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Ashmore

The return of domestic demand: EM's next growth driver

By Jan Dehn

Emerging Markets (EM) growth is accelerating and so far this is mainly due to a pick-up in exports. The next big growth push will come from domestic demand as inflows into local markets ease financial conditions. After record outflows from EM over the past several years there is considerable room for growth upside surprises, in our view. We believe most analysts have missed this point, because they did not accurately identify the turn in the QE trades. We therefore expect broad-based upgrades to EM growth forecasts in the coming quarters, even years. In the global backdrop section we discuss dovish statements from two Fed officials and the short-term extension to the debt ceiling.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.1	–	0.04%
MSCI EM Small Cap	12.7	–	0.86%
MSCI Frontier	11.3	–	0.77%
MSCI Asia	12.6	–	0.03%
Shanghai Composite	13.1	–	-0.04%
Hong Kong Hang Seng	7.8	–	-1.04%
MSCI EMEA	10.2	–	-0.93%
MSCI Latam	14.0	–	1.03%
GBI-EM-GD	5.93%	–	1.32%
ELMI+	3.20%	–	0.83%
EM FX spot	–	–	0.68%
EMBI GD	5.04%	297 bps	0.68%
EMBI GD IG	3.89%	178 bps	0.68%
EMBI GD HY	6.33%	432 bps	0.68%
CEMBI BD	4.89%	295 bps	0.40%
CEMBI BD IG	3.94%	201 bps	0.39%
CEMBI BD Non-IG	6.22%	426 bps	0.43%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.0	–	-0.38%
1-3yr UST	1.29%	–	0.12%
3-5yr UST	1.68%	–	0.27%
7-10yr UST	2.10%	–	0.51%
10yr+ UST	2.71%	–	0.87%
10yr+ Germany	0.33%	–	0.79%
10yr+ Japan	0.01%	–	0.18%
US HY	5.59%	381 bps	0.17%
European HY	2.87%	334 bps	0.12%
Barclays Ag	–	251 bps	0.36%
VIX Index*	11.29	–	1.16%
DXY Index*	91.56	–	-1.07%
EURUSD	1.2002	–	0.89%
USDJPY	108.62	–	-1.00%
CRY Index*	181.17	–	0.23%
Brent	53.5	–	2.24%
Gold spot	1336	–	0.13%

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

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- **EM's next growth driver:** EM growth has started to accelerate relative to growth in developed markets, but there is more to come, in our view. The next incremental driver of EM growth is domestic demand, which is likely to respond positively to the ongoing easing of financial conditions. We think most global growth forecasts have not yet factored in this effect, because very few analysts anticipated the decline in the Dollar and the very strong performance in EM local markets. The failure to predict the improving fortunes of local markets in EM in turn means that most forecasters are likely to underestimate EM growth over the next few years. After all, capital inflows have a powerful impact on domestic demand in EM countries, which are severely finance constrained. For example, EM economies now account for about 60% of global GDP, but have only issued about 20% of global fixed income. Financial conditions tightened significantly between 2010 and 2015 due to the adverse impact of QE on capital flows to EM. In fact, EM bond yields rose to more than 7% amidst declining inflation over this period due to massive selling of EM assets by foreign investors, who preferred to pull money from EM in order to chase returns in the QE sponsored markets.

The good news for EM investors is that EM survived the tighter financial conditions with very few casualties and EM growth rates began to take off already in 2016 due to rising EM net exports (on the back of extremely competitive real exchange rates). The difference between 2017 and 2016 is that this year EM will see its first full year of net capital inflows since 2013. Growth is likely to respond very positively to capital inflows as financial conditions ease. The effect is likely to be felt especially in domestic demand. This effect is unlikely to be adequately captured in most forecasts, including those of the IMF in its World Economic Outlook, since neither the IMF nor most analysts predicted the sharp decline in the Dollar and the very strong performance of EM local bond markets. This means that EM growth forecasts are likely to be revised higher in the coming quarters, even years. What does this mean for EM markets? Clearly, higher growth is good for earnings and better financial conditions will put downwards pressure on default rates as refinancing becomes easier.

