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Ashmore

The main risks in EM

By Jan Dehn

Ashmore called the rally in Emerging Markets (EM) loudly and clearly, but we have been less vocal about the associated risks. This should not be confused with complacency: we strongly believe that there is no such thing as a risk-free investment anywhere, even in EM. To clear up any confusion on this point, this report focuses squarely on the risks facing EM after a year of strong performance. We examine both the risks emanating from within the asset class as well as those coming to the asset class from abroad.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.2	–	1.06%
MSCI EM Small Cap	12.9	–	1.23%
MSCI Frontier	11.3	–	0.43%
MSCI Asia	12.7	–	1.18%
Shanghai Composite	13.1	–	-0.31%
Hong Kong Hang Seng	7.8	–	-0.63%
MSCI EMEA	10.1	–	-1.17%
MSCI Latam	14.3	–	1.57%
GBI-EM-GD	5.95%	–	-0.49%
ELMI+	3.51%	–	-0.46%
EM FX spot	–	–	-0.54%
EMBI GD	5.09%	288 bps	-0.22%
EMBI GD IG	3.95%	170 bps	-0.38%
EMBI GD HY	6.37%	421 bps	-0.08%
CEMBI BD	4.94%	285 bps	-0.12%
CEMBI BD IG	4.01%	193 bps	-0.26%
CEMBI BD Non-IG	6.24%	414 bps	0.08%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.2	–	1.63%
1-3yr UST	1.39%	–	-0.19%
3-5yr UST	1.81%	–	-0.54%
7-10yr UST	2.21%	–	-1.06%
10yr+ UST	2.78%	–	-1.59%
10yr+ Germany	0.44%	–	-1.77%
10yr+ Japan	0.03%	–	-0.37%
US HY	5.52%	364 bps	0.22%
European HY	2.87%	326 bps	0.13%
Barclays Ag	–	250 bps	-0.51%
VIX Index*	10.19	–	-0.54%
DXY Index*	91.86	–	-0.02%
EURUSD	1.1957	–	0.03%
USDJPY	111.23	–	1.68%
CRY Index*	184.05	–	2.88%
Brent	55.5	–	3.08%
Gold spot	1316	–	-0.91%

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

The main risks in EM right now

Introduction

We have elaborated on the strong return prospects for EM asset classes in recent notes, but this report focuses squarely on the risks facing EM investors right now.[1] As such, this report is for the jittery. We see five broad categories of risk facing EM right now, namely EM systemic risks, country-specific risks, China, risks relating to US interest rates and the Dollar and finally shorter-term sentiment drivers. We critically evaluate each of these risk categories before summarising our conclusion.

After a lot of good news…

EM performance began to turn positive more than 18 months ago due to a combination of extremely high real, nominal and comparative yields, thirteen year low real exchange rates, a pick-up in growth led by exports and very benign technicals. A mild tail wind also began to emerge from developed economies as monetary authorities, especially in the US, turned more hawkish. The prospect of higher rates and scaled back asset purchases began to chip away at prospects for further capital gains in the QE-driven developed markets. Thus, in 2016, EM local currency bonds – "the most hated asset class on Planet Earth" and a very good 'early warning' indicator of the EM outlook – surprised many investors by returning 10% in Dollar-terms and this year, the asset class has gone on to do even better, clocking up more than 15% return in Dollar terms, year to date. EM equities have done even better, returning 11.19% in 2016 and 30.45% so far this year. There is obviously a bit of irrationality at play here since capital gains in EM are still modest relative to the capital gains in developed markets in recent years and EM still offers dramatically better carry than developed market assets, but some investors are nevertheless experiencing jitters and asking: what can go wrong here? In the following paragraphs we outline the five broad potential sources of risk facing EM investors right now.

[1] For example, see 'Outlook for EM and global backdrop', The Emerging View, May 2017.

