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WEEKLY INVESTOR RESEARCH

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The pause that refreshes

By Jan Dehn

Volatility is your friend, especially if you are looking to increase your Emerging Markets (EM) allocation. The prospect of US tax cuts and Fed hikes impacted sentiment towards EM last week, but we do not expect them to derail the EM recovery, which has solid backing in valuations, technicals and fundamentals. As such, we suggest that investors ruthlessly exploit such bouts of volatility to add to their EM exposure at marginally more attractive entry levels. Brazil's fiscal numbers are now improving due to recurring tax revenues, Argentina is growing and China prepares to reform state-owned enterprises. The Global Backdrop section explains why the Fed is dovish even when it points to a hike in December, examines the latest trade conflict between the US and UK and ponders wisdom deep and clear about North Korean hope and fear.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.6	–	-1.84%
MSCI EM Small Cap	12.6	–	-1.43%
MSCI Frontier	11.5	–	-0.32%
MSCI Asia	12.0	–	-1.61%
Shanghai Composite	13.0	–	-0.09%
Hong Kong Hang Seng	7.7	–	-1.76%
MSCI EMEA	10.1	–	-2.00%
MSCI Latam	14.1	–	-2.21%
GBI-EM-GD	5.99%	–	-1.55%
ELMI+	3.96%	–	-1.02%
EM FX spot	–	–	-1.37%
EMBI GD	5.20%	286 bps	-0.09%
EMBI GD IG	4.03%	166 bps	-0.17%
EMBI GD HY	6.47%	418 bps	-0.01%
CEMBI BD	4.99%	277 bps	0.05%
CEMBI BD IG	4.05%	184 bps	-0.02%
CEMBI BD Non-IG	6.30%	406 bps	0.13%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.4	–	0.72%
1-3yr UST	1.50%	–	-0.02%
3-5yr UST	1.96%	–	-0.10%
7-10yr UST	2.36%	–	-0.40%
10yr+ UST	2.89%	–	-0.99%
10yr+ Germany	0.49%	–	-0.20%
10yr+ Japan	0.08%	–	-0.72%
US HY	5.45%	347 bps	0.30%
European HY	2.85%	323 bps	0.09%
Barclays Ag	–	250 bps	0.07%
VIX Index*	9.51	–	-0.70%
DXY Index*	93.42	–	0.77%
EURUSD	1.1752	–	-0.82%
USDJPY	112.94	–	1.08%
CRY Index*	183.09	–	-0.48%
Brent	56.7	–	-4.02%
Gold spot	1273	–	-2.89%

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

Emerging Markets

- **Price action:** Last week a bout of volatility afflicted a number of global markets, including EM. Such events should be ruthlessly exploited to buy into EM, in our view. A strong EM recovery is underway, which is backed by valuations, technicals and fundamentals. Investors who do not yet have exposure should use such opportunities to allocate, because they are unlikely to get better opportunities to buy than in such temporary pullbacks. Last week's currency and bond market volatility was triggered by events entirely exogenous to EM itself. The prospect of a Trump tax cut suddenly boosted hopes of stronger US growth. Expectations of fiscal stimulus pushed yields higher in the market for US Treasury bonds, in turn helping to price in a December Fed hike. This enabled the Fed to sound hawkish by signalling an intention to hike in December. The market was poorly positioned for these moves, because neither tax cuts nor a December hike were fully priced just a few weeks ago. Higher growth expectations and Fed hikes also drove the USD higher. In addition, EUR pessimism suddenly re-emerged due to Chancellor Angela Merkel's poorer than expected showing in the recent German election and the market chose, for now, to completely ignore French President Emmanuel Macron's recent strong commitment to meaningful European reform. Finally, some investors took profits after strong moves in EM FX, EUR and the USD in recent months as year-end slowly draws nearer.

