Issued: 30 October 2017

WEEKLY INVESTOR RESEARCH

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# All good comes to those who wait in India

By Jan Dehn

Bank recapitalisation in India is a big deal for both growth and prospects of further access to the Indian bond market. By contrast, the news from South Africa is miserable as the fiscal anchor loosens. China's first Dollar-denominated bond since 2004 should have priced inside US Treasuries based on relative fundamentals, in our view. Brazil's parliament dismissed charges against President Michel Temer and attention now shifts to pension reform. The FX commission steps up Dollar auctions in Mexico. Venezuela takes steps to pay 2020 bonds. South Korean growth picks up strongly on exports. Indonesia puts forward a prudent 2018 Budget. Argentina hiked 150bps as the economy picks up against a backdrop of still stubbornly high inflation. Uhuru's mandate in Kenya has a whiff of illegitimacy about it. The threat of Nigeria's excommunication from the MSCI Frontier declines. In the global backdrop the USD and UST swoons extended further, but should run out of steam before too long due to valuations and positioning and investors should use this opportunity to add to Emerging Markets (EM) longs, especially in local currency bonds and stocks. Draghi was dovish and the Catalonia issue remains unresolved.

| Emerging Markets | Next year forward PE/Yield | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| MSCI EM | 11.8 | – | -0.84% |
| MSCI EM Small Cap | 8.0 | – | -0.26% |
| MSCI Frontier | 11.9 | – | 0.80% |
| MSCI Asia | 12.3 | – | -0.31% |
| Shanghai Composite | 13.0 | – | 1.13% |
| Hong Kong Hang Seng | 8.1 | – | 0.74% |
| MSCI EMEA | 10.1 | – | -2.15% |
| MSCI Latam | 14.1 | – | -2.63% |
| GBI-EM-GD | 6.22% | – | -2.17% |
| ELMI+ | 3.99% | – | -0.84% |
| EM FX spot | – | – | -1.66% |
| EMBI GD | 5.25% | 282 bps | -0.31% |
| EMBI GD IG | 4.09% | 162 bps | -0.26% |
| EMBI GD HY | 6.51% | 413 bps | -0.36% |
| CEMBI BD | 5.04% | 272 bps | -0.23% |
| CEMBI BD IG | 4.12% | 181 bps | -0.22% |
| CEMBI BD Non-IG | 6.31% | 398 bps | -0.26% |

| Global Backdrop | Next year forward PE/Yield/Price | Spread over UST | P&L (5 business days) |
|---|---|---|---|
| S&P 500 | 17.6 | – | 0.23% |
| 1-3yr UST | 1.59% | – | 0.00% |
| 3-5yr UST | 2.01% | – | -0.03% |
| 7-10yr UST | 2.39% | – | -0.26% |
| 10yr+ UST | 2.91% | – | -0.69% |
| 10yr+ Germany | 0.38% | – | 0.53% |
| 10yr+ Japan | 0.07% | – | 0.19% |
| US HY | 5.43% | 334 bps | -0.12% |
| European HY | 2.60% | 305 bps | 0.15% |
| Barclays Ag | – | 251 bps | 0.08% |
| VIX Index* | 10.60 | – | -0.47% |
| DXY Index* | 94.68 | – | 0.74% |
| EURUSD | 1.1621 | – | -1.09% |
| USDJPY | 113.61 | – | 0.16% |
| CRY Index* | 187.13 | – | 2.42% |
| Brent | 60.6 | – | 5.70% |
| Gold spot | 1271 | – | -0.90% |

