Issued: 25 September 2017

Ashmore

Fed unwinds QE: what is in store for EM?

By Jan Dehn

What happens to Emerging Markets (EM) as Quantitative Easing (QE) gets unwound? We expect the big four 'QE trades' of the past few years to go into reverse gear. This should be bullish for EM assets, especially local currency and equities. In EM country-specific news, we highlight fiscal policy in India, Russia's intervention to support B&N bank and South Africa's reserve bank's decision not to cut rates despite expectations to the contrary. In other news, the date for Kenya's election re-run has been set for 26 October, S&P undermines its own reputation by downgrading China's sovereign credit rating, Mexico's inflation prints finally fall below expectations, Ecuador's President Moreno calls for a referendum on political reform and the good macroeconomic news continues in Brazil. The global backdrop section highlights the next focus in European politics after the German election, UK's Brexit woes and the fact that the FOMC looks set for major changes in the coming months.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.7	–	0.03%
MSCI EM Small Cap	12.8	–	-1.18%
MSCI Frontier	11.6	–	0.91%
MSCI Asia	12.1	–	0.13%
Shanghai Composite	13.0	–	0.00%
Hong Kong Hang Seng	7.7	–	0.37%
MSCI EMEA	10.2	–	-0.17%
MSCI Latam	14.3	–	-0.13%
GBI-EM-GD	5.93%	–	0.03%
ELMI+	3.43%	–	-0.22%
EM FX spot	–	–	-0.18%
EMBI GD	5.17%	289 bps	-0.40%
EMBI GD IG	4.00%	169 bps	-0.36%
EMBI GD HY	6.46%	425 bps	-0.43%
CEMBI BD	4.96%	281 bps	-0.03%
CEMBI BD IG	4.03%	189 bps	-0.06%
CEMBI BD Non-IG	6.27%	411 bps	0.02%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.3	–	0.09%
1-3yr UST	1.44%	–	-0.07%
3-5yr UST	1.86%	–	-0.21%
7-10yr UST	2.25%	–	-0.43%
10yr+ UST	2.78%	–	-0.44%
10yr+ Germany	0.45%	–	-0.06%
10yr+ Japan	0.02%	–	0.18%
US HY	5.50%	356 bps	0.21%
European HY	2.85%	323 bps	0.17%
Barclays Ag	–	250 bps	0.00%
VIX Index*	9.59	–	-0.58%
DXY Index*	92.25	–	0.20%
EURUSD	1.1922	–	-0.26%
USDJPY	112.25	–	0.61%
CRY Index*	183.57	–	-0.48%
Brent	56.8	–	2.36%
Gold spot	1292	–	-1.15%

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

Emerging Markets

Implications for EM of the unwinding of QE in the United States

The Fed reached an important milestone last week when it announced the commencement of the unwinding of its USD 4trn asset purchase programme. How will this decision impact global financial markets including EM? To understand how, it is important to recognise from the onset that QE was not only the largest ever direct government intervention in financial markets, but also by far the most distortionary. For example, by the middle of 2016, the combination of zero interest rate policies and asset purchases had pushed yields on the entire US Treasury curve below the rate of inflation. QE distorted markets far beyond the US, however. The Fed and the other three QE central banks did not buy bonds pro rata across global fixed income markets; rather they only bought their own government bonds. The interventions had powerful first order effects on bond yields in the QE markets, but also induced powerful secondary effects via global asset allocators, who responded to QE by altering their allocations in favour of the QE-sponsored markets.

Three distinct views about how QE would impact global markets came to dominate asset allocation. First, a bullish view of the US led to enormous inflows into Dollars and US stocks on the grounds that since the US had fixed its banks early in the crisis, the US economy should bounce back resulting in stronger growth, inflation and rate hikes. Second, a bearish European view resulted in a massive bid for core European bonds on the grounds that Europe's banks had not been fixed and hence Europe would never grow, never have inflation and therefore the ECB would never hike rates. Third, a borderline cataclysmic EM view emerged largely as a residual of the US and European views. After all, if US stocks were going to triple in value and if the Dollar was going up 40% then why hold EM local currency bonds? Also, if 30-year German bonds were going to deliver more than 60% in capital gains then why hold, say, Ecuadorian bonds at 9% yield? Investors sold EM in size to chase returns in the US and Europe.

