seeking to extend maturity, possibly with the aid of China. He said he would introduce measures to encourage more foreign direct investment and asked his team to implement fiscal savings. Finally, he promised a more liberal attitude towards the media. The government successfully tapped the global markets for 6 and 10 year bonds totalling USD 2bn. The bonds carry coupons of 8.75% and 9.625%, respectively.
- Philippines: Parliament's Lower House passed a tax reform, which will finance a large and much needed infrastructure investment programme. The tax reform should also increase economic efficiency. EM countries are quietly undertaking reforms on a regular basis, this being the most recent example. The reason why EM countries reform far more than developed countries is that the former generally are not able to run counter-cyclical fiscal policies or engage in QE and other myopic policies.
- India: First quarter growth slowed to 6.1% yoy versus 7.0% yoy expected. The negative surprise is mainly attributed to the uncertainty surrounding the demonetisation exercise and growth should be supported by gradually declining interest rates and stronger exports. The manufacturing PMI index declined marginally to 51.6 in May from 52.5 in April. The budget deficit for the year to March was 3.5% of GDP in line with the government budget projection.
- Peru: Peru will use up to half of the USD 8.3bn in the Fiscal Stabilization Fund to fund infrastructure, according to Finance Minister Thorne. This should ensure that Peru's debt stock does not increase as a result of infrastructure investment. Total government debt to GDP in Peru is 26.3% as of the end of 2016. In other news, the current account deficit narrowed dramatically to 1.9% of GDP in Q1 2017 compared to 5.5% of GDP in Q1 2016. Also, we note that CPI inflation declined to 3.04% yoy in May from 3.69% yoy in April. Note that the market expectation was 3.48% yoy. This means that inflation turned negative (-0.42%) on a month by month basis versus 0.0% mom expected.

Continued overleaf

Ashmore

Emerging Markets

Snippets:

- **Chile:** April industrial production contracted at a yoy rate of 4.2% yoy. Manufacturing was also weaker.
- **China:** Manufacturing was broadly stable in May. The official PMI index was 51.2 vs 51 expected, while the Caixin PMI index declined marginally to 49.6 versus 50.1 expected.
- **Indonesia:** CPI inflation ticked marginally higher to 4.33% yoy in May from 4.17% yoy in April, but core inflation declined to 3.20% yoy from 3.28% yoy over the same period. Manufacturing PMI slowed to 50.6 in May from 51.2 in April.
- **Ivory Coast:** The government announced a major refinancing operation to buy back the 2014 and 2032 benchmark bonds with proceeds from a new USD denominated benchmark bond with 16 year maximum maturity and a EUR denominated benchmark bond with 6-8 year maturity.
- **Malaysia:** Manufacturing PMI was 48.7 in May, down from 50.7 in April.
- **Mexico:** The May PMI index picked up from 50.7 in April to 51.2 in May. Central Bank governor Agustin Carstens indicated that inflation in Mexico should converge towards 3% by 2018.
- **Pakistan:** The government secured a loan of USD 1bn from a Chinese bank to repay a recently matured 2017 Eurobond.
- **Qatar:** Moody's cut Qatar's sovereign credit rating to Aa3 from Aa2 with a stable outlook.
- **Russia:** The May PMI index was 52.4 versus 50.8 expected. The central bank's FX reserves increased to USD 406.1bn in the week to 26 May from USD 405bn the previous week.
- **South Korea:** The real economy expanded at a yoy pace of 2.9% in Q1 2017, which was a 0.2% yoy upwards revision from the advance estimate issued earlier. Investment and exports drove growth higher. Exports expanded at a rate of 13.4% yoy in May, but industrial production only increased at a rate of 1.7% yoy in April versus 5.0% yoy expected.
- **Thailand:** The current account surplus increased to USD 2.9bn in April from USD 2.6bn in March. Inflation declined 0.1% in May versus an expectation of an increase of 0.2% mom.