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

## Emerging Markets

- **India:** They say good things come to those who wait. In the case of India, the good just arrived. In a very meaningful policy announcement the government said it will recapitalise public sector banks to the tune of 1.4% of GDP, or USD 32bn. According to the government this will be sufficient to cover losses from all remaining problem loans in the public sector banks. The recapitalisation of public sector banks will have to be followed up by material changes in the management of these institutions to avoid a repeat of the NPL issue when public sector banks were abused by the former Congress-led government resulting in a major quasi-fiscal deterioration. The Modi Administration has undertaken bold reforms and has now finally decided to tackle the banking sector problem. This is extremely good news for India. Firstly, bank recapitalisation was the single largest urgent reform still outstanding in India. Stronger banks will enable corporate and household credit conditions to improve, which should lead to stronger domestic demand-led growth in the coming years. Secondly, once the banking sector is healthy there is no real reason (other than lobbying from interest groups) for India not to grant foreign investors greater access to its bond domestic bond market. This will in turn lead to lower interest rates over the cycle, in our view. The news of bank recapitalisation comes against a backdrop of slowing growth due to GST implementation. The government is working to deal with the teething problems associated with GST and the system should start to function as intended within the next couple of quarters. Meanwhile, Indian inflation is under control as monsoons have been decent, but the Reserve Bank of India is still cautious as the fiscal deficit looks set to widen. This is partly due to bank recapitalisation and partly due to the announcement that the government will spend INR 6trn on infrastructure (mainly roads) over the next five years. In reality, spending will be far less, because India implements infrastructure spending extremely slowly.

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**Emerging Markets**

Still, this is also positive news because the government is clearly acknowledging the need to deal with the country's enormous infrastructure deficit. The bottom-line is that India's medium-term outlook is improving very sharply on the back of Modi's reforms. As GST drags fade, banks get healthier and infrastructure issues are addressed India will be able to realise its enormous potential. The flipside is that the markets tend to take a much more myopic view. Markets may push bond yields and weaken the currency a bit until the upside actually materialises. Stock markets in India are also expensive with many of these developments priced in, so failure on the part of the government to deliver would pose some risk given rich valuations.

- South Africa: The news from Johannesburg was unambiguously negative. The South African Medium Term Budget Policy Statement – a key document setting out the government's fiscal projections – pointed to a material deterioration in fiscal policy with major increases in borrowing requirements for the next couple of years, which will push up the government's debt burden. Revenue projections are also poor as the economy remains sluggish and the Zuma administration seems more concerned with sustaining its support within the ANC by corrupt means than sustaining the South African economy as a whole. The immediate implication of the deteriorating fiscal outlook is that the risk of ratings downgrades is now materially higher. A downgrade could have material implications for South African bonds and the currency, since South Africa would lose investment grade. Moody's and S&P are due to review South Africa on 24 November. There are some silver-linings, however. South Africa is not about to default nor will South Africa have a major balance of payments crisis. South Africa's gross debt to GDP was 51.7% at the end of 2016 compared to, say, 107.5% for the United States. Also, a change in ANC leadership in December could usher in better policies. Hence, the loss of a fiscal anchor may reprice markets, but if markets reprice too far South Africa will be a buy on value grounds. A more material improvement in the economic outlook will require deep reforms. This will probably only happen if fresh blood is injected into South African politics in the shape of a new ruling party. However, this still looks unlikely under the very long and dark shadow still cast by South Africa's apartheid past.

- China: The government issued its first Dollar-denominated sovereign bonds since 2004. The two bonds, a 5-year and 10-year benchmark bond sized at USD 1bn each were priced at 15bps and 25bps over the US Treasury curve. Markets are therefore pricing China as an AAA credit, underlining the biases that are embedded in ratings agencies due to the perverse incentives they face (the biggest debtors are their biggest clients). Despite the narrowness of spreads the bonds look cheap relative to most developed market bonds, in our view. China has far less debt, undertakes reforms instead of stimulus, grows faster, has stronger political leadership and, besides, issues far fewer bonds. Demand for the two bonds exceeded USD 21bn. We understand that the unrated bonds will enter the JP Morgan EMBI GD index, which already harbours 67 sovereign names. The Chinese bonds augment the already very broad suite of risk profiles on offer within the diverse EM external debt universe. They also improve the efficiency of the USD-denominated corporate bond market within China, because corporates can now price bonds off the government curve. In other news, industrial profits accelerated in September (27.7% yoy versus 24% yoy in August). Revenues also improved (11.1% yoy versus 10.1% yoy in August).

