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WEEKLY INVESTOR RESEARCH

Ashmore

It has begun

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Developed Markets (DM) bonds have begun to suffer outright losses and are now underperforming Emerging Markets (EM) bonds. As we explain in the global backdrop section, the current bout of risk aversion in global bond markets led by a repricing of German bonds is more technical than fundamental in nature, and hence a great opportunity to reset longs in EM fixed income. We expect the pattern of EM outperformance to continue for several years. We have explained below that due to the very low starting point for DM bond yields it will take a very long time for carry to make up for the capital losses currently experienced in DM. Meanwhile, since EM yields are much higher, the opportunity cost of staying invested in DM bonds is very large. Investors would be far better off switching to EM now. As for the risk aversion arising from the lack of US leadership in the G20 and the Qatar and the North Korean situations, we do not expect them to impact EM fundamentals meaningfully.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	-0.58%
MSCI EM Small Cap	12.0	–	-0.34%
MSCI Frontier	10.6	–	0.09%
MSCI Asia	12.2	–	-0.62%
Shanghai Composite	12.5	–	0.93%
Hong Kong Hang Seng	7.5	–	0.21%
MSCI EMEA	9.4	–	-1.33%
MSCI Latam	12.4	–	-0.01%
GBI-EM-GD	6.28%	–	-1.38%
ELMI+	4.26%	–	-0.56%
EM FX spot	–	–	-0.82%
EMBI GD	5.52%	313 bps	-0.89%
EMBI GD IG	4.25%	182 bps	-0.73%
EMBI GD HY	6.94%	462 bps	-1.05%
CEMBI BD	5.18%	291 bps	-0.30%
CEMBI BD IG	4.19%	193 bps	-0.34%
CEMBI BD Non-IG	6.60%	432 bps	-0.24%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.6	–	0.30%
1-3yr UST	1.40%	–	-0.06%
3-5yr UST	1.94%	–	-0.33%
7-10yr UST	2.38%	–	-0.91%
10yr+ UST	2.93%	–	-1.98%
10yr+ Germany	0.56%	–	-1.59%
10yr+ Japan	0.10%	–	-0.45%
US HY	5.75%	370 bps	-0.20%
European HY	3.31%	358 bps	-0.28%
Barclays Ag	–	246 bps	-0.28%
VIX Index*	11.19	–	-0.25%
DXY Index*	96.03	–	-0.19%
EURUSD	1.1400	–	0.31%
USDJPY	114.21	–	0.73%
CRY Index*	172.56	–	0.67%
Brent	46.9	–	-5.60%
Gold spot	1207	–	-1.11%

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

Emerging Markets

The ongoing bout of volatility in the German bond market should not distract investors from the fact that a great rotation in global bond markets is already underway. Over the past year, DM bonds have sustained material losses and may lose more in the coming years. Meanwhile EM bonds have not only outperformed, but delivered strong outright positive returns. Specifically, the past twelve months have seen the entire US Treasury yield curve sustain outright losses in the range of 0.17% at the short end to 11.1% at the long end. Over the same period long bonds in Germany and Japan have lost 12.3% and 9.1%, respectively. By contrast, EM local currency bonds have returned 5.9% in Dollar-terms, while EM sovereign bonds are up 4.0% and EM corporate high yield bonds are up 10.5%. For details, see the 1-year return numbers in the table at the end of this report.

This relative performance marks a significant turn-around in the global bond markets, where until not so long ago, performance in DM strongly exceeded that of EM. DM bonds performed very strongly over 2010-2015 partly due to economic weakness and partly due to strong sponsorship from quantitative easing (QE) policies. QE is now being scaled back, but growth has not become particularly strong, so DM governments are gearing up for more fiscal stimulus. However, this will mean more supply. The resulting double-whammy of tighter money and more bond issuance is likely to translate into more outright capital losses for DM bonds over the coming years.

The low starting point for yields in DM is a further complication. If investors choose to remain invested in these markets they will incur significant capital losses and it will take many years for the carry to make up for the capital losses. To illustrate this point, the table below shows how many years an investor would have to hold a given bond in order to make up for losses associated with a modest 50bps rise in yields. Note that investors in German and Japanese 5 year bonds would never be able to make up for the capital losses,

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because the bonds have negative nominal yields. In the 10 year segment, investors would have to stay invested for more than 50 years in Japanese bonds and for nearly a decade in German bonds in order to regain their losses if 10-year yields go up 50bps. In the 30 year segment, the corresponding lock up periods would be between 3 years and 12 years depending on the country in question. By contrast, we expect that it would take less than 5 months for investors to make up for capital losses associated with a 50bps move in the yield curve in EM local currency bonds and EM corporate bonds, while the carry on EM sovereign bonds would cover the capital loss in six months.

Fig 1: **Years of carry required to break even for a given move in the yield curve**

	50bps shock			Return to pre-crisis yields
Maturity	**5yr**	**10yr**	**30yr**	**10yr**
US	1.2	1.8	3.1	9.1
UK	3.5	3.3	5.6	16.5
Germany	Infinite	8.2	7.3	41.3
Japan	Infinite	51.4	11.7	224.2

Source: Ashmore, Bloomberg.