Continued overleaf

Who gets the biggest hangovers when the punchbowl is removed? Those who imbibed the most. The scaling back of QE is likely to push the big QE trades into reverse gear. After all, QE was little more than a massive technical intervention in bond markets by central banks, which almost guaranteed capital gains for a time, but also steadily eroded yields in the process. The QE economies have undertaken almost no reform and investors in these markets should now be asking: with no carry and potential capital losses in store where are the returns going to come from in the next five years?

The situation in EM countries could hardly be more different. In the QE years investors pulled money from EM. This pushed down asset prices and increased yields. This means that EM now offers both carry and potential capital gains.

If we are right that the QE trades of the past several years are now going into reverse then investors should, as a first approximation, go long EUR versus USD, go long European stocks versus US stocks and go long US Treasuries versus Bunds. Enormous volumes of risk willing capital are vested in these trades, which, when it moves, will affect both sentiment and actual economic performance (case in point: strong European PMIs and business confidence indicators last week). However, the most profitable trade is likely to be to take profits on the QE markets as a whole and go long the non-QE markets, which were so out of favour in the last few years. The QE trades are exhausted and crowded. The non-QE markets are uncrowded and far more attractively priced.

The brutal outperformance of EM countries versus developed markets of the past 12-18 months looks set to continue if investors embark on the QE unwinding trades. We believe that institutional investors have barely begun to adjust their asset allocations to the post-QE reality. As capital returns to EM's finance constrained economies there will be further positive growth surprises, because domestic demand will finally pick up after years in the doldrums. Positive economic surprises are obviously important to investor sentiment towards the EM asset class, but EM currencies also perform well when EM's growth rates surprise to the upside relative to growth rates in developed countries. In other words, stronger EM growth will beget further currency strength, which in turn will encourage even more inflows, which will stimulate growth even more and so on. This benign feedback loop only ends when real effective exchange rates (REER) become overvalued, but the prospect of REER overvaluation is still quite distant.

Stronger economic performance in turn positively impacts other variables with direct influence on spreads such as fiscal balances, debt levels, issuance volumes, etc. Tax revenues rise and fiscal balances improve. This means less issuance (for governments) as well as lower defaults and stronger earnings (for companies). Investors should therefore expect spreads to contract in the sovereign and corporate credit markets, while earnings should be revised higher (justifying higher stock prices for given P/Es).

How long will it take for the Fed and the other QE central banks to unwind their balance sheets? A long time, in our view. A rapid unwinding of balance sheets would risk collapsing both stock and bond markets and could even seriously disrupt the global currency markets (crashing the Dollar). The process of deflating bubbles is by nature very risky, so the QE central banks are also likely to go easy on rate hikes for the foreseeable future. Our base case is that the Fed will only hike if markets have fully priced the hike. This is the only way the Fed can minimise the risk that the hike will cause serious economic damage.

The other question is how long it will take institutional investors to recognise that the unwinding of QE marks a major shift in the direction of global markets, including EM? In fact, many institutional investors have already realised this and performance clearly reflects the shift too. Still, it took more than five years for institutional investors to put on the QE trades, so it will likely take a similar amount of time to unwind them, in our view. The reality is that most institutional investors are constrained by various processes, which means that they typically respond to material changes in the market with a lag of 18-24 months.[1] Global markets began to anticipate the Fed's announcement last week as far back as early 2016. This means that the bulk of institutional money has yet to respond and creates a positive technical backdrop for EM going into 2018. Taken together with healthy valuations (in real, absolute and relative terms), cheap currencies, stronger growth and a dismal outlook for returns in developed markets we think that the unwinding of QE should serve EM performance and EM fundamentals well for the foreseeable future.