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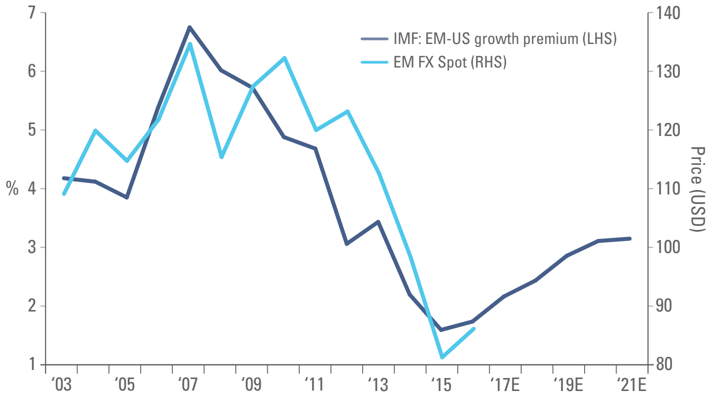
Stronger growth will also increase tax revenues and reduce cyclical expenditures for governments. Finally, stronger growth implies more upside for EM currencies. The chart below shows the relationship between EM currencies and the growth differential between EM countries and the US. This chart is based on IMF's current forecasts for growth. Hence, as IMF revises EM growth higher it is likely that EM currencies will have more upside too.

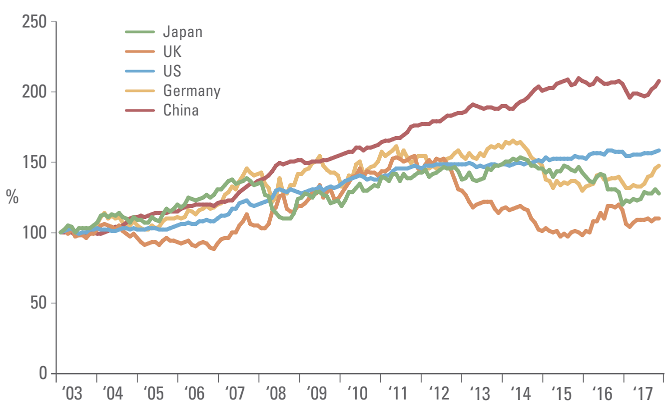
Fig 1: **EM FX versus EM-US growth differential**



Source: Ashmore, IMF, Bloomberg, JP Morgan.

- **China:** CNY has rallied nearly 5% versus the Dollar this year, which led the Chinese authorities at the weekend to amend FX reserve requirements for offshore banks pertaining to FX forwards. This change will enable the currency to have more two-way volatility. FX forward positions held by and on behalf of overseas clients by offshore banks were responsible for heavy speculation against CNY in 2015. The ultimate objective of the Chinese authorities is to achieve a floating currency, but this objective will take some time on account of the imbalance between foreign holdings of Chinese assets and Chinese demand for foreign assets. Meanwhile, Chinese government bonds continue to pay far higher yields than other countries in the Special Drawings Rights (SDR) club of currencies. Chinese bond yields are higher in both real and nominal terms. As the chart below shows Chinese government bonds have also returned far more than other SDR bond markets since 2003 with lower volatility. Yet Chinese bonds remain vastly under-represented in global bond portfolios. China's reform momentum is set to ratchet higher following October's political conference and the economy continues to perform with Caixin services PMI accelerating to 52.7 in August from 51.5 in July and the trade balance narrowing to USD 42bn in August from USD 46.7bn in July on the back of strong imports, which suggests that domestic demand is resilient. This view is also supported by CPI inflation, which ticked higher in August (1.8% yoy from 1.4% yoy in July) and PPI inflation, which increased to 6.3% yoy from 5.5% yoy. FX reserves as of end-August were broadly stable at USD 3.1trn.

Fig 2: **3-5 year bond market returns (in USD terms) for the 5 main SDR countries**



Source: Ashmore, Bloomberg.

- **Brazil:** It has been a great week for Brazilian fixed income markets, which responded positively to a long list of positive news. First, the central bank cut rates by 100bps. Second, inflation dropped to a yoy rate of just 2.46% in August. Third, industrial production picked up smartly in July (2.5% yoy). Fourth, questions were raised about the integrity of the testimony which forms the basis for accusation of corruption against President Michel Temer. Fifth, formal charges were presented against former presidents Lula and Dilma. The political

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focus in now shifting rapidly towards the question of who will emerge as PSDB's candidate for president in the 2018 election. The struggle is between veteran politician Geraldo Alckmin, a medical doctor with a reputation for honesty, and his former protégé, Sao Paulo mayor Joao Doria. With the PT party in disarray and PMDB unlikely to field a candidate, the 2018 election is PSDB's to lose.

- Turkey: German Chancellor Angela Merkel said last week that she is open to talks aimed at ending Turkey's EU accession efforts. From a market perspective, this is hardly news. After all, the market has not been pricing any hope of Turkish EU accession for the past several years. While analysts far removed from everyday market realities may, perhaps, have nursed some notion of comfort in the idea that Turkey could, one day, join the EU the truth is that prospects of Turkish EU accession have always been extremely distant and have in fact been dimming for years due to the antics of Erdogan, French opposition and now German opposition too. Merkel is merely stating the obvious.