Global backdrop

The US data released in the past week is ambiguous enough not to warrant major shifts in policy from the Fed relative to current expectations, in our view. Manufacturing was flat and core inflation declined, while pending home sales and construction softened. Consumer confidence was also lower and the trade deficit widened, which will detract a bit from growth, but growth will still be materially stronger in Q2 2017 than in Q1 2017. The labour market data was mixed as well. Challenger job cuts rose sharply and initial claims and non-farm payrolls were weaker than expected, but ADP payrolls were strong and unemployment dropped to 4.3% mainly due to a lower participation rate. Case Schiller home prices rose at a pace of 5.9% yoy. Lael Brainard of the Fed warned that soft inflation may require a rethink on rates. On the political front, the US government disengaged further from the rest of the world as President Donald Trump announced a US withdrawal from the Paris climate accord following a tense meeting with other G7 heads of state.

China confirmed its commitment to the Treaty and therefore further increases its global influence at the expense of the US.

In Europe, Prime Minister Renzi of Italy signalled that he would be open to moving the general election forward from 2018 to autumn this year if parliament agrees to change the election law. European PMIs were generally strong with readings above 50 in the Netherlands, Spain, Italy, France and Germany and Eurozone unemployment declined 0.1% in April to 9.3%.

Continued overleaf

Ashmore

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.01%	18.51%	28.83%	2.25%	5.38%
MSCI EM Small Cap	0.72%	15.95%	19.77%	1.67%	6.29%
MSCI Frontier	1.36%	16.32%	15.61%	-3.31%	8.65%
MSCI Asia	1.03%	22.15%	29.49%	5.84%	9.03%
Shanghai Composite	-0.37%	0.26%	8.36%	17.65%	8.15%
Hong Kong Hang Seng	0.62%	13.79%	26.96%	5.11%	5.99%
MSCI EMEA	1.39%	9.05%	21.93%	-4.03%	1.55%
MSCI Latam	0.54%	10.18%	26.88%	-5.16%	-2.39%
GBI EM GD	0.83%	10.77%	12.97%	-2.24%	0.56%
ELMI+	0.23%	7.40%	7.93%	-2.00%	0.19%
EM FX Spot	0.54%	5.22%	4.07%	-8.80%	-6.02%
EMBI GD	0.33%	6.69%	9.74%	5.69%	6.57%
EMBI GD IG	0.34%	5.91%	6.04%	4.39%	4.79%
EMBI GD HY	0.31%	7.55%	14.03%	6.73%	8.97%
CEMBI BD	0.15%	4.95%	8.53%	5.02%	5.94%
CEMBI BD IG	0.13%	4.22%	5.43%	4.20%	5.02%
CEMBI BD Non-IG	0.18%	6.08%	13.57%	5.99%	7.65%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.14%	9.91%	18.30%	10.50%	16.23%
1-3yr UST	0.01%	0.77%	0.88%	0.77%	0.63%
3-5yr UST	0.06%	1.66%	0.78%	1.82%	1.37%
7-10yr UST	0.38%	3.49%	-0.18%	3.48%	1.67%
10yr+ UST	0.94%	6.32%	-2.06%	6.26%	1.93%
10yr+ Germany	0.43%	-1.57%	-2.86%	7.79%	4.46%
10yr+ Japan	-0.07%	-0.35%	-4.71%	5.74%	5.06%
US HY	0.21%	5.01%	13.92%	4.78%	7.46%
European HY	0.16%	3.44%	8.72%	5.02%	9.81%
Barclays Ag	0.21%	3.34%	4.74%	4.05%	4.51%
VIX Index*	-2.40%	-27.64%	-24.57%	-13.01%	-58.83%
DXY Index*	-0.02%	-5.20%	3.05%	20.56%	16.99%
CRY Index*	-1.40%	-7.92%	-6.05%	-41.74%	-34.44%
EURUSD	0.06%	6.98%	-0.92%	-17.64%	-9.65%
USDJPY	0.16%	5.75%	-2.75%	-7.41%	-28.80%
Brent	-1.71%	-12.97%	-0.38%	-54.55%	-49.97%
Gold spot	0.97%	11.65%	2.88%	2.20%	-20.77%

*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.

Continued overleaf

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 347 0649

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Other locations
Lima
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper

Continued overleaf