The last column of the table shows the years of carry required to achieve breakeven through carry if 10-year yields were to return to the pre-crisis levels, that is, if the 10-year UST bond yield was to go up 290bps from current levels. Investors would have to sit on the loss-making bonds between 9 and 224 years before breaking even, depending on the market in question.

However, the real cost of sitting on loss-making positions in DM bonds will be the associated opportunity cost, that is, the return forgone by not placing the funds elsewhere. We expect EM fixed income returns to range from 25% in corporate bonds to 50% in local currency bonds in the current five year period (2017-2021) – for more details see *'Outlook for EM and global backdrop'*, The Emerging View, May 2017.

- Brazil: The Senate gave approval to fast track labour market reform, which looks set to be voted upon next week. Industrial production rose at a rate of 4.0% yoy in May, which was well in excess of expectations (2.9% yoy). The trade surplus was USD 7.2bn in June versus USD 7.0bn expected. This means that Brazil's 12-month rolling trade surplus is now USD 60.3bn. Yoy inflation dropped from 3.6% in May to just 3.0% in June.
- Chile: The real economy expanded 0.5% in May, below expectations (1.0% mom). Former President Sebastian Pinera easily won the nomination as presidential candidate for the centre-right Alianza bloc ahead of November's general election. The CPI inflation rate was 1.7% yoy in June, which is below the central bank's target range of 2%-4%.
- Venezuela: Opposition leader Leopoldo Lopez has been released from prison and placed under house arrest. The concession occurs amidst severe policy pressure on President Nicholas Maduro from all sides, including from within his government.

Snippets:

- China: CPI inflation was running at a rate of 1.5% yoy in June, unchanged from May and in line with market expectations.
- Colombia: The CPI inflation rate was 3.99% yoy in June versus 4.1% yoy expected. The central bank cut the policy rate by 0.50% to 5.75%.
- Gabon: Moody's cut the sovereign credit rating to B3 with a negative outlook from B1 on fiscal issues.
- Ghana: The real economy expanded at a rate of 6.6% yoy in Q1 2017, mainly due to a rise in oil production.
- India: The composite PMI index rose to 52.7 in June from 52.5 in May.
- Mexico: Gross fixed investment declined by 1.3% in the month of April. Inflation hit a cyclical high of 6.31% yoy in June versus 6.16% yoy in May.
- Mongolia: Democratic Party candidate Battulga Khaltmaa won the presidential election after campaigning on a populist message, which challenges the opening of more mines and an ongoing IMF programme. Parliament is controlled by the opposition party. This will give Battulga Khaltmaa relatively little room for movement, in our view.
- Peru: Inflation was negative 0.16% in June, taking the yoy inflation rate to 2.73%, which is within the central bank's 1%-3% target range.

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- **Poland:** The central bank left the policy rate unchanged at 1.5%.
- **Qatar:** Moody's downgraded the outlook on Qatar's credit rating to negative (Aa3) as the conflict with Saudi Arabia and other countries in the region continues over Qatar's alleged links with Iran.
- **Romania:** The National Bank of Romania left the policy rate unchanged at 1.75%.
- **Russia:** June's inflation rate was 4.4% yoy, which was higher than expected (4.2% yoy). The stock of FX reserves rose to USD 412bn in the week to 30 June 2017 from USD 409bn the previous week.
- **South Africa:** The ANC policy conference concluded without major political changes, largely because all delegates are focused on December's leadership contest.
- **South Korea:** CPI inflation was -0.1% mom (1.9% yoy) in June. The market expectation was an inflation rate of 2.0% yoy.
- **Thailand:** The Bank of Thailand left the policy rate unchanged at 1.5%.
- **Turkey:** The yoy rate of CPI inflation declined to 10.9% in June from 11.7% in May.
- **Ukraine:** The central bank maintained the policy rate at 12.5% as the next tranche of IMF support is pushed to Q3 2017 after a delay in approving land reform.
- **Vietnam:** The central bank cut the policy rate by 0.25% to 6.25%.

Global backdrop

Four stories are weighing on global market sentiment, namely the tension between Qatar and its neighbours in the Middle East, the North Korean situation, the G20 summit and the recent hawkish tilt on the part of central banks in Europe and the US.

Our view is that the Qatari and the North Korean situations may well impart short-term volatility, but that the fundamentals in the majority of EM countries will be completely unaffected by these conflicts, which will ultimately subside. As for G20, the obvious lack of US leadership should not be too surprising by now and we believe the rest of the world is likely to be able to manage its affairs without the benefit of President Donald Trump's leadership.

The recent hawkish turn by central banks in developed economies is allegedly due to a desire on their part to stamp out bubbles. After all, growth rates are still relatively modest compared to previous business cycles and inflation remains tame. However, we think central banks are also positioning themselves tactically for the rising probability of larger fiscal deficits in most developed countries. Governments across the developed world appear to be moving towards greater fiscal stimulus, whether via tax cuts in the US, busting the public sector wage cap in the UK or increasing defence spending in Europe.

