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Ashmore

The forest and the trees

By Jan Dehn

Markets tend to focus on very immediate events and sometimes miss the big picture. The big picture is that the QE trades of the last few years – long Dollar, US stocks and European bonds and short EM – are reversing. Will the next few years in global financial markets offer a mirror image of the performance of the 2010-2015 period?

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.1	–	2.04%
MSCI EM Small Cap	12.5	–	2.12%
MSCI Frontier	11.2	–	2.07%
MSCI Asia	12.7	–	1.76%
Shanghai Composite	13.2	–	2.32%
Hong Kong Hang Seng	8.1	–	6.06%
MSCI EMEA	10.4	–	3.08%
MSCI Latam	14.0	–	1.96%
GBI-EM-GD	6.05%	–	0.85%
ELMI+	3.45%	–	0.74%
EM FX spot	–	–	0.65%
EMBI GD	5.21%	304 bps	0.37%
EMBI GD IG	4.00%	179 bps	0.41%
EMBI GD HY	6.55%	444 bps	0.33%
CEMBI BD	4.97%	294 bps	0.27%
CEMBI BD IG	4.02%	200 bps	0.22%
CEMBI BD Non-IG	6.34%	431 bps	0.36%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.8	–	0.68%
1-3yr UST	1.31%	–	-0.01%
3-5yr UST	1.69%	–	0.07%
7-10yr UST	2.11%	–	0.22%
10yr+ UST	2.71%	–	0.27%
10yr+ Germany	0.34%	–	0.18%
10yr+ Japan	0.01%	–	0.31%
US HY	5.70%	382 bps	0.36%
European HY	2.94%	338 bps	0.08%
Barclays Ag	–	250 bps	0.15%
VIX Index*	13.41	–	2.06%
DXY Index*	91.78	–	-1.77%
EURUSD	1.2040	–	2.36%
USDJPY	108.57	–	-0.91%
CRY Index*	178.01	–	1.46%
Brent	51.6	–	-0.54%
Gold spot	1320	–	2.75%

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

Emerging Markets

Jackson Hole did nothing to dispel recent market dynamics, which have seen the Dollar decline and European stocks rally, while US bonds have outperformed German bonds and EM has outperformed developed markets in almost all asset classes. Astute observers of global market dynamics will have noticed that these latest market moves are a perfect mirror image of the market moves, which characterised global financial markets during the big Quantitative Easing (QE) era, that is, between 2010 and late 2015.

What we are witnessing is the start of the unwinding of the four big QE trades. They were: to go long US dollars, US equities and European bonds and to sell everything in EM. Recall that the original rationale for these four trades was that QE would impact the US, Europe and EM quite differently and that investor behaviour would, if anything, amplify the impact. The QE trades also leaned heavily on simplistic, but deeply held convictions about how a wounded world economy would recover from crisis. Specifically, the views brought to bear on the world of QE were:

- Bullish on the US: The argument was that under QE the US would be able to stage a spectacular economic recovery from the 2008/2009 crisis, since, unlike Europe, the US had fully recapitalised its banks early in the crisis. Stronger US growth would in turn require early Fed hikes and this combination of higher growth and higher rates would be unambiguously favourable to both US stocks and the Dollar. These two trades therefore emerged as two of the four major consensus QE trades.
- Bearish on Europe: The market quickly settled on a bearish view of Europe's economy predicated on the notion that Europe's banks are insolvent, that the periphery is in trouble and that EU institutions are deficient. These problems would make growth impossible and hence there would not be any inflation either. Yet, with the ECB buying copious amounts of European fixed income, it clearly made sense in this context to go long core European bonds. Hence, the third QE trade was born.
- Cataclysmic on EM: Not a single QE central bank ever bought a single EM asset, so QE grossly distorted global bond markets strongly in favour of developed markets and against EM fixed income. Investors therefore pulled money from EM to allocate to the QE-sponsored markets. Being finance constrained to begin with, EM economies began to slow when investors pulled their funding. The slowdown in growth in turn further invigorated the EM bears.[1] The final QE trade was born – sell everything EM.