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Risk #1: EM systemic risks

Barring a global outbreak of the plague, a foreign invasion and World War III, we see five types of external shocks which could potentially pose a systemic threat to the entire EM asset class. The good news is that EM just survived four of them and the fifth – a US border adjustment tax – now looks unlikely to materialise. The four potentially lethal shocks, which EM countries have already weathered are: (a) the massive capital flight episode we now know as the Taper Tantrum; (b) the 45% rally in the US Dollar versus EM currencies between late 2010 and the end of 2015; (c) the halving of commodity prices in 2014; and (d) the start of the Fed hiking cycle in December 2015. Not only did EM countries have to face these shocks in very rapid succession, but they also had to cope with some very serious concurrent pessimism about China. In general, the investor community decided to shoot and ask questions later. They sold heavily, which inflicted even further headwinds on EM. Indeed, by late 2015 EM bond yields had been pushed to higher levels than in 2006, when the Fed had rates at 5.25%. EM countries were in effect forced to live with a de facto full normalisation of US Fed policy in the midst of the largest easing episode ever in global financial history.

With hindsight, we can now see that the 2013-2015 was a profound robustness test for EM. Perceived EM vulnerability to a sequence of shocks initially sparked heavy selling. Investors then went on to mistake the resulting price volatility for riskiness. And ultimately they ended up seriously under-estimating EM resilience and overselling the asset class. It is now very clear that EM fundamentals not only weathered the Developed Markets Crisis of 2008/2009, but also the perceived EM systemic risks as they unfolded in 2013-2015. Very few countries and corporates defaulted. There were hardly any serious balance of payments problems anywhere. IMF programs were only extended to a very small number of the most vulnerable and poorest countries in the world. The single thing that proved genuinely vulnerable was investor sentiment. And it is precisely the resulting mismatch between investor sentiment and resilient EM fundamentals over this period, which forms the basis for the strong EM performance in 2016 and 2017 and we see more upside to come over the next few years as the QE trades continue to unwound.

Risk #2: Country-specific EM shocks

The single largest concern about country-specific blow-ups in EM is that one such episode might morph into an asset class wide rout – so-called contagion. In the bad old days a crisis in, say, a few Asian countries would not only trigger indiscriminate selling across the entire EM asset class, but would also unleash serious fundamental economic stresses and thus create so-called self-fulfilling prophecies, that is, sell-offs, which find ex-post justification in real world economic crises.

The good news is that this link between financial instability and economic crisis has been thoroughly broken in the EM asset class. EM has not experienced self-fulfilling prophecies since 1998 and the reason is simple and irreversible: EM countries are today largely self-financing through the development of local pension systems. This means that even heavy selling by foreign investors – such as EM experienced between 2013 and 2015 – is typically offset by local buying, which keeps yields from spiking to terminal levels. Notice also how IMF programs are rarely needed these days for the same reason. Of course, the lower debt levels, large stocks of FX reserves and better overall macroeconomic management in most EM countries also helps to insulate them from the erstwhile damaging effects of external shocks.

That is not to say that EM countries do not experience shocks. In fact, a small number of EM countries – typically you can count them on one hand – screw up every year. These episodes are almost always self-inflicted, although occasionally a few EM countries are sent reeling by external shocks, typically if they happen to be very economically undiversified, such as single-commodity exporters (not that there are very many such countries left in the universe of EM bond issuers these days). Despite the often shrill media attention afforded to such events the reality is that defaults are extremely rare and recovery rates are often high. Of course, the vast majority of idiosyncratic shocks do not even end in default and typically turn out to be excellent opportunities for specialist active EM managers to generate alpha.

Brazil is a classic case in point: a recent survey by Credit Suisse showed that foreigners still hold fewer than 13% of Brazilian bonds despite a +60% rally (in Dollar terms) in the Brazilian local bond market in 2016. This means that most non-specialist foreign investors completely missed this trade. The same was the case in Russia in 2015, when Russia was the best performing external debt market in the world largely as a result of irrational bearishness on the part of investors due to the fall in oil prices and the Crimea troubles the year before.

