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WEEKLY INVESTOR RESEARCH

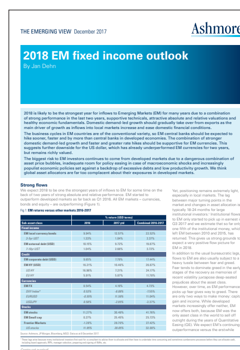
Ashmore

Announcement:

We wish all readers a Happy New Year!

This is the last issue of Ashmore's Weekly Investment Research in 2017. Publication will resume on 8 January 2018.

The 2018 Emerging Markets (EM) fixed income outlook is available here:



Risk and volatility in EM

By Jan Dehn

The most obvious expression of inefficiency in the EM asset class is that EM bonds have beaten US stocks for a quarter of a century. Still, investors still have far more money in US stocks than in EM bonds. Much of the reluctance to increase EM exposure to rational levels revolves around fears about price volatility. Yet, EM bonds have also had lower volatility than US stocks. Besides, volatility is not the same as risk, especially in EM countries, where risks are often poorly priced and typically overstated. Exploiting this inefficiency requires a special approach to investing. We explain why and how.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.1	–	0.71%
MSCI EM Small Cap	12.9	–	1.63%
MSCI Frontier	12.1	–	-0.09%
MSCI Asia	12.7	–	0.52%
Shanghai Composite	12.7	–	-0.73%
Hong Kong Hang Seng	7.8	–	0.68%
MSCI EMEA	10.4	–	1.83%
MSCI Latam	13.5	–	0.52%
GBI-EM-GD	6.18%	–	0.24%
ELMI+	3.08%	–	0.24%
EM FX spot	–	–	0.21%
EMBI GD	5.25%	289 bps	0.42%
EMBI GD IG	4.03%	165 bps	0.20%
EMBI GD HY	6.55%	421 bps	0.63%
CEMBI BD	5.05%	275 bps	0.10%
CEMBI BD IG	4.15%	185 bps	0.08%
CEMBI BD Non-IG	6.26%	395 bps	0.12%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.2	–	0.95%
1-3yr UST	1.85%	–	-0.03%
3-5yr UST	2.17%	–	-0.03%
7-10yr UST	2.37%	–	0.26%
10yr+ UST	2.70%	–	1.46%
10yr+ Germany	0.30%	–	0.35%
10yr+ Japan	0.04%	–	0.19%
US HY	5.74%	350 bps	0.03%
European HY	2.96%	362 bps	-0.02%
Barclays Ag	–	254 bps	0.39%
VIX Index*	9.42	–	-0.16%
DXY Index*	93.85	–	-0.02%
EURUSD	1.1772	–	0.03%
USDJPY	112.67	–	-0.79%
CRY Index*	184.52	–	-0.49%
Brent	63.7	–	-1.61%
Gold spot	1257	–	1.19%

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

Emerging Markets

If you invested one Dollar in EM external debt 25 years ago you would have USD 12.4 today.[1] If you had instead put the same Dollar into the S&P 500 you would only have USD 10.1 today. Moreover, you would have suffered less volatility in your EM investment than in your S&P 500 exposure, since the volatility of the EM external debt has only been 11.8% over the period compared to 14.2% for the S&P 500. These simple facts – that returns have been higher and volatility lower in EM external debt than in the S&P 500 – illustrate the shocking degree of inefficiency, which characterises global financial markets, especially with respect to EM. Investors clearly ought to have had more money invested in EM bonds than in US stocks over in the last quarter of a century. The simple fact that they did not is one of the main reasons why EM investments perform so well. After all, when investors do not buy enough bonds then yields remain excessive relative to

[1] This analysis is based on JP Morgan's EMBI GD benchmark index. This is the market's preferred benchmark for EM external debt. The index has 67 countries and a track record, which dates back 25 years.