- India: Many countries struggle with the same weaknesses over and over again, a bit like bad habits. India's bad habit is weak fiscal policy. Recall how the former government led by the Congress Party lost control of fiscal policy towards the end of its time in office. Wider fiscal deficits forced the central bank to step up rate hikes, which crowded out private investment, but did nothing to restore confidence. The currency therefore weakened amidst growing current account deficits and capital outflows. Investors are therefore right to ask if the fiscal menace is back given that the Modi Administration looks set to announce wider borrowing targets this week. We think not. India has undertaken multiple bold reforms in recent years, including demonetisation, establishment of Unique Identification Authority of India (UIDAI)/Aadhaar, GST etc. Reforms cause short-term

[1] This lag reflects the fact that consultant often take several months to recognise market shifts. They then have to convince their pension fund clients. If convinced, the pension funds then have to conduct a study and approve changes to strategic asset allocation at board level. Then follows the process of issuing RFPs, manager search and final selection of manager. Even after a manager has been found, there is typically months of delay due to the need to agree on IMAs, etc.

Continued overleaf

Emerging Markets

pullbacks in growth and associated revenue shortfalls, which the government is now trying to neutralise with temporary fiscal stimulus, but over the slightly longer horizon the reforms will actually improve the fiscal picture. Investors should therefore not let myopia cloud their vision. In fact, they can now buy into the story a bit more easily, because the government has increased the quota for foreign portfolio investment into Indian local currency corporate bonds by a further USD 6.7bn. This means that an increase in the quota for foreign investment into government bonds may rise soon too, in our view.

- Russia: The Central Bank of Russia stepped in rapidly to shore up B&N bank after the privately owned institution got into trouble. The intervention follows a similar operation with Otkritie bank recently. There are no systemic problems in the Russian banking sector, however. The problems are contained within a fringe of smaller private banks, which have struggled in the recession. The central bank is now cleaning up this sector. In other news, inflation was zero in the week to 18 September 2017 and retail sales surprised to the upside in August with a print of 1.9% yoy (the consensus expectation was 1.1% yoy). Fitch upgraded the outlook on Russia's long-term BBB- rated credit rating to positive from stable.

- South Africa: The South African Reserve Bank surprised the markets by not cutting rates by 25bps. The market consensus expectation was for a cut, but SARB left rates unchanged at 6.75%. The SARB is concerned about potential upside inflation risks due to political developments leading up to the December ANC conference, fiscal vulnerabilities and potential credit ratings action.

- Kenya: The re-run of the presidential election will take place on 26 October. The date is set so as to give the election commission sufficient time to iron out the problems that led to mis-recording of votes in the last election, whose result was nullified.

- China: Ratings agency S&P downgraded China's sovereign credit rating from AA- (negative) to A+ (stable). This decision perfectly illustrates all the problems with ratings agencies: they are late; they are biased and in this case completely wrong, in our view. China's outlook is improving, not deteriorating. China's credit fundamentals are also improving and in any case stronger than those of higher rated developed economies (China has lower debt, stronger growth and reforms more). It is fashionable to blame the slowdown in China's growth rates in recent years on leverage, but in fact it has more to do with China's massive reform efforts, which are ultimately good for China's credit outlook. We expect an even stronger reform momentum following the conclusion of next month's policy conference, including further capital account liberalisation. Chinese stocks are up more than 40% this year. Given the improving outlook for China why does S&P downgrade the country now? We think S&P has done its own reputation more damage than that of China.

- Mexico: We have shown, using annual data, that pass-through from exchange rate shocks to inflation is a myth.[2] FX pass-through is only a short-term phenomenon. This means that bouts of FX volatility are almost always a buying opportunity provided the overall macroeconomic framework is sound. Mexican policy is certainly sound and Mexican inflation now seems to be following the conventional pattern with respect to FX pass-through. Inflation dipped well below expectations last week following the Trump related sell-off in MXN late last year. Specifically, Mexican CPI inflation in the first half of September was 0.34% mom versus 0.40% mom expected. Real GDP also accelerated on a seasonally adjusted basis to 3.0% yoy in Q2 2017 from 2.6% yoy (sa) in Q1 2017.

- Ecuador: President Moreno announced a referendum on a set of political reforms the details of which have yet to be announced. The reforms will likely take aim at reducing the power of the Executive over key areas of policy and thus increase accountability and transparency in the government. The balance of powers in Ecuador was significantly eroded during President Correa's administration.