[1] The extent to which EM is finance constrained is evident when one considers that EM only accounts for 20% of global fixed income, but contributes 60% to global GDP. By contrast, developed economies account for 40% of global GDP, but have issued 80% of global bonds. No wonder developed market bond yields are so much lower than EM bond yields.

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Emerging Markets

Though compelling in their simplicity, the QE trades were ultimately just that – trades. Asset purchases were gigantic and highly distortionary interventions in global bond markets, but they were never accompanied by deep reforms and deleveraging. Lacking fundamental backing they eventually began to look stretched. By 2016 the QE trades were already losing steam. In particular, EM currencies surprised many by outperforming the Dollar in 2016, which ought to have been bad for EM due to the Turkish coup, Brexit, three Fed hikes priced in and the election of Trump. In 2017, EM outperformance in absolute terms and relative to developed markets accelerated further, while European stocks rallied and the Dollar started falling precipitously. US bonds are beating German bonds.

How long will it take to unwind the QE trades? There is no way to predict this with any precision, because there are powerful herd dynamics involved and countries are to some extent masters of their own fortunes. For example, if the US chooses to implement deep structural reforms that push up the US trend growth rate then the Dollar may well sink more slowly, all else even. Having said that, we think the main mechanisms which will determine the speed of the unwinding of the QE trades will be the following:

First, there is a large technical imbalance in the market. We think that enormous positions have been established among institutional investors, such as pension funds, insurance, sovereign wealth funds and central banks. It took more than five years for these institutions to build up the QE trades, so it could easily take the same amount of time for them to unwind them.

Secondly, valuations are unsustainable unless the forces which sustain them are maintained. These forces now look less likely to be sustained. Both the Fed and ECB are talking about scaling back asset purchases. The proximity of full employment will force the hand of central banks. They will be most concerned about the real economy and therefore more inclined to scale back QE than raise rates. Balance sheet reduction will address the froth in financial markets. Once this has been reduced it becomes safer for the Fed to hike rates meaningfully without creating a massive recession. Balance sheet expansion helped the Dollar and US stocks, was bad for EUR, good for European bonds and bad for EM.

Thirdly, relative return prospects will exert a powerful influence on investor behaviour. It is going to get ever tougher to ignore double digit Dollar returns in EM, when assets are making outright losses in developed markets. Investors must surely also begin to recognise that most EM countries have just proved their fundamental resilience in the face of major shocks, such as the Taper Tantrum, the strong Dollar, falling commodity prices and the start of the Fed hiking cycle. In other words, buying EM is not as risky as many perceive.

The simplest way to think about the unwinding of QE is therefore to imagine it along the lines of a retreating tsunami. Once the geological forces which pushed the ocean onto dry land begin to dissipate, the water will naturally flow back into the sea. Similarly, once the financial forces of QE (and herd dynamics) begin to wane so the value proposition will naturally start to shift capital back towards EM. Outflows of capital from the US will naturally soften the US growth trajectory, while capital inflows to Europe and EM will naturally improve risk appetite and investment, especially in finance constrained EM countries. In turn, the better absolute and relative economic performance will induce further inflows.

This dynamic naturally begs the question whether the unwinding of the QE will be the exact mirror image of the original QE trades? We think not. Ultimately, the size of the value propositions in EM and the extent of mispricing of assets in developed economies is not just a function of the price levels of the assets, but also what has happened to the underlying fundamentals in the meantime. Here the picture is quite different from before QE in ways, which clearly favour EM. Specifically:

1. Reforms: A large number of EM countries have undertaken significant structural reforms during the QE period, so they will be able to grow faster before they run into inflation compared to before the crisis. By contrast, with the exception of a few countries in the European periphery, developed countries have undertaken hardly any reforms and in some cases made their fundamental situation worse. For example, Brexit has structurally weakened the UK, while the withdrawal from TPP has done the same to the US.
2. Debt: Developed economies have become far more indebted than EM countries despite much higher debt levels to begin with. IMF data shows that the average level of gross government indebtedness to GDP has increased from 36% in 2007 to 47% in EM, but has increased 72% of GDP to 107% of GDP in developed economies.
3. Policy room: EM bond yields rose about 200bps during the QE period, while inflation rates declined from 5% to below 4%. This gives EM central banks plenty of room to stimulate their economies using monetary policy in the event of an economic downturn. By contrast, the QE central banks have almost no room to stimulate their economies in the event of a recession and fiscal largesse has also eroded the scope for fiscal stimulus.
4. Competitiveness: EM currencies depreciated 45% during the QE period. This has rendered EM economies materially more competitive, especially versus the US. EM real effective exchange rates hit 13 year lows in early 2016. The US real effective exchange rate is now very uncompetitive, especially in the context of the seven-fold decline in productivity since the early 2000s.