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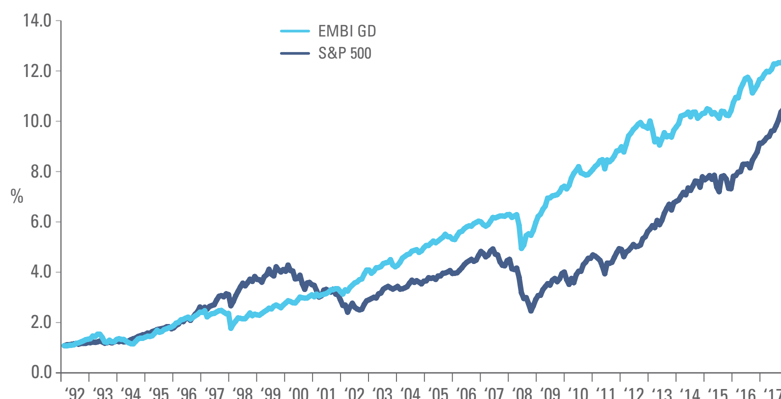
Emerging Markets

the risk. We were able to quantify this inefficiency in a recent report, where we showed that since 1998, investors in EM external debt have been paid a whopping 350bps spread over Treasuries *after subtracting all default related losses*, that is, a *de facto* risk-free spread of 350bps per year. It is hardly surprising returns have been so good over the long term when the asset class pays such a high risk free spread every year. What is far more shocking is that the finance industry – one of the best informed and most educated in the world – still clings so tenaciously to outdated and irrational notions of the riskiness of the EM asset class.

Fig 1: **If you invested one Dollar in 1992…**

Total return on a Dollar invested in EM external debt and S&P 500 in 1992 (in USD terms)



Source: Ashmore, JP Morgan, Bloomberg (data as of 15 December 2017).

This means that prices often fall far further even than what is justified by the erosion of fundamentals. The Crimea Crisis in 2014 was a perfect example. Markets quickly pushed Russian sovereign bond spreads out to more than 720bps over Treasuries in what can only be characterised as a fit of total panic. Caught up in this emotional experience even experienced EM investors completely forgot that Russia had – and still has – extremely strong credit fundamentals, a strong President and very orthodox policy-makers. Unsurprisingly, less than a year after spread spiked they were back to 250bps over Treasuries and today Russia trades 184bps over Treasuries.[2] The lowest Russia has traded in spread terms is 92bps over Treasuries back in 2005.

How, then, given the inefficiency, should investors think about identifying risk and opportunity in EM? First, investors should closely follow the price action. They should recognise that asset prices respond not just to local and global events, but that asset prices are often a very poor guide to actual riskiness and that sell-offs are – as a general rule – a signal that buying opportunities are emerging. Similarly, EM markets can be overbought and investors should be prepared to reduce exposure when leveraged and other momentum-type investors get involved in the later stages of market cycles. Second, investors should religiously pay attention to individual credit fundamentals. Political and economic fundamentals – that is, the factors which influence ability and willingness to pay – are the best possible indicators of actual riskiness. Thirdly, investors should juxtapose the price action and the fundamental analysis to identify value. Simple regional generalisations, fads (e.g. BRICS) and other simplistic types of analysis are not recommended. Hence, we generally do not favour regional specific investments. Sure, there are important broad differences *between* regions in EM, but typically the differences between countries within region are far greater than the broad differences between regions. Think Chile versus Venezuela, China versus India, and Russia versus Czech Republic. In any case, opportunity is not solely about fundamentals, rather it about pricing versus fundamentals and each individual opportunity must be assessed on its own merits.

The aim of any assessment of EM sovereigns is to generate as realistic an assessment of the risk as possible. This is critically important, because the sovereign risk assessment forms the basis for identifying value. Value is the difference between what is priced in and what is actually going to happen. It can only be identified properly if the risk assessment is correct. Indeed, the price, say a sovereign spread, is meaningless in itself without an understanding of the credit fundamentals. When it comes to assessing sovereign riskiness conceptually, EM sovereigns generally fall into four broad risk categories according to their handling of the economy, notably demand-side and supply-side management. In ascending order of riskiness:

- Lowest risk: The majority of EM countries fall into this category. These are countries, where governments undertake structural reforms when the need arises, while at the same time managing the business cycle – monetary and fiscal policies – in an orthodox manner. There are many countries in this category including Mexico, China, South Korea, Indonesia, India, Thailand, Philippines, etc.

[2] Ashmore was one of the few EM asset managers to recommend buying Russia in December 2014. See "Russia: Macroeconomic Overview", Market Commentary, 18 December 2014.