We believe that pullbacks, such as those we saw last week are inevitable and ultimately very healthy. Moreover, in the specific environment, which prevails today they are also likely to be short-lived.[1] The reasons are the following:

1. A US tax reform, if it materialises, is likely to be modest in size due to constraints on funding following the failure to repeal Obamacare. Besides, the tax cut is more of a fiscal stimulus than a reform per se in that it looks set to add more to the US debt stock than to the trend growth rate. This should ultimately push the lower long-term equilibrium interest rate (r*) lower and thus support a lower Fed funds rate too.

[1] In a recent publication we highlighted the most likely source of EM volatility in the near-term is investor behaviour in response to hopes of a modest tax reform in the US. We highlighted that the resulting downside is likely to be small due to strong technicals and strong fundamentals. See *'The main risks in EM'*, Weekly Research, 18 September 2017.

Emerging Markets

2. A December Fed hike is now nearly fully priced and the Fed will not want the market to move on to price in any more hikes for fear of unsettling both markets and the economy.
3. Sentiment towards Europe is likely to improve as Merkel forms her government and begins to work with Macron on reforms, though the Catalan referendum will create negative headlines in the short term (see Global Backdrop section for further details). We think the market is too bearish on Germany. For example, if, as looks the case, Finance Minister Wolfgang Schauble becomes the next president of the Bundestag then he will be replaced by someone from FDP. If FDP is put in charge of fiscal policy in Germany then the pro-EU elements of the Merkel coalition will likely run relations with Germany's EU partners, including Macron. This bodes well for progress on European reforms.
4. The European economy continues to look solid, which means that ECB will continue to slowly move towards tapering.
5. The broader backdrop of unwinding the QE trades remains intact: technicals, fundamentals and valuations strongly favour EM.

In conclusion, the pullback in markets last week is the pause that refreshes. These inevitable bouts of volatility are excellent opportunities to leg into the big trades, which will dominate financial markets in the next few years, including long EUR versus USD, long US bonds versus European bonds, long European equities versus US equities and, above all, long the non-QE markets, including EM FX, equities and local bonds versus the QE-sponsored markets.

- Brazil: Recurring tax revenues are now directly responsible for improving fiscal numbers in Brazil. The central government's primary deficit of BRL 9.6bn in August was materially lower than expected (BRL 15.6bn). Expenditures went up modestly, but recurrent revenue, which reflects the underlying economic performance, was the main source of the improvement. The primary deficit is now also on a declining trend on a yoy 12-month cumulative basis. The current account deficit in August narrowed to USD 302m from USD 3.4bn in July and FDI inflows increased to USD 5.1bn from USD 4.1bn in July. The unemployment rate declined to 12.6% in August from 12.8% in July. Foreigners still only own 12.7% of local currency bonds in Brazil, according to new data from Credit Suisse for the month of August.

- Argentina: Industrial production is growing robustly. IP was up at a rate of 5.1% yoy in August compared to -5.7% yoy in the same month of 2016. Argentina has considerable room for private sector growth, but realising this potential requires government spending to be cut back. That is why the Macri Administration's proposal to do a tax reform after the upcoming mid-term election scheduled to be held on 22 October may be good news. Stronger growth has shifted the odds back in favour of the pro-Macri alliance, which is now leading in the polls for the Senate seat for the Province of Buenos Aires, a key position. Meanwhile, the central bank left the policy rate unchanged at 26.25%. Taking a step back, the main problem with Argentina's recovery is that at this still very early stage in the recovery the trade deficit is already ballooning sharply (USD 1.1bn in August from USD 785m in July). Reforms are too slow and fiscal spending is still too high. The combination of tighter monetary policies and massive debt issuance by the government is crowding out private investment, so the supply side of the economy remains too sluggish. The result is a widening of the current account deficit. Argentina is able to attracts hot money, but this money does not stay (it comes mainly for the temporary FX upside). Argentina needs to get much more aggressive about privatisation and a broader reduction in the size of the state. Perhaps once the mid-term election is out of the way…