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Emerging Markets

The net effect of the big moves in asset prices and the fundamental changes listed above have been to make EM countries economically healthier and developed economies economically weaker. It follows that EM investments are not only safer relative to before QE, but also far more lucrative in absolute terms and relative to the QE markets.

- Brazil: The government continues to pass reforms. The Lower House last week passed legislation to phase out subsidised loans from the state development bank, BNDES. The bill still needs to pass in the Senate. The government also announced plans to privatise Electrobras, the national electricity company. We think that a watered down reform of the pension system may yet find support in the Legislature. Former president Luiz Inacio Lula da Silva indicated that he may not be able to run in 2018 due to his recent conviction for corruption. The current account deficit continued to narrow. It was USD 3.4bn in July versus USD 4.0bn in July 2016.

- Argentina: Real GDP picked up smartly just ahead of mid-term elections. The monthly GDP proxy showed that the economy expanded at a rate of 4.0% yoy in June. Unfortunately, the trade deficit is also widening this early in the expansion, which reflects the unfortunate constellation of easy fiscal policies, tight monetary policies and insufficient attention to supply-side reforms.

- Venezuela: Local media reported that China will launch a fund specifically to buy Venezuelan and PDVSA bonds. Such a fund would, if it bought short-dated bonds and swapped them into longer-dated securities, significantly reduce near-term default risk in spite of US sanctions on primary issuance.

The United States Department of the Treasury acting through the Office of Foreign Asset Control (OFAC) announced on Friday a series of new sanctions intended to penalise the regime of Venezuelan President Nicolas Maduro. The new sanctions prohibit US persons to deal in new debt (beyond short maturities) and equity issued by the government of Venezuela and its state oil company [PDVSA]. This includes rollover of existing debt, i.e. exchanges. In addition, the new sanctions preclude dealing in existing bonds owned by the Venezuelan public sector. Only one bond – a hastily-issued 2036 bond issued but never distributed by the government in December 2016 – falls under the prohibition of dealing in existing bonds. The rationale for the specific reference to the 2036 bond is that it was never distributed to the public, so that any sale of the security would represent new funds flowing to the Venezuelan government.

US financial institutions can continue trading, clearing and servicing all other PDVSA and Republic of Venezuela bonds, hence, they continue to be eligible for trading by US persons in the secondary market.

Prior to Friday's announcement, a wide range of options had been under consideration, many of which would have been extremely difficult to enforce. Consideration of a ban on the export of Venezuelan oil to the US or other comparable policies was deemed to have a disproportionate impact on the US oil refining industry and has not progressed. The latest announcement confirms that the US government aims to target the regime while minimising the impact on US businesses and investors. Notably, CITGO, a US oil distribution business owned by PDVSA, is specifically exempted from the new sanctions.

Snippets:

- Angola: status quo is likely to be maintained after the legislative election. The ruling party MPLA (People's Movement for the Liberation of Angola) is leading a provisional vote count by 61%. Angola is set to have a new leader – Joao Lourenco as the previous president Jose Eduardo dos Santos, in power for 38 years, decided not to stand as presidential candidate. Lourenco is seen as a clean, pro-reform politician.
- Azerbaijan: Moody's downgraded Azerbaijan's sovereign credit rating to Ba2 with stable outlook.
- Chile: Moody's affirmed Chile's sovereign credit rating at Aa3, but moved the outlook from stable to negative.
- China: Industrial profits were 16.5% higher in July of this year than in July 2016. This marked a marginal slowdown from a very strong pace of growth of 19.1% yoy in June.
- Ecuador: Fitch affirmed Ecuador's sovereign rating of B with negative outlook.
- Hong Kong: The trade deficit narrowed from HKD 48.3bn in May to HKD 29.6bn in June. This was a narrower deficit than expected (HKD 40.0bn). CPI inflation increased to 2.0% yoy in July from 1.9% yoy in June.
- Hungary: The National Bank of Hungary left the policy rate unchanged at 0.9%.
- Indonesia: Bank Indonesia cut the policy rate to 4.5% from 4.75%. The market had expected the central bank to keep rates unchanged, but core inflation has been moderating.
- Mexico: Retail sales surprised to the downside in June: 0.4% yoy versus 2.8% yoy expected. The economy expanded at a yoy rate of 1.8% in Q2 2017 as expected. The current account posted a narrow deficit of USD 0.3bn in the second quarter compared to median market expectations of USD 4.3bn.
- Peru: Moody's kept Peru's sovereign credit rating unchanged at A3 with stable outlook.
- Singapore: Core CPI inflation was 0.1% mom sa in July, unchanged from June.
- South Africa: Retail sales in June surprised significantly to the upside in Q2 2017. Retail sales were 8.9% higher in the quarter than in the previous quarter, which raises the possibility that the economy is emerging from technical recession.
- Thailand: Exports rose strongly in July at a yoy rate of 10.5%. Imports were also strong (18.7% yoy).

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.93%	28.17%	23.53%	2.65%	5.37%
MSCI EM Small Cap	1.15%	21.63%	15.21%	1.57%	5.83%
MSCI Frontier	4.35%	23.08%	25.87%	-1.47%	9.36%
MSCI Asia	0.85%	30.66%	24.41%	5.83%	8.98%
Shanghai Composite	2.84%	10.46%	11.77%	17.49%	12.85%
Hong Kong Hang Seng	4.75%	25.18%	23.40%	5.09%	7.70%
MSCI EMEA	4.06%	16.05%	16.91%	-2.06%	0.08%
MSCI Latam	4.87%	25.29%	21.35%	-4.59%	-1.48%
GBI EM GD	1.70%	14.57%	7.65%	-1.31%	-0.39%
ELMI+	1.07%	10.11%	6.03%	-1.12%	-0.20%
EM FX Spot	0.97%	7.09%	1.11%	-7.82%	-6.40%
EMBI GD	1.19%	8.36%	4.32%	5.64%	5.17%
EMBI GD IG	1.03%	7.82%	1.68%	4.32%	3.63%
EMBI GD HY	1.34%	8.99%	7.36%	6.79%	7.21%
CEMBI BD	0.67%	6.54%	5.29%	5.03%	5.16%
CEMBI BD IG	0.54%	5.61%	2.74%	4.06%	4.32%
CEMBI BD Non-IG	0.86%	7.96%	9.33%	6.28%	6.61%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.85%	10.64%	15.04%	9.23%	14.02%
1-3yr UST	0.16%	0.82%	0.59%	0.80%	0.68%
3-5yr UST	0.47%	2.07%	0.44%	1.86%	1.29%
7-10yr UST	1.18%	3.99%	-1.35%	2.81%	1.80%
10yr+ UST	2.88%	7.89%	-4.96%	4.70%	3.00%
10yr+ Germany	2.68%	-1.76%	-8.05%	5.21%	5.31%
10yr+ Japan	0.86%	0.21%	-4.10%	5.28%	5.22%
US HY	-0.28%	5.79%	8.44%	4.70%	6.44%
European HY	0.29%	4.57%	6.36%	5.03%	8.52%
Barclays Ag	0.65%	4.57%	2.44%	3.79%	4.16%
VIX Index*	30.70%	-4.49%	3.63%	11.94%	-21.40%
DXY Index*	-1.17%	-10.21%	-3.98%	10.91%	12.54%
CRY Index*	-2.54%	-7.53%	-3.48%	-39.19%	-42.04%
EURUSD	1.67%	14.48%	7.61%	-8.32%	-3.91%
USDJPY	-1.53%	-7.17%	6.52%	4.30%	37.94%
Brent	-2.01%	-9.20%	4.73%	-50.00%	-54.16%
Gold spot	4.02%	15.07%	-0.22%	2.57%	-20.29%

*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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