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Emerging Markets

- **Low risk:** A smaller number of EM countries fall into this category. These are countries, which continue to manage aggregate demand in a sound manner through prudent monetary and fiscal policies, but where the attention to structural reforms has become neglected, often for political reasons. South Africa would be case in point. The ANC has been in power for too long, so the reform momentum has stopped, but the South African Reserve Bank and the Treasury continue to be well managed, so macroeconomic stability is not really in serious jeopardy. Russia is also a good example.
- **Medium risk:** This is a very small group of countries. They are characterised not just by lack of reform, but also by an increasing propensity to compensate for slowing growth rates by overreliance on fiscal and/or monetary stimulus. This tends to lead to overheating and ultimately macroeconomic instability. Turkey falls into this category. Brazil was in this category prior its crisis a few years ago.
- **High risk:** These are countries, which have graduated from the 'medium risk' category by imposing draconian supply-side interventions such as capital, controls, price controls, pension fund nationalisations, confiscation of private property and other coercive measures in order to attack the symptoms of excess demand stimulus and inadequate reforms. Argentina under Christina Kirchner, Zimbabwe under Mugabe and Venezuela today fall into this category.

Here, then, is the key point about value investing: the risk assessments listed above only form one part of the process of value investing, namely the benchmark against which value opportunity is assessed. Investors can profitably take exposure to *all* countries in the four categories listed above, not just in the low to medium risk categories. The value opportunity depends on the riskiness *relative* to the price. Hence, countries in the higher risk categories may be a greater risk of, say, default, but if their bonds are already pricing default with an overly pessimistic recovery rate then investors can still generate major alpha by going long. In short, the value investment principle applies to all credits, regardless of their quality.

- **Chile:** Sebastian Pinera is Chile's next President after winning a stronger than expected victory in Sunday's run-off election against Alejandro Guillier. Pinera's win means that yet another Latin American government has turned its back on populism in favour of more reform-minded government following similar developments in Mexico, Argentina and Brazil.

- **India:** Prime Minister Modi's BJP won elections in both Gujarat and Himachal Pradesh. This means that Modi's reform drive remains in place. In practice, this means that public sector bank recapitalisation continues although the Modi Administration's focus should now gradually switch to the parliamentary elections scheduled for 2019. In other news, Indian CPI inflation rate climbed to 4.9% yoy in November compared to 4.3% yoy in October, but three quarters of the move in prices was caused by vegetable prices, which are volatile on account of unseasonal rains. Vehicle sales rebounded strongly in November. The current account deficit narrowed to USD 7.2bn in Q3 2017 from USD 15bn in Q2 2017 and exports rose strongly (30.6% yoy) in November.

- **Peru:** The presidency of Pedro Pablo Kuczynski (PKK) suddenly looks very shaky following a report from a commission investigating graft stated that PKK had links to Odebrecht, a corruption-riven Brazilian construction company. On Friday the Peruvian congress voted overwhelmingly in favour of a motion to remove PKK. PKK will present his defence this week. His removal, if confirmed, would likely usher in early elections with Keiko Fujimori, opposition leader, poised to win. We would not expect major changes in economic policies as a result. In other news, the monetary policy committee of the Peruvian central bank left the main policy interest rate unchanged at 3.25%.

- **South Africa:** ANC, the political party ruling South Africa, is in the final stages of selecting a new president with a result expected shortly. The choice stands between Cyril Ramaphosa and Nkosana Dlamini-Zuma. The former stands for institutional integrity, reforms and prudent macroeconomic policies, while Dlamini-Zuma is seen as a populist candidate. As such, the result will be keenly watched by the market. In other news, the rate of headline CPI inflation declined to 4.6% yoy in November from 4.8% yoy in October. Eskom, the national power company, was given permission to raise prices 5.2%, which is less than the company needs, but also reduces inflationary pressures.

- **Argentina:** The government suffered a setback in failing to pass a social security reform in the Lower House. The Senate has passed the bill and the Administration of President Macri can yet resort to passage via degree, but it is expected that a fresh attempt to pass the reform will be made this week. Meanwhile, the central bank left the policy rate unchanged at 28.75%. Inflation was 1.4% in the month of November. The government announced that it will tax foreign investments in the Lebac central bank paper at a rate of 5%. This is done in a bid to ensure that Lebacs are used for their intended purpose, namely domestic liquidity management. To offer a viable alternative instrument to investors the government last week issued USD 1.7bn in treasury notes of various maturities up to one year.

