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Ashmore

Contagion!

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The plunge of the Turkish lira has immediately led to cries of contagion. But what is contagion and how to trade it? It turns out that there are two types of contagion. One is dangerous, the other is replete with opportunity. The volatility surrounding Turkey is very much an example of the latter, but you need to be active to take full advantage.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.5	–	-0.99%
MSCI EM Small Cap	10.6	–	-1.43%
MSCI Frontier	10.2	–	-2.42%
MSCI Asia	11.5	–	1.02%
Shanghai Composite	9.8	–	2.05%
Hong Kong Hang Seng	7.0	–	2.33%
MSCI EMEA	7.5	–	-5.62%
MSCI Latam	11.1	–	-6.67%
GBI-EM-GD	6.70%	–	-3.50%
ELMI+	4.75%	–	-1.89%
EM FX spot	–	–	-2.90%
EMBI GD	6.50%	363 bps	-1.31%
EMBI GD IG	4.84%	196 bps	-0.38%
EMBI GD HY	8.43%	558 bps	-2.26%
CEMBI BD	6.10%	328 bps	-0.70%
CEMBI BD IG	4.83%	201 bps	0.00%
CEMBI BD Non-IG	7.70%	488 bps	-1.56%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.9	–	-0.18%
1-3yr UST	2.59%	–	0.15%
3-5yr UST	2.72%	–	0.36%
7-10yr UST	2.85%	–	0.74%
10yr+ UST	3.02%	–	1.43%
10yr+ Germany	0.31%	–	1.27%
10yr+ Japan	0.10%	–	0.12%
US HY	6.26%	337 bps	0.12%
European HY	3.45%	416 bps	0.09%
Barclays Ag	2.02%	-83 bps	-0.11%
VIX Index*	14.72	–	3.45%
DXY Index*	96.48	–	1.12%
EURUSD	1.1374	–	-1.56%
USDJPY	110.23	–	-1.05%
CRY Index*	191.69	–	-1.54%
Brent	72.5	–	-1.65%
Gold spot	1205	–	-0.21%

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

Emerging Markets

Contagion!

The Turkish lira's plunge has been dramatic! So dramatic, in fact, that the other high beta Emerging Markets (EM) currencies also pulled back as did EURUSD, USDJPY and US stocks, while US Treasury bonds rallied. In other words, all the signs of classic risk aversion, but with the added twist that since Turkey, an EM country, is the anchor for this particular event the media was soon out in force with shrill cries of contagion. Contagion! Hardly is this word out when a vast image of *Spiritus Oeconomicis* troubles the sight of investors! But what is contagion and how should investors position themselves when it occurs?

Soros style contagion

In fact, there are two distinct types of contagion in the context of EM investing. The original version of contagion was common during the Cold War period. It is closely associated with the concept of 'reflexivity' as popularised by veteran investor George Soros. Soros observed that the widely held belief at the time that bad fundamentals caused EM crises simply did not fit the facts. Instead, he observed, perfectly healthy EM economies could suddenly find themselves in big economic trouble solely due to events taking place in global financial markets. In other words, Soros argued that causality runs from financial market volatility to economic crisis, not *vice versa*.

It should be obvious that Soros' reflexivity, to the extent it happens, is an extremely serious matter for EM countries. After all, it implies that EM economies can be plunged into economic collapse regardless of how well they manage their own affairs. Moreover, if one country were to fall then other EMs could quickly follow, hence contagion. The EM crises of 1997 and 1998 were important examples of Soros style contagion, because financial shocks spread across disparate EM economies and ended up causing a string of economic crises.

Fortunately, the EM crises of the late 1990s were also the last time EM experienced Soros-style contagion. To understand why Soros style contagion is no longer with us, it's insightful first to examine why it happened in the first place.

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Emerging Markets

The importance of domestic markets

Soros style contagion requires one specific condition to be satisfied across a large number of large EM countries at the same time, namely that they must have few or no domestic savings institutions. To see why the existence of domestic savings institutions, such as pension funds, are so important in limiting the impact of global financial instability consider what used to happen in EM before such institutions emerged. Back in the days before pension funds, EM countries could only issue in local currency if external conditions were extremely benign, such as during a commodity boom. During such times, EM currencies would appreciate against the Dollar and the relatively high domestic yields on offer in EM would suddenly attract foreign investor interest. Governments would issue local bonds to the foreign investors in spite of, or perhaps because of, their inability to issue at home. Unfortunately, if the currency were suddenly to fall, say, due to a change in global sentiment, foreign investors would then quickly turn into sellers to avoid FX related losses, but there would be no domestic bid for the bonds due to the lack of a local institutional investors. When bonds were liquidated into a domestic vacuum, yields soon spike to sky high levels, which then depressed economic activity, in turn undermining tax revenues just as local populations clamoured for higher public spending to soften the blow of the economic downturn. Cut off from external funding, EM governments would have no choice but to turn to their central banks for funding with the result that their currency crashed, leading to massive capital flight. As soon FX reserves were depleted, the government, unable to service external debt, would default and be castigated into EM purgatory until the next commodity price boom.