- Brazil: The Brazilian parliament dismissed charges of corruption against President Michel Temer, who now has a brief window of opportunity to present a pension reform to parliament for approval before year end. However, it is unclear if the bill will pass. There is very little time and many other bills compete for space in the legislative agenda. Temer is also very unpopular and the charges against him were dismissed with a reduced majority relative to the last time he faced a similar vote. On the other hand, failure to reform now only means that the reform will have to be passed under the next administration, which will pay a high price to do so. Many parliamentarians will therefore understand the logic of passing the reform now and letting Temer take the blame. The next administration will take office after elections scheduled for late 2018. The importance of reforming the pension system is illustrated richly by the dynamics of fiscal deficit. The government has slashed discretionary spending by more than 14% in real terms this year, but social security spending has increased 10.3% over the same period. Hence, statutory social security payments are almost entirely nullifying what is a very serious spending adjustment in the rest of the public sector. Meanwhile, the current account declined to the lowest level since March 2008 (0.6% of GDP in rolling 12-month terms). The current account was in outright surplus to the tune of USD 0.4bn in September versus a consensus expectation of USD 0.3bn).

- Venezuela: Venezuelan sovereign bonds rallied on Friday on news that PDVSA, the national oil company, is taking steps to make an amortisation payment on its 2020 bonds. A principal repayment on the 2017 bonds is due on 2 November. The market prices default ahead of almost every major payment, but the government insists that it will pay and has been true to its word over the last decade despite material deterioration in economic circumstances.

- Mexico: As the Mexican peso continues to be under pressure due to concerns over the future of NAFTA and next year's election the FX commission has announced that it will auction larger amounts of Dollars to the market. Auction amounts will increase from USD 1bn to USD 5bn. MXN is frequently favoured by fast money as a way to play short-term sentiment towards EM due to great liquidity in the Mexican market. During periods of uncertainty pertaining to Mexico specifically the volatility can become considerable with potential spill over to domestic economic sentiment and inflation (in the short run). This is why the government has an FX

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## Global backdrop

intervention programme. It is purely intended to reduce volatility, not to change the direction of the currency. In other news, the trade deficit was USD 1.9bn in September versus an expectation of a deficit of USD 1.3bn. On a 12-month rolling basis the September deficit was also marginally wider at USD 9.9bn versus USD 9.5bn in August. On the other hand a little goldilocks situation is emerging with respect to growth and inflation. The monthly GDP proxy (IGAE) expanded at a yoy rate of 2.3% in August, up from 1.1% yoy in July, while the rate of inflation continued to decline to 6.32% yoy in H1 October from the peak in August of 6.66% yoy.

- South Korea: At 3.6% yoy, Q3 real GDP growth was materially stronger than expected (3.0% yoy). Exports have been particularly strong reflecting a wider trend across EM in response to Dollar strength in recent years. We expect domestic demand also to pick up in the coming year, so the Bank of Korea is eyeing rate hikes. In addition to the strong growth numbers there was also positive news that that Chinese tourism to Korea has resumed. Korean stocks rallied strongly in response. Recent tensions over deployment of US missiles in South Korea appear to be fading following a meeting of senior officials from both countries and an extension of a currency swap arrangement between the central banks of the two countries. In other news, the government announced prudency policy guidelines, which require borrowers to be evaluated with respect to their debt service capabilities and total loan burdens with respect to income. The measures are introduced to ensure that household debt levels do not get out of control.

- Indonesia: The government's draft budget for 2018 is pencilling in a reduction in the fiscal deficit to 2.2% of GDP from 2.7% of GDP this year. The savings will be on the expenditure side, where subsidies and transfers to local governments will be reduced. The budget is based on a real GDP growth assumption of 5.4% and an oil price of USD 48 per barrel. Both are conservative assumptions.

- Argentina: The central bank hiked the policy rate by 150bps to 27.75% following a pickup in economic indicators, while inflation remains elevated. Core CPI is still running at a hefty rate of 1.6% per month with inflation expectation tough to break, because the government has continued to stimulate fiscal policy in a bid to maintain its popularity. Economic activity was strong in August with the EMEA monthly GDP proxy increasing at a rate of 4.3% yoy, while consumer confidence also improved in October (51.1 versus 51.0 in September). The stronger economy is finally beginning to help the public finances. The primary deficit for September was therefore materially better than at the same time last year (ARS 31.3bn versus ARS 37bn in September 2016).

- Kenya: The re-run of the Kenyan presidential election will likely put incumbent President Uhuru Kenyatta back into the presidency, but a widely observed boycott by opposition supporters means that his legitimacy as president will be weaker than under normal circumstances. The result of the election will be announced this week. The election was overseen by the same election commission, which messed up the previous election. This precipitated a ruling by the Supreme Court that the election result was null and void. In addition to the result itself market participants will therefore also be paying attention to how the Supreme Court will rule with respect to this latest attempt at democracy in Kenya. Greater activism by the Kenyan courts is clearly welcome news for the longer term, because it reduces impunity at the level of the Executive, but a weaker and less legitimate Executive is clearly bad news for the near term.