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Emerging Markets

- **Brazil:** Core and broad retail sales rose at a rate of 2.5% yoy and 7.5% yoy in October. The central bank's monetary policy committee minutes signalled a further cut of 25bps in upcoming meetings. The Porto Alegre appeals court will decide on former President Lula's appeal of his conviction on corruption charges on 24 January 2018. If the appeals court upholds the conviction then Lula can still appeal to a high court, but he would be barred from running for office.
- **China:** China's banking regulator (CBRC) says China will continue to open the banking sector including greater foreign involvement. The rate of total credit growth slowed to 13.6% yoy in November from 13.9% yoy in October. Fixed asset investment and industrial production slowed marginally in November, while retail sales picked up moderately. This is the broad direction of change the government is trying to encourage.
- **Venezuela:** President Nicholas Maduro threatened to exclude opposition parties from the upcoming general election unless they participate in local elections. The Latin American Development Fund (CAF) extended a USD 400m credit line to Venezuela's central bank. PDVSA, the national oil company, said on Friday that it has begun to pay coupons on bonds maturing in 2021, 2024, 2026 and 2035. This means that PDVSA has now announced payment on bonds with due payments.
- **Philippines:** The Senate and House of Representatives versions of the tax reform have now been reconciled, so the bill should be signed into law by President Duterte this week. The country's trade deficit widened to USD 2.845bn in October from USD 1.915bn in September. The central bank left the policy rate unchanged at 3%.

Snippets:

- **Colombia:** The current account deficit narrowed to USD 2.6bn in Q3, down from USD 3.6bn in Q3 2016. S&P Global Ratings cut Colombia's sovereign credit rating to one notch above investment grade (BBB-) with stable outlook.
- **El Salvador:** The country's sovereign credit outlook was raised to positive by S&P Global Ratings.
- **Indonesia:** Bank Indonesia left the policy rate unchanged at 4.25% as the trade surplus narrowed to USD 100m in November from USD 1bn in October.
- **Lebanon:** Prime Minister Hariri invited Hezbollah to a national dialogue in a bid to reduce tensions.
- **Malaysia:** Industrial production was 3.4% higher in October compared to a year prior.
- **Mexico:** Industrial production disappointed in August, declining 0.1% in the month relative to expectations of a rise of 0.7%.
- **Romania:** The rate of inflation increased to 3.2% yoy in November from 2.6% yoy in October as the current account swung into deficit of EUR 578m in October compared to a surplus of EUR 50m in October 2016.
- **Russia:** The Russian central bank cut the policy rate by 50bps to 7.75% with the possibility of further cuts in H1 2018. The cut was larger than expected (25bps).
- **Singapore:** November non-oil domestic exports increased at a rate of 9.1% yoy versus 6.4% yoy expected.
- **Turkey:** The Central Bank of Turkey left the policy rate unchanged at 8% and only raised the late liquidity rate by 50bps, which was lower than expected. The Turkish Lira weakened as a result.

Global backdrop

Sentiment in the US stock market was buoyant last week on mounting expectations that the Trump tax cut will be approved. Still, the political outlook could become somewhat cloudier once the euphoria surrounding the tax bill has died down. First, Democrat Doug Jones's surprise win over Republican Roy Moore in the Senate race in Alabama (a strongly Republican state) suggests that not all Republicans are happy with the Alt-right movement, which strongly supported Trump last year. Second, the tax cut is unlikely to have much impact on the economy or Trump's white blue collar electoral base. Indeed, it may even reinforce perceptions that Washington looks after its own as it becomes clearer that the bill is basically a major payday for Trump and Republican corporate campaign sponsors. Third, the Robert Muller inquiry into illicit ties between the Trump campaign and Russia could gather steam. The Republicans only hold a narrow 51-49 majority in the Senate ahead of next year's congressional election.

In other US news, the Fed hiked 25bps in line with expectations. The hike was almost 100% priced in and did not move markets. However, the FOMC's failure to project higher future inflation despite marginally stronger growth expectations stoked some concerns. After all, the low inflation forecast followed an outright decline in the rate of CPI inflation to 1.7% yoy in November from 1.8% yoy in October and lower than expected unit labour costs and hourly earnings in the recent labour market report. Low inflation matters, because long bond

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Global backdrop

yields have moved much lower recently, so low, in fact, that many investors simply do not want to buy bonds. This raises the spectre of a Keynesian Liquidity Trap far out the yield curve. Clearly, if yields cannot fall much further the effectiveness of QE is reduced, should it be needed again. The Fed could still buy stocks, of course, but this would only blow more hot air into the stock market bubble without clear evidence that this would help the economy. Indeed, it might discourage investors from putting money into the real economy.