The death of Soros style contagion

The emergence of domestic pension systems across EM in the aftermath of the Asia and Russia crises in the late 1990s put an end to Soros style contagion once and for all. EM fundamentals also improved sharply in other areas with the widespread adoption of inflation targeting, flexible exchange rates, reserve accumulation and much better fiscal policies. Today EM fixed income is a USD 24trn investment universe of which 87% is denominated in local currencies. Foreign investors only own about 10% of the bonds, with the balance in the hands of local institutions, which are ready to pick up paper when foreigners sell. This prevents the devastating spikes in yield, which used to sink EM economies. While foreign investors still behave as if Soros contagion was a real risk, the reality is that the associated volatility in assets prices no longer triggers serious and widespread economic crises across EM as a whole. In fact, not only are economic crises fewer in between in EM these days, they are also highly idiosyncratic and emphatically they do not spread from one country to the next the way Soros described. Soros style contagion has not happened in EM for twenty years, nor, in our opinion, will it ever re-appear.

Investor Contagion

A Reuters headline from Friday evening illustrates perfectly the other less dangerous type of contagion: "Emerging market contagion back with a vengeance as Turkey pops".[1] This is pure EM market volatility and it is usually triggered, when something scary is happening somewhere in EM, or even outside of EM. The entire asset class then re-prices for a time with particularly violent price action in high beta currencies. While such events are often labelled 'EM contagion', this is really a misnomer, because it is just a manifestation of severe risk aversion among investors with nothing common to all EM countries justifying simultaneous re-pricing of assets across such a disparate universe of issuers.

Take the current situation in Turkey. Turkey's problem is very specific to Turkey. It is entirely self-inflicted and it will not suddenly appear in, say, Poland or Uruguay. Hence, it would be far more accurate to label any weakness in other EM countries arising from the Turkish situation 'Investor Contagion', because it clearly originates among and spreads between investors. Why investors behave this way is down to a complex set of reasons, including herd dynamics due to institutional incentives, fear, myopia, ignorance and prejudice, or simply speculation that other investors will behave in the same way.

The resilience test of 2013-2015

The defining feature of Investor Contagion is that it is largely confined to the sphere of asset prices without 'causing' economic crises in EM economies. As such, it is far more benign than Soros style contagion. That EM counties are resilient to Investor Contagion should be clear from what happened to EM in the 2013-2015, which once and for all demonstrated that the link between market volatility and economic crises in EM has been decisively broken.

During 2013-2015, EM economies were exposed to a truly awe-inspiring quadruple whammy of external shocks with roots in the Quantitative Easing (QE) policies in developed economies. EM currencies fell 45%

[1] https://www.reuters.com/article/us-turkey-markets-emerging-contagion-ana/emerging-market-contagion-back-with-a-vengeance-as-turkey-pops-idUSKBN1KV218

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Emerging Markets

versus the Dollar. The associated selling of local currency assets pushed bonds yields to the point where they priced in a full normalisation of US monetary policy. As if that was not enough, commodity prices then fell by 50% and to add insult to injury EM experienced the largest ever capital flight episode in its history.

There is no doubt whatsoever that in a more distant past, the events of 2013-2015 would have unleashed a wave of Soros style contagion across EM. However, this did not happen due to the existence of domestic pension funds, where were able to pick up the bonds discarded by foreign investors as thus limit the economic fallout. Sure, EM growth rates slowed (although they never fell below an average of 4%) as financial conditions tightened, but the cyclical slowdown in EM never translated into outright economic crisis due to the much better overall macroeconomic policy environment. There were hardly any balance of payments crises, very few IMF programs and the small number of defaults were idiosyncratic in nature. Most impressively, EM corporate high yield (HY) bonds had lower default rates than US HY bonds despite the far more favourable financial circumstances, which prevailed in the United States.

Investors are slow to learn

Some 20 years have gone by without a single example of Soros style contagion. Yet, despite the evidence of EM fundamental resilience in the face of external headwinds, such as we saw in 2013-2015 investors continue to cling onto notions of EM vulnerability, which are ultimately rooted in outdated fears of Soros style contagion. Finance is a very conservative industry and prejudice evolves more slowly than economic development. The fact that Investor Contagion still exists is the most obvious manifestation of this sad reality. Rules of thumb, such as the tendency of markets to divide the world 'risky' and 'risk free' markets is part of the problem, but since such witless practices are also entrenched in the regulatory system, which governs the operation of financial markets, change will take a long, long time. Which begs the question: since bouts of Investor Contagion will continue to be regular occurrences, how should investors respond when they happen?