- Sri Lanka: Parliament has approved a fiscal reform, which was a critical requirement under the IMF program. Sri Lanka has experienced recurring problems on the fiscal side, therefore this reform, which removes tax exemptions and increases direct taxation in a number of areas, is very good news.

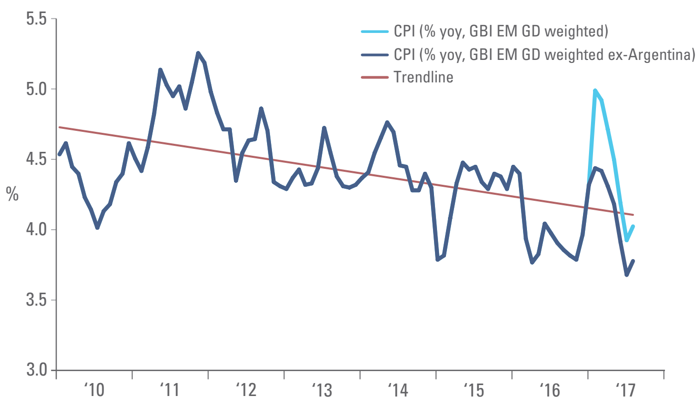
- Mongolia: Parliament has dismissed the prime minister in an internal party struggle, which seeks to settle scores following a poor showing in the recent presidential election. The change in prime minister is not expected to lead to significant changes in economic policy.

- Venezuela: Rick Waddell, a senior White House advisor on national security, said last week that the sanctions imposed on Venezuela were not aimed at achieving regime change, but rather to encourage the government to re-impose democratic standards. This appears to be a softening of the US stance on Venezuela, which should be good for performance of Venezuelan bonds. President Nicholas Maduro reaffirmed his government's commitment to servicing debt.

- South Africa: South Africa just bounded out of recession on the back of stronger than expected GDP in Q2 2017. The economy expanded at a rate of 1.1% yoy in the quarter versus 0.5% yoy expected. Growth in Q1 2017 was 1.0% yoy. In qoq saar terms, growth was 2.5% versus 0.6% in Q1 2017 and better than the consensus expectation of 2.3%.

- Russia: Central Bank governor Elvira Nabiulina is obviously a superstar. In addition to handling the tough triple whammy of collapsing oil prices, geopolitical tension and sanctions in 2014/2015 for which she was awarded the Central Banker of the Year Award in 2015, she has now managed to push inflation to the lowest level in the post-Soviet era: 3.3% yoy. This means that inflation is now comfortably within the central bank's 4% target. EM inflation in general has been declining since QE began on account of the effect of financial tightening on domestic demand (see chart below). This means that local bond yields are high in absolute terms, in real terms and relative to developed markets.

Fig 3: **EM CPI inflation**



Source: Ashmore, Bloomberg, JP Morgan.

Snippets:

- Chile: Growth is finally coming back to Chile. The economic activity index for July was 2.8% higher than a year ago versus 2.3% expected.
- Colombia: CPI inflation increased to 3.87% yoy in August from 3.4% yoy in July.
- Hong Kong: The PMI for August declined to 49.7 from 51.3 in July.
- Hungary: GDP growth was 3.2% yoy in Q2 2017, unchanged from Q1 2017. Inflation was 2.6% yoy in August.
- Malaysia: The central bank kept the policy rate unchanged at 3.0%. The trade surplus was USD 1.9bn in July on the back of surging exports (23% yoy) and strong imports (14% yoy). Industrial production beat expectations in August (6.1% yoy versus 5.1% yoy expected).

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- **Nigeria:** The recession is over. Q2 2017 real GDP growth was 0.6% yoy, up from -0.9% yoy in Q1 2017.
- **Philippines:** CPI inflation accelerated to 3.1% yoy in August from 2.8% yoy in July due to food prices, which were affected by heavy rains.
- **Poland:** The central bank left the policy rate unchanged at 1.5%.
- **Singapore:** The PMI index rose to 51.8 in August from 51.0 in July with particular strength in new orders and output.
- **Taiwan:** The rate of CPI inflation was 0.96% yoy in August versus 1.12% yoy expected. Export growth was strong at 12.7% yoy in August (versus 12.5% yoy in July).
- **Turkey:** The yoy rate of CPI inflation increased materially in August – 10.7% versus 9.8% in July. Turkey is one of the few countries in the EM local currency bond universe with really poor macroeconomic policies.