Finally, the US Federal Communications Commission has scrapped net neutrality. This means that internet service providers (ISPs) can block, slow or accelerate customer access to websites and applications. In addition to increasing the potential for political manipulation the abolishment of net neutrality creates much more room for vertical integration within the ISP business, i.e. increase the scope for monopolistic behaviour on the part of ISPs with the result that consumers have less choice and get less value for money.

In the UK, Tory rebels inflicted a stinging defeat on the May Administration, which was forced to grant members of parliament a vote on a final Brexit deal. This took place as inflation drifted higher than the 3% threshold. UK growth is also slowing, so real incomes are declining for large sections of the population, especially those who supported Brexit. Unsurprisingly, polls are now showing a majority of Brits in favour of remaining within the European Union. Clearly, the UK government must now turn the economy around while keeping a deeply divided Cabinet unified amidst complex trade negotiations before the final vote on the Brexit deal comes around, or risk defeat. Against this backdrop the Bank of England left the policy rate unchanged.

In Europe, German PMI was very strong and flash PMIs for the Eurozone for December were also strong. This suggests that the positive economic momentum in Europe is continuing. Still, the ECB left the policy rate unchanged and President Mario Draghi continues to believe inflation will remain below the target for the forecast horizon, regardless of a generally upbeat growth assessment.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.18%	32.64%	33.66%	9.45%	4.18%
MSCI EM Small Cap	-0.86%	28.13%	28.36%	7.79%	5.12%
MSCI Frontier	1.14%	29.29%	30.86%	5.74%	8.91%
MSCI Asia	-0.20%	37.97%	37.08%	10.72%	7.71%
Shanghai Composite	-1.54%	7.40%	6.92%	5.38%	11.33%
Hong Kong Hang Seng	-0.96%	25.82%	24.71%	4.27%	4.08%
MSCI EMEA	-0.47%	16.47%	20.60%	5.84%	-1.13%
MSCI Latam	-0.08%	18.69%	23.68%	5.14%	-3.45%
GBI EM GD	-0.08%	12.84%	14.73%	2.09%	-1.82%
ELMI+	-0.20%	10.31%	10.73%	2.02%	-0.73%
EM FX Spot	-0.46%	4.38%	5.51%	-4.74%	-7.15%
EMBI GD	0.61%	10.12%	11.38%	8.05%	4.62%
EMBI GD IG	0.35%	9.19%	10.16%	5.75%	3.25%
EMBI GD HY	0.86%	11.12%	12.69%	10.89%	6.31%
CEMBI BD	0.20%	7.83%	8.57%	6.54%	4.66%
CEMBI BD IG	0.16%	6.24%	6.94%	4.70%	3.84%
CEMBI BD Non-IG	0.25%	10.20%	11.01%	9.52%	5.89%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.14%	21.86%	20.69%	12.71%	15.99%
1-3yr UST	-0.01%	0.39%	0.69%	0.58%	0.56%
3-5yr UST	0.01%	1.03%	1.78%	1.23%	1.01%
7-10yr UST	0.53%	2.92%	4.34%	1.69%	1.50%
10yr+ UST	2.53%	9.51%	11.35%	3.09%	3.44%
10yr+ Germany	1.30%	-0.46%	2.37%	3.35%	5.61%
10yr+ Japan	0.27%	0.40%	1.21%	4.16%	5.10%
US HY	0.09%	7.27%	7.86%	7.03%	5.77%
European HY	-0.22%	5.77%	6.24%	5.67%	7.10%
Barclays Ag	0.76%	5.86%	7.08%	3.97%	3.90%
VIX Index*	-16.49%	-32.91%	-22.79%	-43.96%	-39.50%
DXY Index*	0.86%	-8.18%	-8.84%	5.17%	18.26%
CRY Index*	-2.46%	-4.15%	-3.61%	-22.43%	-37.57%
EURUSD	-1.11%	11.90%	13.17%	-4.18%	-11.01%
USDJPY	0.12%	-3.70%	-3.77%	-5.19%	33.80%
Brent	0.13%	12.02%	15.29%	7.39%	-41.52%
Gold spot	-1.43%	9.07%	10.45%	4.84%	-24.79%

*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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