- Brazil: The good macroeconomic news continues in Brazil. Mid-month CPI inflation was 0.11% mom in September. This marked yet another sharp deceleration from the mid-month inflation print of 0.35% mom in August. The lower print took yoy inflation to below-target 2.56% yoy from 2.68% in August. The policy rate is still 8.25%, but likely to fall further. The fiscal news was also positive as federal tax revenues surprised on the upside in August. Tax revenues were up 10.8% yoy in real terms (BRL104.2bn versus the median market expectation of BRL92.4bn).

- Venezuela: The Trump Administration slapped a travel ban on select Venezuelan officials. Canada also placed sanctions on some 40 officials. Meanwhile, the government paid the USD 185m coupon on the Venezuela 2027 bond after a minor delay due to alleged processing delays at a correspondent bank.

Snippets:

- Argentina: Real GDP growth was 2.7% yoy in Q2 2017. This is a major acceleration from the 0.4% yoy growth rate obtained in Q1 2017. The fiscal balances also improved on slower expenditure growth relative to tax revenue growth.
- Colombia: The trade deficit was lower than expected in July at USD 520m.
- Croatia: S&P revised Croatia's outlook to positive from stable (BB).

[2] See '*The myth of EM FX pass-through*', The Emerging View, 14 March 2017.

Continued overleaf

Emerging Markets

- **Hungary:** The central bank cut the overnight deposit interest rate to -0.15% from -0.05% in line with the median consensus expectation.
- **Indonesia:** Bank Indonesia surprised the market by cutting the 7-day reverse repo rate by 25bps to 4.25%.
- **Malaysia:** The rate of core CPI inflation declined to 2.4% yoy in August from 2.6% yoy in July.
- **Philippines:** The central bank left the policy rate unchanged at 3.0%.
- **Saudi Arabia:** The government has mandated banks to issue Dollar-denominated benchmark 5-year, 10-year and 30-year bonds.
- **Singapore:** Core CPI inflation was zero mom for the second month in a row in August.
- **South Korea:** Exports surged to a rate of 31.1% yoy in the first 20 days in September, aided by working day adjustments.
- **Taiwan:** Industrial production increased 2.3% in the month of August (3.2% yoy). This was much stronger than expected (1.9% yoy). The central bank kept the policy rate at 1.375% in line with expectations.
- **Thailand:** Exports expanded at a rate of 13.2% yoy in August, which was much stronger than the consensus expectation of 5.0% yoy.
- **Turkey:** The Erdogan Administration rejected the results of a Kurdish independence referendum and launched airstrikes against PKK targets in Northern Iraq.

Global backdrop

German voters returned Angela Merkel to power in the election at the weekend and although much of the media attention naturally focuses on the entry into the Bundestag of the extremist AfD party, the fact remains that AfD will play no part in German policy. Nor will German foreign and EU policy change meaningfully despite the change in the make-up of the coalition backing the next Merkel Administration. With the election out of the way the focus will soon shift to the more substantial question of how France's Emmanuel Macron and Angela Merkel can exploit the strong economic momentum in the Eurozone plus the fact that the UK is no longer an obstacle to pushing forward material reform of the European Union. Both leaders have a mandate to move 'Europe' forward and will likely do so with the only remaining question being how far they can go. AfD and other extremist elements in various European countries will only matter to the reform progress in terms of impacting the speed of reform, not in terms of altering the general direction of travel, which is forward, in our view.

The fact that German voters did not concern themselves at all with the question of Brexit underlines how unimportant the UK has already become in Europe. Meanwhile, the UK continues to marginalise itself further as Prime Minister Theresa May had to make further concessions to the EU in her much touted but ultimately disappointing Florence speech. EM member states are still waiting for the UK to deliver on essential elements of the Brexit plan. This is proving challenging. The fact of the matter is that Mrs May's government looks like a fragile version of the John Major Administration of the early 1990s, which was also rife with cabinet rivalry, pretenders to the top job, divisions over Europe, a weak parliamentary position, including dependence parliamentary votes from extremist Northern Irish MPs. As every EM investor knows political frailty is deeply worrying at a time such as this, when London has to undertake so many reforms, in so many areas with so weak a political position. No wonder, therefore, that Moody's downgraded the UK credit rating. The only question is why the ratings agency took so long to do so.