When investors evaluate country-specific risks in EM they also need to take into account the fact that EM is now a very diverse asset class with more than 80 indexed individual markets in government fixed income alone. This means that investors will never again experience a situation, such as 2001, when a single country, Argentina, could account for 20% of the benchmark index. This does not justify blindly buying into such country-specific shock episodes, however. After all, such events do occasionally result in large permanent losses. Recent examples include Belize's default on a USD 500m bond and the collapse of the Mozambique 'tuna bond'. Still, the rational approach is to recognise that the odds of making money during EM stress episodes are heavily skewed in favour of those who buy into weakness and that the best way to mitigate the

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risks is to work with active specialist managers many of whom will confess that they secretly wish there were more EM blow-ups. Unless and until more blow-ups occur, however, the best way to think of EM fixed income is that of an attractive yield play occasionally punctuated by great alpha opportunities around rare country-specific shocks.

Risk #3: China

China has maintained high, gently declining growth rates for many years amidst low stable inflation, but this has not prevented markets from cultivating a narrative about China as a country lurching from hard landing to overheating, seemingly with nothing in between. China reforms more than any other country. Still, the country is regarded by many investors as hugely risky, because, so the narrative goes, China's debt stock is unsustainable, which is why growth is slowing, which in turn explains why capital is trying to flee the country. Since China also imports a lot of commodities many investors think that EM's fortunes are directly linked to China's.

In our view, this is actually a good thing, because China is opening itself to international trade and China is set to be some 2-3 times larger than the US economy by 2050.Between now and then China will increase its consumption share of GDP and therefore start to absorb more imports from the rest of the world. Clearly, EM should position to take advantage of this.

We also strongly disagree with the view that China is heading for some kind of crisis. Most of the common market rhetoric about China is downright wrong. China's debt stock is not unsustainable. Growth is slowing due to deep and broad reforms, not debt. And outflows of capital reflect a temporary imbalance due to a healthy desire on the part of China's savers to diversity their savings portfolios by adding foreign assets pending foreign investors adding to their China positions, which they will only do after China has joined the main benchmark indices.

The view that EM countries are commodity producers – and therefore terribly exposed to China – is also very outdated. Two thirds of EM countries are today net commodity importers and China trades more with developed countries than with EM countries in terms of trade as a share of DM and EM GDP. In fact, we think EM countries could become even safer if they traded far more with China. China is 38% of EM GDP, but only 9% of EM trade is with China. There is no doubt that a major slowdown in China would hurt some EM countries, but the biggest pain would be felt in developed markets, whose bond markets are also more vulnerable to a crisis in China on account of China's large holdings of developed market bonds within its USD 3trn of FX reserves.

Risk #4: US-specific shocks

Trump has been great for EM. Despite Trump, however, US markets do pose a greater risk for EM than, say, Europe or Japan, because the bulk of liquid EM currency crosses are versus the Dollar and the bulk of EM external debt trades as a spread over the US Treasury curve. In previous hike cycles, such as 1994 and 2004 the risks associated with US monetary policy normalisation were fully priced into EM before the hikes even began and EM performed strongly once hikes got underway. The same has been the case this time around: EM began to perform shortly after the first hike in December 2015. If anything, the risks have been even more overstated by the markets in this cycle.

After all, between 2013 and December 2015, EM literally priced in a full normalisation of US monetary policy by pushing local bond yields even higher than where they were back in 2006 when the Fed Funds rate was 5.25%. With the target Fed Funds rate unlikely to get back to 5.25% for a while this was irrational. The fact that EM countries had to cope with such egregious mispricing was unfortunate, but it also means that now they are not particularly vulnerable to a bit of Treasury volatility around current low levels of yields.[2]

It is a similar situation with respect to the Dollar. The value of EM currencies declined by 45% against the Dollar between 2010 and 2015 and EM survived the experience despite frequent panics over alleged FX mismatches, etc. It is difficult to see a sustained decline in EM currencies versus the Dollar after such large moves and even more difficult to see how weaker currencies could pose major fundamental risks to EM countries, when they are already basking in strong export recoveries at the current competitive levels of real exchange rates.