- China: The main thrust of reforms in China after next month's party congress is becoming clearer. A key focus will be on reform of state-owned enterprises (SOEs). This is a politically challenging task, because SOEs are heavily indebted and employ a lot of people. The value-added tax system will also be made more efficient and China will work to broaden financial markets. China continues to reform in much the same way that most Western economies continue to stimulate using fiscal and monetary policies. The difference between reform and stimulus becomes very obvious in the longer term, when reformers sustain stronger growth rates, while those who merely stimulate demand eventually sink under slowing growth and rising debt levels. As such, we remain very positive about the future for China. Meanwhile, cyclical indicators are also positive at the moment. Official manufacturing PMI rose to a five-year high of 52.4 in September versus 51.6 expected, although the Caixin PMI moderated. This index represents smaller and medium-sized industries better. This may be one of the reasons why the State Council last week cut the reserve requirement ratio for bank lending specifically to smaller and medium-sized businesses in an effort to offset the negative effects of ongoing deleveraging efforts on such companies. In other news, the current account surplus increased to 1.7% of GDP in Q2 2017 from 0.7% of GDP in Q1 2017, according to SAFE. The improvement was driven by a large increase in the merchandise trade balance. China's net international investment position improved 1.1% in the quarter to USD 1.75trn.

- Thailand: Former Prime Minister Yingluck Shinawatra was sentenced to 5 years in jail for corruption. The economic news was also broadly positive. First, the current account balance improved sharply to USD 4.6bn in August from USD 2.8bn in July on the back of very strong exports (15.3% yoy versus 8.0% yoy last month). Secondly, September core CPI inflation was low and unchanged in September at 0.5% yoy (headline CPI inflation 0.9% yoy versus 0.5% yoy consensus. Finally, Bank of Thailand kept the policy rate unchanged at 1.5%.

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Emerging Markets

- **Poland:** FTSE, the index provider, has reclassified Poland as developed economy effective September 2018. No consultations have yet taken place on reclassifying Poland for purposes of the MSCI indices. In other news, President Andrzej Duda is preparing to amend laws aimed at increasing the power of the Executive over the Judiciary in order to bring them into line with EU requirements. Finally, we note that CPI inflation was higher than expected (2.2% yoy versus 2.0% yoy expected).

Snippets:

- **Chile:** Economic activity picked up smartly in August: industrial production increased at a yoy rate of 5.1% versus 3.0% yoy expected.
- **Colombia:** The central bank left the policy rate unchanged at 5.25% in a 5-2 split vote. Two directors favoured a cut.
- **Ecuador:** Real GDP growth was 1.9% in Q2 2017, which is the strongest rate of growth recorded since Q2 2014.
- **Ghana:** The Markit PMI hit the highest level of the index's short history in August, when it reached 56.1 (from 55.7 in July). The index was started in January 2014. The central bank left the policy rate unchanged at 21%.
- **Honduras:** Moody's raised Honduras' credit rating from B2 to B1 and the outlook to stable from positive in recognition of better fiscal performance.
- **Indonesia:** The rate of CPI inflation declined to 3.7% yoy in September from 3.8% yoy in August.
- **Kenya:** The rate of real economic growth increased to 5.0% yoy in Q2 2017 from 4.7% yoy in Q1 2017 despite election-related noise.
- **Mexico:** The central bank left the policy rate unchanged at 7.0% in line with expectations as the trade deficit widened to USD 2.7bn in August from USD 1.5bn in July.
- **Nigeria:** The central bank left the policy rate unchanged at 14%.
- **Pakistan:** The central bank left the policy rate unchanged at 5.75%.
- **Panama:** Moody's changed the outlook for Panama's sovereign credit rating (Baa 2) to positive from stable.
- **Rwanda:** Real GDP growth accelerated to 4.0% yoy in Q2 2017 from 1.7% yoy in Q1 2017.
- **Saudi Arabia:** The ban on women driving cars has been lifted. Car insurance stocks boomed on the news reflecting expectations of more cars and the fact that women are far better drivers than men.
- **Singapore:** Industrial production was 32.3% higher in August on a qoq sa basis, or 19% yoy (versus 16% yoy expected).
- **South Africa:** Credit to the private sector accelerated from 5.7% yoy in July to 6.0% yoy in August and the August trade balance was stronger than expected (ZAR 5.9bn versus ZAR 2.1bn expected).
- **South Korea:** Exports rose dramatically in September. In yoy terms exports were 35% higher than in September of last year, led by semiconductors (+70% yoy). Industrial production was also strong: up at a rate of 2.7% yoy versus 1.3% yoy expected. The rate of CPI inflation declined to 2.1% yoy in September from 2.6% yoy in August.