In the US the Federal Reserve's monetary policy committee is about to undergo significant changes in its membership over the next 6 months. In fact, so many FOMC members are being replaced that the committee's current interest rate projections are largely meaningless. The confidence interval surrounding forecasts for US Treasuries and assets sensitive to US policy rates should therefore be narrowed, in our view. However, markets are not travelling completely blind when it comes to Fed policy. For example, the policy preferences of the Trump Administration are clear: Trump wants low rates and a weak Dollar. Trump also likes Yellen because she is a dove (and maybe because Trump himself is a real estate guy). Investors should also consider the economic backdrop. A recession, should one occur, would be difficult to reverse with only four hikes on the books. Fed caution on rates therefore seems justified. It helps in this regard that inflation is not only contained, but also that it is veiled in mystery right now as academics ponder the relative importance of tightness in the labour markets versus disinflationary impulses from robots, Amazon, the death of high street retail, etc. This ambiguity will surely be welcomed by the new FOMC members bearing in mind that the Fed has now embarked on the risky process of scaling back QE. In short, we see plenty of reasons – quite apart from structural problems such as high debt levels and declining productivity – why the Fed should move very slowly on rates regardless of the composition of the new FOMC. Basically, investors should expect the Fed to pursue the least risky option of hiking rates only if the market has fully priced the hike.

Continued overleaf

Ashmore

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.47%	30.48%	22.84%	4.73%	4.64%
MSCI EM Small Cap	1.50%	24.47%	15.45%	2.99%	5.21%
MSCI Frontier	2.38%	25.22%	26.99%	-1.53%	8.86%
MSCI Asia	1.50%	33.30%	23.02%	7.70%	8.20%
Shanghai Composite	-0.16%	10.22%	12.48%	15.71%	13.25%
Hong Kong Hang Seng	-1.38%	22.94%	16.76%	5.44%	6.59%
MSCI EMEA	-1.85%	14.27%	13.81%	-1.15%	-1.25%
MSCI Latam	3.88%	29.88%	26.34%	-0.96%	-1.60%
GBI EM GD	1.23%	16.08%	8.41%	0.15%	-0.60%
ELMI+	0.40%	10.48%	6.50%	-0.38%	-0.56%
EM FX Spot	0.28%	7.26%	1.65%	-6.84%	-6.71%
EMBI GD	0.10%	9.09%	4.47%	6.28%	4.97%
EMBI GD IG	-0.05%	8.30%	2.23%	4.94%	3.50%
EMBI GD HY	0.23%	9.94%	7.00%	7.40%	6.84%
CEMBI BD	0.30%	7.18%	5.70%	5.39%	5.01%
CEMBI BD IG	0.11%	5.95%	3.11%	4.36%	4.19%
CEMBI BD Non-IG	0.57%	9.01%	9.71%	6.72%	6.36%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.34%	13.43%	17.32%	10.14%	13.74%
1-3yr UST	-0.15%	0.71%	0.32%	0.78%	0.65%
3-5yr UST	-0.48%	1.68%	-0.29%	1.87%	1.19%
7-10yr UST	-0.98%	3.27%	-2.37%	3.09%	1.76%
10yr+ UST	-1.18%	7.19%	-4.95%	5.62%	3.43%
10yr+ Germany	-1.60%	-3.05%	-9.22%	5.14%	5.82%
10yr+ Japan	0.11%	0.32%	-1.96%	5.47%	5.18%
US HY	0.60%	6.69%	9.06%	5.31%	6.17%
European HY	0.47%	5.20%	7.33%	5.28%	8.08%
Barclays Ag	-0.32%	4.39%	2.32%	4.01%	4.02%
VIX Index*	-9.44%	-31.70%	-21.97%	-38.68%	-37.85%
DXY Index*	-0.46%	-9.75%	-3.39%	8.28%	15.96%
CRY Index*	1.50%	-4.65%	0.26%	-34.25%	-40.15%
EURUSD	0.10%	13.33%	5.94%	-6.49%	-7.57%
USDJPY	2.06%	-4.06%	11.88%	3.22%	44.28%
Brent	8.42%	-0.05%	23.75%	-41.45%	-48.58%
Gold spot	-2.19%	12.17%	-3.40%	5.81%	-26.59%

*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

Ashmore

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 1 316 2070

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