- Nigeria: MSCI has removed its threat to place Nigeria on standalone basis, i.e. de facto excommunication from the MSCI Frontier Equity index. MSCI cites improvements in the FX market. FX market intervention triggered Nigeria's excommunication from JP Morgan's GBI EM GD index for local currency bonds.

Snippets:

- Botswana: The central bank cut the policy rate by 50bps to 5%.
- Hungary: The central bank kept the policy rate unchanged at -0.15%.
- Malaysia: The draft 2018 Budget is prudent as the fiscal deficit is projected to decline to 2.8% of GDP from 3.0% of GDP this year.
- Namibia: The central bank left the policy rate unchanged at 6.75%.
- Poland: The rate of unemployment dropped to 6.8%, which is the lowest level since 1991.
- Russia: Bank of Russia cut the policy rate by 25bps to 8.25%. The rate cut was accompanied by a characteristically prudent commentary as the central bank emphasised that it still regards inflation expectations as elevated.
- Singapore: September industrial production increased at a solid rate of 14.6% yoy versus a consensus expectation of 10% yoy.
- Taiwan: Industrial production expanded at a strong rate of 5.2% yoy in September. The market had expected even stronger at 5.4% yoy.
- Turkey: The monetary policy committee left all the main policy rates unchanged, but sounded more hawkish in its written statement with a promise to keep rates at current levels until inflation shows improvement. The hawkish forward guidance is good news, because the core inflation rate in Turkey is high at 10.98% yoy.

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## Global backdrop

In Europe, the EUR sank sharply in trading last week as ECB President Mario Draghi announced that QE will be scaled back by 50% from EUR 60bn per month to EUR 30bn per month starting in January and that the policy of negative interest rates will be continued well beyond the end of QE. The market had expected a more hawkish set of messages from Draghi. Meanwhile, nationalism reared its ugly head once more in Europe, the world's most tribal and violent continent. Catalonia declared independence and Spain said it would impose direct rule and level rebellion charges against the secessionists. This is a localised issue, which will not spread to other countries, but it nevertheless underlines the basic fact that no country – developed or EM – should be regarded as risk free. The notion that some countries are risk free by convention is a religious construct with zero foundation in reality.

Against this backdrop the Dollar rallied and US Treasury yields move higher. Strong tech earnings, hopes for tax reform and generally stronger US data also helped. The only problem is that so much good news has been priced into the US markets after years of QE and heavy positioning that the upside is rather limited. Therefore we do not expect the momentum to continue for very long, perhaps not even beyond the current quarter. Investors should use this temporary bounce in US sentiment to add to EM trades at marginally improved valuations, especially in local markets, in order to take advantage of much better return prospects in the next few years.

Both the Fed and the ECB are now tapering, so what will be the main similarities and differences in terms of how they normalise monetary policy in the coming years? First, both central banks basically face the same two fundamental constraints to normalising policy, namely (a) they do not have enough ammunition in case they get a recession and (b) they risk triggering large asset price collapses (stocks in the US, bonds in Europe) if they normalise rates too quickly. Secondly, the core strategies of both central banks will be to scale back QE, i.e. gradually taking the steam out of asset price bubbles, before hiking rates materially. This is the sensible sequencing as long as inflation is low and as long as they do not have enough ammunition to cure a recession. Thirdly, they will differ with respect to rates only to the extent that the Fed will opportunistically hike if and only if the market actually prices in a hike, while the ECB has clearly committed itself to not raising rates until QE is over. This difference with respect to rates policy is possible, because (a) the US has a strong banking sector and Europe does not (the US recapitalised banks early, while Europe never did) and (b) Europe cares about solvency issues in its indebted periphery, while the US does not (e.g. Puerto Rico). Ultimately the difference in the ECB and Fed's approaches to the periphery boils down to the fact that US is a fully matured currency zone, while the Eurozone is not. Anyway, the bottom line is that the only difference between the Fed and the ECB is that the former implements opportunistic hikes, while the latter does not. Since rate hikes are actually quite risky at this late stage in the business cycle in the context of such inflated asset prices it follows that the US outlook is ultimately riskier than the European outlook due to the greater risk of policy mistakes in the US. On the other hand, there may be rewards too in that the Dollar can move sharply higher during brief periods of growth optimism, such as now, when the market readily prices in a rate hike or two. The other implication is that Europe will continue to experience easier financial conditions, while is ultimately better for growth, wherefore European stocks should do better, at the margin, than US stocks as financial conditions tighten in the US, unless, of course, a miracle of productivity growth occurs in the US.