Having said that, there is no doubt that the US economy is edging ever so slowly towards full employment and it is only prudent to expect the Fed to react. In addition to evaluating the risks to EM associated with a normalisation of US monetary policy within the context of financial and economic conditions in EM so it is essential to understand the US context. In this respect, the Fed would ordinarily be willing to hike at the first whiff of inflation had this been a normal business cycle, because the Fed would feel confident that a recession, should one occur, would be shallow and short-lived. However, this cycle is different in two important respects: first, it is unclear whether a recession would be shallow or short-lived. The debt load is heavy, productivity is very low and the Dollar is overvalued. Moreover, the Fed can only cut three times, but is three cuts enough to haul the US economy out of a recession? The fiscal powder is also running low and large sections of Congress are ideologically opposed to greater government spending. Secondly, valuations in financial markets are

[2] In contrast, the same cannot be said for developed markets bonds, which will suffer outright capital losses with little or no off-setting carry if the yields go higher.

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distorted due to years of excessive reliance on monetary stimulus in preference to reforms and deleveraging. Tightening could therefore trigger a stock market crash, which would only make a recession even deeper and longer. In this cycle it is therefore far safer for the Fed first to deflate asset bubbles before hiking rates meaningfully. Once the bubbles are deflated the Fed can then hike more safely in the knowledge that if a recession should occur at least it will not be made worse by a concurrent asset price collapse.

These considerations lead us to expect the Fed to focus on scaling back asset purchases ahead of raising rates beyond what is already fully priced into the market (and therefore not risky). Current benign inflation pressures also make it easier for the Fed to justify scaling back asset purchases ahead of hiking rates, especially if inflation is low in part due to structural reasons.[3]

If we are right that the path towards monetary policy normalisation involves unwinding QE before material rate hikes, then the Dollar falls and US stock markets deliver ever diminishing marginal returns as risk willing capital seeks better returns elsewhere in the global economy, though the US Treasury market may attract more inflows as investors rotate out of even more overbought bonds in Europe.

Risk #5: Short-term sentiment drivers

The most likely source of EM volatility in the near-term is investor behaviour. Year-end is approaching and after a year of very strong performance some investors will want to take profits (the somewhat inane practice of year-end position squaring). We do not expect much downside, if any and we do not expect the associated volatility to translate into actual losses, i.e. defaults or anything like it. The extent of price volatility will be low, because positioning in EM among institutional investors remains extremely light. Pullbacks will be caused mainly by momentum jockeys and institutional investors should view this as an opportunity to close underweights by adding to positions ahead of what we expect to be strong real money inflows to the asset class in 2018.

Another potential short-term driver could be improving sentiment about the US. Certainly, hopes are rising for higher inflation and even a modest tax reform in the US. There are also hopes in some quarters that President Donald Trump will scale down ideology in favour of greater pragmatism. These hopes are based on recent US support for a UN-backed resolution on North Korea and agreements between Trump and Democrats over the "Dreamers" program, hurricane relief and the debt ceiling extension. A less ineffective US government should bring temporary relief for the Dollar. Again, however, we stress that the broader outlook for the Greenback remains troubled due to low productivity, high debt levels, valuations as well as pregnant positioning among the big swingers, such as central banks, sovereign wealth funds and most pension and insurance players.