Global backdrop

The Catalan independence referendum was ultimately a noisy and very expensive opinion poll, which did not expose a major shift in support of Catalan independence. Low and very selective turnout undermined the credibility of the vote. Taking turnout into account, roughly 60% of Catalans still oppose independence, which is in line with long-running poll results, which show about 40% support for independence. About 90% of the 2.26m Catalans, who cast their vote in the unofficial referendum supported independence. This group, 2.03m voters, is 38% of 'eligible' Catalan voters (5.3m). With 60% therefore still appearing not to support independence this referendum result contains very little 'new' news other lurid footage of heavy handed police action during the vote. While such footage may temporarily strengthen the hand of those in favour of independence and even fan fears of rising nationalism in Europe, we expect this effect to be short-lived. Media attention will soon move elsewhere. Besides, the European Union is unlikely to recognise the result, in our view. The Catalan issue is a very local event, which is not reflective of the broader direction of travel in Europe. Indeed, we expect higher level positive developments in Europe to move into focus in the coming year as Merkel and Macron start reforms to strengthen the Eurozone.

The market is now focusing heavily on who will become the next Fed Chairperson. However, we think US monetary policy is now largely endogenous to the conditions, which prevail in the financial markets. This is because Fed QE (and investors chasing QE flows) have pushed asset prices to such bloated levels that

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Global backdrop

meaningful tightening could crash the stock and bond markets. Against a backdrop of a heavily indebted economy with declining productivity and an overvalued currency – and the fact that the Fed still has too little room to cut rates to turn the economy around if the worst should happen – there is every reason to expect the Fed to continue to be well behind the curve regardless of who becomes Fed Chairperson.

This may sound too optimistic. After all, didn't Fed Chairwoman Janet Yellen just last week prepare the market for a December hike? Yes, she did. But we think Yellen's comments should not be confused for hawkishness. If anything, we think the most significant take-away from the last FOMC meeting was that the Fed revised down its long-term equilibrium interest rate forecast from 3.00% to 2.75%. This forecast, also known as r*, is the benchmark against which Fed sets the funds rate. Also, San Francisco Fed Governor John Williams last week proposed that the Fed's 2% target inflation rate be raised. Hence, we think the primary reason why the Fed wants to hike in December is that it can do so with very little risk, since the market has largely priced the hike already. The Fed knows that a recession is coming at some point and desperately wants to get a few hikes done, so that it has room to cut if an economic downturn sets in.

As such, the Fed's problem is that it can only hike if the market prices the hike first. This explains why Fed commentary is generally bullish and quite pro-cyclical: the Fed is consciously exploiting occasional bouts of bullish sentiment to sneak in rate hikes. So far this strategy has worked a treat. However, it is by no means a risk-free strategy. After all, each hike does tighten financial conditions at the margin and eventually the cumulative hikes will be felt in the real economy. Also, the whole notion that the Fed only hikes when markets price in the hike first means that in effect the Fed is taking its cue from the stock market. It is of course no secret that stock markets occasionally exhibit symptoms of bipolarity. Hence, a fit of irrational exuberance in stock markets could conceivably lead the Fed to hike more than warranted only to discover later that the market was wrong and that a policy mistake has been committed. Endogenous monetary policy is a very dangerous thing!

In other global news, the Trump Administration imposed 219% tariff on the Canadian aircraft maker Bombadier's Northern Ireland operation. The UK cannot effectively retaliate on account of the massive subsidies afforded to US airline industry, mainly via defence contracts. The UK government's fragile coalition hinges critically on support from the DUP, a unionist party in Norther Ireland. The DUP will likely demand support from the UK government. If the government refuses it could wreck the Brexit coalition, if it coalesces the fiscal balances will worsen. Perhaps most importantly of all the illusion that the UK can easily enter into trade deals with key partners, such as the US, has been shattered by this development.