Central banks in developed countries have been arguing for years that governments should do more on the supply-side, i.e. reforms. Fiscal spending, on the other hand, would stimulate demand, not supply. Since most developed countries now operate close to full employment it is likely that the central banks are keen not to be seen to fall behind the curve if spending is ramped higher.

Yield curves in developed economies are responding to the hawkish rhetoric from the central bankers, led by the German curve, which was also the most overbought, hence the magnitude of the move. However, we do not see the sell-off extending very far due to the underlying fundamentals in DM, which are not very resilient. In other words, the move is more technical than fundamental. We think investors in EM should use the ongoing pull-back to reset longs in EM fixed income, especially in local currency bonds, where the upside remains very material over the current five-year period as explained (and quantified) in *'Outlook for EM and global backdrop'*, The Emerging View, 11 May 2017.

Investors should look beyond the current yield curve volatility and pay greater attention to the longer-term implications of the coming shift to greater fiscal spending in developed countries. The constellation of coincident tighter monetary policies and looser fiscal policies is precisely the same policy mix currently being pursued in Argentina. Like most DM countries, Argentina's government is also averse to implementing deep supply-side reforms and keen to increase fiscal spending for political reasons. It also has a central bank, which likes to normalise monetary policy, hence the tight monetary conditions.

While there are many important differences between Argentina and most developed countries, not least that Argentina has far less debt than most developed countries, the mix of loose fiscal and tight monetary policies is nevertheless the same. This policy mix does not bode well for private sector growth, because higher rates and more bond issuance crowd out private sector investment. The debt stock obviously also goes up, which means higher future taxes, which in turn places an additional dampener on the willingness to invest in the private sector. Finally, the loose fiscal/tight monetary policy mix tends to encourage hot money flows. The resulting currency instability will, on balance, also discourage rather than encourage long-term investment in the real economy.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.58%	17.86%	24.37%	0.71%	3.95%
MSCI EM Small Cap	-0.34%	15.64%	16.47%	0.46%	4.93%
MSCI Frontier	0.09%	15.60%	19.25%	-3.55%	8.25%
MSCI Asia	-0.62%	22.10%	26.35%	4.44%	7.73%
Shanghai Composite	0.93%	4.58%	8.52%	18.20%	10.15%
Hong Kong Hang Seng	0.21%	12.71%	23.40%	2.92%	5.12%
MSCI EMEA	-1.33%	3.80%	13.94%	-6.11%	-1.23%
MSCI Latam	-0.01%	10.31%	18.90%	-6.61%	-3.65%
GBI EM GD	-1.38%	8.84%	5.88%	-3.23%	-0.87%
ELMI+	-0.56%	6.61%	4.89%	-2.48%	-0.49%
EM FX Spot	-0.82%	3.57%	0.07%	-9.35%	-6.80%
EMBI GD	-0.89%	5.25%	3.95%	5.07%	5.31%
EMBI GD IG	-0.73%	4.95%	0.58%	4.15%	3.75%
EMBI GD HY	-1.05%	5.64%	7.95%	5.52%	7.40%
CEMBI BD	-0.30%	4.69%	5.63%	4.68%	5.35%
CEMBI BD IG	-0.34%	4.01%	2.66%	4.02%	4.52%
CEMBI BD Non-IG	-0.24%	5.75%	10.47%	5.36%	6.83%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.14%	9.49%	18.02%	9.31%	14.75%
1-3yr UST	-0.03%	0.42%	-0.17%	0.74%	0.62%
3-5yr UST	-0.22%	1.00%	-1.52%	1.69%	1.11%
7-10yr UST	-0.64%	1.73%	-5.24%	2.81%	1.31%
10yr+ UST	-1.58%	3.85%	-11.11%	5.47%	2.09%
10yr+ Germany	-1.59%	-5.38%	-12.34%	5.97%	4.68%
10yr+ Japan	-0.45%	-1.08%	-9.10%	5.32%	4.92%
US HY	-0.24%	4.68%	11.39%	4.36%	6.71%
European HY	-0.28%	3.06%	8.68%	4.62%	8.90%
Barclays Ag	-0.28%	2.86%	1.55%	3.83%	4.22%
VIX Index*	0.09%	-20.30%	-15.23%	-11.12%	-40.22%
DXY Index*	0.42%	-6.04%	-0.28%	19.85%	15.15%
CRY Index*	-1.27%	-10.36%	-7.81%	-42.42%	-40.22%
EURUSD	-0.23%	8.37%	3.09%	-16.23%	-6.94%
USDJPY	1.64%	-2.38%	11.09%	12.70%	43.79%
Brent	-2.13%	-17.46%	0.30%	-56.84%	-52.13%
Gold spot	-2.81%	4.72%	-10.97%	-9.67%	-23.01%

*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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