Global backdrop

The Fed is likely to err on the side of caution when it comes to normalising the current extremely distorted monetary conditions. We think the Fed's overriding objective will be to avoid a severe recession during this process. Hence, the sensible thing to do is to deal with the two problems of asset bubbles and inflation one at a time. We think the Fed will first seek to deflate the massive asset bubbles before it begins to meaningfully raise rates. This is the less risky approach, since if the stock, bond and currency bubbles in the US are deflated then the risk to the real economy from raising rates is clearly reduced as well. Such considerations may well be behind statements by Fed presidents Lael Brainard and Neel Kashkari, who last week talked down inflation risks. Brainard said inflation may be low for structural reasons and Kashkari said that early rate hikes could do real damage. Fed Vice-Chairman Stanley Fischer's early departure will also tilt the Fed to a more dovish direction. The fact that inflation is very low helps to justify the focus on deflating bubbles. The scaling back of QE will impact the Dollar and US stock markets negatively, the EUR and European stocks positively, European bonds negative and all EM markets positively, in our view. ECB will also scale back asset purchases, which will disproportionately hurt European bonds, in our view.

In other news, President Donald Trump and Congress Democrats voted on a short extension to the US debt ceiling. The agreement removes the near-term risk of default, which enabled US treasuries bonds to rally. However, the agreement merely postpones the debt ceiling issue. The market will therefore have to fret about the possibility of a US default again within a few months. Moreover, the agreement could make it difficult to find time in the legislative agenda to undertake the keenly awaited tax reform. Of course, it is not impossible that Congress opts to remove the debt ceiling altogether. This would certainly suit Democrats, who can then paint Republicans as fiscally irresponsible. Removal of the debt ceiling at this time would be deeply ironic. After all, the debt ceiling was imposed to prevent government debt from rising. In reality it has failed miserably in this regard. The US government's gross debt stock has increased from 53% of GDP in 2001 to 107% of GDP in 2016 and it set to continue to rise to more than 117% of GDP by 2022, according to the IMF. Of course, this does not matter at all, because the debt is risk free by definition.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.38%	29.08%	20.76%	2.62%	5.23%
MSCI EM Small Cap	1.46%	24.42%	15.20%	2.00%	6.00%
MSCI Frontier	1.02%	23.56%	25.60%	-1.65%	9.16%
MSCI Asia	0.20%	31.58%	21.01%	5.85%	8.95%
Shanghai Composite	0.15%	10.57%	10.93%	15.24%	12.28%
Hong Kong Hang Seng	-1.12%	23.27%	15.89%	3.07%	7.49%
MSCI EMEA	-0.52%	15.83%	15.36%	-2.72%	-0.65%
MSCI Latam	2.41%	28.04%	20.81%	-3.86%	-1.28%
GBI EM GD	1.70%	16.62%	8.64%	-0.70%	-0.34%
ELMI+	1.09%	11.24%	6.61%	-0.72%	-0.20%
EM FX Spot	1.01%	8.03%	1.93%	-7.41%	-6.43%
EMBI GD	0.72%	9.77%	5.00%	6.18%	5.18%
EMBI GD IG	0.69%	9.10%	2.55%	4.80%	3.68%
EMBI GD HY	0.75%	10.51%	7.79%	7.40%	7.14%
CEMBI BD	0.44%	7.33%	5.72%	5.26%	5.21%
CEMBI BD IG	0.43%	6.29%	3.14%	4.29%	4.37%
CEMBI BD Non-IG	0.47%	8.90%	9.77%	6.51%	6.62%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.38%	11.51%	15.19%	9.40%	13.71%
1-3yr UST	0.12%	0.98%	0.60%	0.87%	0.70%
3-5yr UST	0.27%	2.45%	0.53%	2.06%	1.33%
7-10yr UST	0.51%	4.82%	-0.89%	3.39%	1.98%
10yr+ UST	0.87%	9.42%	-3.47%	6.00%	3.49%
10yr+ Germany	0.23%	-1.25%	-6.97%	5.61%	5.96%
10yr+ Japan	0.30%	0.51%	-2.37%	5.46%	5.23%
US HY	0.17%	6.23%	8.40%	4.98%	6.34%
European HY	0.18%	4.89%	6.23%	5.17%	8.30%
Barclays Ag	0.20%	4.93%	2.85%	4.08%	4.21%
VIX Index*	6.61%	-19.59%	-35.49%	-11.80%	-31.20%
DXY Index*	-1.19%	-10.42%	-3.96%	8.62%	14.66%
CRY Index*	0.18%	-5.89%	-0.75%	-35.93%	-42.47%
EURUSD	0.77%	14.12%	6.83%	-7.14%	-6.64%
USDJPY	-1.24%	-7.13%	6.65%	1.41%	39.67%
Brent	2.16%	-5.83%	11.46%	-45.44%	-53.63%
Gold spot	1.07%	16.39%	0.59%	7.63%	-22.88%

*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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