Finally, the North Korean situation waxes and wanes. In the latest twist President Donald Trump publicly undermined his own Secretary of State's efforts to find a diplomatic solution to the crisis. Our view remains that a nuclear conflagration will not happen, so spikes in risk aversion directly attributable to the North Korean conflict should be bought. We also like that fact that the market continues to give more weight to the downside risks than the upside risks. Our base case is that the conflict remains frozen, but a North Korean 'grand bargain', which resolves the North Korean issue, is probably more likely than a nuclear conflagration, in our view. A grand bargain would see China remove Kim Jong-un to pave the way for the two Koreas to unify in exchange for the US military pulling out of South Korea. If President Donald Trump agreed to such a deal he would be awarded the Nobel Peace Prize, in our view. Under a grand bargain China's role in Asia would be significantly boosted and the US influence in the region would decline further. Japan and the US military are likely to be strongly opposed to such a grand bargain.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.39%	28.08%	22.87%	5.27%	4.33%
MSCI EM Small Cap	0.05%	22.69%	15.13%	3.35%	4.83%
MSCI Frontier	2.06%	24.82%	25.48%	-1.41%	8.66%
MSCI Asia	-0.13%	31.16%	22.98%	8.19%	7.73%
Shanghai Composite	-0.26%	10.12%	13.76%	14.45%	12.58%
Hong Kong Hang Seng	-3.12%	20.78%	18.43%	5.78%	6.16%
MSCI EMEA	-3.82%	11.99%	14.13%	-0.76%	-1.31%
MSCI Latam	1.58%	27.00%	26.01%	-0.02%	-1.68%
GBI EM GD	-0.34%	14.28%	7.32%	0.26%	-0.91%
ELMI+	-0.63%	9.35%	5.43%	-0.35%	-0.74%
EM FX Spot	-1.09%	5.79%	0.76%	-6.83%	-6.90%
EMBI GD	0.01%	8.99%	4.61%	6.50%	4.91%
EMBI GD IG	-0.22%	8.12%	2.41%	5.13%	3.43%
EMBI GD HY	0.22%	9.93%	7.06%	7.64%	6.79%
CEMBI BD	0.35%	7.23%	5.82%	5.57%	5.02%
CEMBI BD IG	0.10%	5.94%	3.14%	4.46%	4.15%
CEMBI BD Non-IG	0.70%	9.16%	9.97%	7.05%	6.49%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.06%	14.24%	18.60%	10.80%	14.20%
1-3yr UST	-0.17%	0.69%	0.23%	0.76%	0.64%
3-5yr UST	-0.58%	1.58%	-0.51%	1.78%	1.13%
7-10yr UST	-1.38%	2.85%	-3.01%	2.76%	1.50%
10yr+ UST	-2.16%	6.13%	-6.26%	4.74%	2.82%
10yr+ Germany	-1.80%	-3.24%	-9.74%	4.68%	5.25%
10yr+ Japan	-0.61%	-0.41%	-3.71%	4.98%	4.93%
US HY	0.90%	7.00%	8.88%	5.83%	6.36%
European HY	0.56%	5.29%	7.68%	5.66%	8.21%
Barclays Ag	-0.25%	4.46%	2.25%	4.05%	3.92%
VIX Index*	0.00%	-32.26%	-28.44%	-41.15%	-39.47%
DXY Index*	0.37%	-8.60%	-2.14%	9.13%	17.15%
CRY Index*	0.00%	-4.89%	-1.73%	-33.98%	-41.22%
EURUSD	-0.52%	11.71%	4.82%	-7.24%	-9.04%
USDJPY	0.36%	-3.47%	11.11%	4.17%	44.50%
Brent	-1.55%	-0.30%	15.47%	-39.36%	-49.22%
Gold spot	-0.57%	10.47%	-3.04%	4.81%	-28.27%

*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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