## Benchmark performance

| Emerging Markets | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| MSCI EM | 2.68% | 31.52% | 25.83% | 7.14% | 5.11% |
| MSCI EM Small Cap | 2.63% | 25.92% | 19.09% | 5.59% | 5.72% |
| MSCI Frontier | 1.97% | 27.28% | 27.78% | 0.80% | 9.10% |
| MSCI Asia | 3.73% | 36.06% | 28.95% | 9.92% | 8.72% |
| Shanghai Composite | 2.03% | 12.36% | 12.05% | 16.42% | 13.25% |
| Hong Kong Hang Seng | 6.72% | 28.90% | 26.04% | 8.09% | 6.24% |
| MSCI EMEA | 0.23% | 12.24% | 15.81% | -0.31% | -0.93% |
| MSCI Latam | -2.17% | 24.25% | 12.75% | 1.75% | -2.19% |
| GBI EM GD | -3.06% | 10.78% | 5.34% | -1.19% | -1.62% |
| ELMI+ | -0.90% | 8.37% | 5.47% | -0.58% | -0.93% |
| EM FX Spot | -2.33% | 3.33% | -0.66% | -7.40% | -7.26% |
| EMBI GD | 0.06% | 9.05% | 5.76% | 6.06% | 4.72% |
| EMBI GD IG | -0.14% | 7.96% | 3.56% | 4.41% | 3.25% |
| EMBI GD HY | 0.24% | 10.20% | 8.17% | 7.67% | 6.55% |
| CEMBI BD | 0.17% | 7.41% | 5.96% | 5.34% | 4.78% |
| CEMBI BD IG | -0.07% | 5.86% | 3.53% | 4.07% | 3.89% |
| CEMBI BD Non-IG | 0.51% | 9.72% | 9.68% | 7.10% | 6.23% |

*Continued overleaf*

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## Benchmark performance

| Global Backdrop | Month to date | Year to date | 1 year | 3 years | 5 years |
|---|---|---|---|---|---|
| S&P 500 | 2.55% | 17.16% | 23.50% | 11.89% | 15.21% |
| 1-3yr UST | -0.10% | 0.59% | 0.28% | 0.59% | 0.63% |
| 3-5yr UST | -0.28% | 1.29% | -0.22% | 1.29% | 1.15% |
| 7-10yr UST | -0.58% | 2.26% | -1.91% | 1.87% | 1.54% |
| 10yr+ UST | -1.17% | 4.89% | -2.91% | 3.33% | 2.81% |
| 10yr+ Germany | 0.48% | -2.78% | -4.17% | 4.25% | 5.69% |
| 10yr+ Japan | -0.06% | -0.46% | -3.21% | 4.82% | 4.95% |
| US HY | 0.37% | 7.40% | 8.36% | 5.58% | 6.24% |
| European HY | 0.94% | 6.28% | 7.41% | 5.97% | 7.95% |
| Barclays Ag | 0.35% | 4.83% | 3.45% | 3.82% | 3.82% |
| VIX Index* | 11.46% | -24.50% | -34.53% | -27.00% | -40.48% |
| DXY Index* | 1.72% | -7.37% | -3.73% | 9.90% | 18.45% |
| CRY Index* | 2.21% | -2.80% | -1.10% | -31.38% | -36.96% |
| EURUSD | -1.63% | 10.50% | 5.83% | -7.86% | -10.32% |
| USDJPY | 0.98% | -2.86% | 8.39% | 4.03% | 42.67% |
| Brent | 5.39% | 6.72% | 21.99% | -29.68% | -44.41% |
| Gold spot | -0.70% | 10.74% | -0.51% | 6.00% | -25.67% |

*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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