Conclusion

EM fundamentals have just passed a profound robustness test involving pricing in a full normalisation of Fed policy, severe capital flight, a commodity crash and a crazy Dollar rally. These shocks coincided with morbid and unfounded China pessimism. It is therefore time to revise the widely held view that EM countries are fragile. They are clearly not. In evaluating the risks facing EM now it is extremely important not to lose sight of the big picture: QE was like a giant tsunami of liquidity, which washed out of EM and into developed markets. QE pushed developed market asset prices to unsustainable levels and created great value in EM, especially since EM economies held up so well during the QE period relative to asset prices. QE liquidity is now flowing back to EM and will likely continue to do so for several years. This will boost EM growth, which in turn will improve public finances, reduce already declining default rates and justify lower spreads. EM currencies have plenty of room to appreciate further before they approach the ceilings of established real exchange rate ranges. Since positioning is light investors should not even fear volatility too much for now at least. There are plenty of risks out there, but they are mainly located in developed economies, which have far more debt, declining productivity, overvalued asset prices and weaker growth. As if this was not enough, politics is getting worse too. Above all, QE, the biggest source of capital gains in developed markets in recent years, is about to be scaled back. With no carry on offer the prospect is for outright losses.

[3] For more discussion of the possible structural reasons for low US inflation see global backdrop section of 'EM growth is strong with more to come', Weekly Investor Research, 21 August 2017.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.44%	30.45%	27.25%	4.21%	4.48%
MSCI EM Small Cap	2.71%	25.95%	20.27%	3.18%	5.60%
MSCI Frontier	1.46%	24.09%	27.19%	-1.64%	8.93%
MSCI Asia	1.38%	33.13%	26.78%	7.26%	8.17%
Shanghai Composite	-0.16%	10.23%	14.02%	14.96%	12.25%
Hong Kong Hang Seng	-1.75%	22.49%	19.93%	4.53%	6.47%
MSCI EMEA	-1.68%	14.47%	17.97%	-1.72%	-1.60%
MSCI Latam	4.02%	30.05%	31.84%	-1.78%	-1.90%
GBI EM GD	1.20%	16.05%	10.60%	-0.03%	-0.72%
ELMI+	0.62%	10.73%	7.72%	-0.43%	-0.60%
EM FX Spot	0.46%	7.45%	3.23%	-7.01%	-6.83%
EMBI GD	0.50%	9.52%	6.63%	6.48%	5.08%
EMBI GD IG	0.31%	8.69%	4.13%	5.19%	3.62%
EMBI GD HY	0.67%	10.42%	9.44%	7.48%	6.92%
CEMBI BD	0.33%	7.20%	6.50%	5.47%	5.08%
CEMBI BD IG	0.17%	6.02%	3.74%	4.46%	4.27%
CEMBI BD Non-IG	0.55%	8.99%	10.85%	6.76%	6.42%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.25%	13.33%	18.86%	10.30%	13.64%
1-3yr UST	-0.07%	0.79%	0.32%	0.81%	0.67%
3-5yr UST	-0.27%	1.89%	-0.08%	1.94%	1.26%
7-10yr UST	-0.55%	3.71%	-1.48%	3.29%	2.02%
10yr+ UST	-0.74%	7.67%	-2.58%	6.08%	3.97%
10yr+ Germany	-1.54%	-2.99%	-6.72%	5.40%	6.17%
10yr+ Japan	-0.07%	0.14%	-1.73%	5.56%	5.12%
US HY	0.39%	6.47%	9.59%	5.30%	6.12%
European HY	0.31%	5.02%	7.53%	5.25%	8.11%
Barclays Ag	-0.32%	4.39%	3.02%	4.10%	4.16%
VIX Index*	-3.78%	-27.42%	-33.70%	-15.30%	-28.14%
DXY Index*	-0.87%	-10.13%	-4.42%	8.94%	15.91%
CRY Index*	1.77%	-4.39%	1.81%	-34.49%	-40.93%
EURUSD	0.39%	13.69%	7.00%	-7.48%	-8.36%
USDJPY	1.14%	-4.90%	9.12%	2.34%	41.12%
Brent	5.96%	-2.32%	21.26%	-43.19%	-50.46%
Gold spot	-0.45%	14.64%	0.18%	7.38%	-25.73%

*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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