Turkey

The starting point should always be to establish the nature of the problem causing Investor Contagion in the first place. Today, this is Turkey. As far back as 2010, Turkey began to implement a new and fundamentally flawed monetary policy framework.[2] The new framework guaranteed over-easy monetary policies, while President Erdogan constantly applied pressure on the central bank to keep interest rates low. As such, Turkey's problem is as self-inflicted as it is conventional. The solution is simple: tighten monetary policies until inflation expectations are broken and the current account deficit becomes sustainable. This requires Turkey to abandon its entire flawed monetary policy framework from 2010. The result will almost invariably be a severe and lengthy recession, which in turn could easily cause major problems in the banking sector and eventually much higher levels of government debt. Sadly, President Erdogan continues to be in total denial about the nature of the problem and his role in causing it in the first place. He says he will not give in to the "interest rate lobby" and blames an "economic war" against Turkey (he borrowed the expression "economic war" from Venezuela). In short, the massive decline in the Lira and Turkish asset prices in general is entirely justified and could extend further.

The rest of EM

But what about the rest of EM? No EM countries face challenges identical to those of Turkey. As far as we know, Turkey is the only country in EM, whose president believes that raising interest rates causes inflation. Also, no other country in EM has Turkey's weird monetary policy framework. Granted, one can draw superficial similarities between Turkey and the few other EM countries with macroeconomic imbalances, but in reality the domestic circumstances, particularly the political circumstances, which ultimately dictate the policy response, tend to be very different. Thus, while Argentina is struggling with a legacy of massive excess demand stimulus during the Kirchner era, the government in Buenos Aires has been relatively quick to recognise the problem and is now seeking IMF assistance. Like Turkey, Brazil also leaned heavily on the central bank to keep rates too low for a time during the Dilma Rousseff Administration, but then got rid of her corrupt government in a peaceful and constitutional manner, and has since reverted to orthodoxy. Most importantly of all, among the 70 odd readily investable EM countries, only a very small handful indeed do not maintain credible macroeconomic policy frameworks. Hence, it is clear that Turkey's economic problems are not suddenly going to manifest themselves across the rest of EM.

[2] Fancy academic-looking articles such as this one were used to justify the departure from monetary policy orthodoxy: http://www.asecu.gr/Seeje/issue23/issue23-eskinat.pdf

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Opportunity versus risk

This means one thing: when Investor Contagion pushes down asset prices across the whole EM universe (and some developed markets too) at a time when fundamental re-pricing is only justified in one of them, then opportunities are created. Turkey may be heading for a lengthy recession and possibly a far more complicated political scenario, so TRY could clearly continue to weaken for some time. However, in the rest of EM, once markets get their head around the nature of the Turkish problem, prices will recover to their fair value. Investors should therefore buy into bouts of Investor Contagion, they should buy the current weakness in non-Turkey EM.

The need to be active

For most institutional investors, which invest via broad mandates, which cover the whole EM universe, the only way to buy non-Turkey EM is to place funds with active managers, because passive managers will assign index weight to Turkey regardless of what is happening fundamentally in that country. As Turkey explodes, it should be clear just how dangerous passive investing can be. The problems in Argentina earlier this year and now in Turkey are shots across the bows of the passive investment crowd. TRY weakened nearly 16% on Friday, but CNY only declined by 36bps. MXN was down just over 1%, but THB only 6bps, outperforming EUR. Clearly, a large underweight or even zero weighting to Turkey relative to the index can generate substantial alpha in the current conditions, just as exposure to China, an off-benchmark position, or THB can do from the long side relative to the index.

The death of passive foretold

Passive investing is dead. You may not yet see the bodies in the street, but it is just a question of time. The long period of declining yields, which began in the 1980s and extended into QE period, encouraged the growth of passive investing, but this is at an end. Monetary policies are slowly being normalised in the US and elsewhere. Political risks are rising sharply in developed economies, where populism is rampant. Fiscal policy is ramping higher in the US despite full employment, while reform needs and mounting debts continue to be ignored. Protectionism is back in a bid to blame declining productivity trends on foreign trade practices. These worrisome developments will inevitably lead to more volatility in global financial markets, including EM, because investors continue to have far too much money invested in developed economies. In EM, where Soros style contagion is a thing of the past, there will continue to be bouts of Investor Contagion. They ultimately present opportunities, but only for those who are able to sell Turkey and buy the rest of EM.
Be active or be dead.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.22%	-6.55%	3.28%	9.12%	5.07%
MSCI EM Small Cap	-1.57%	-8.67%	3.81%	5.19%	3.99%
MSCI Frontier	-2.21%	-9.67%	1.34%	3.25%	3.41%
MSCI Asia	-0.86%	-4.67%	5.61%	10.07%	8.21%
Shanghai Composite	-2.76%	-13.62%	-12.29%	-8.79%	8.82%
Hong Kong Hang Seng	-0.74%	-3.21%	5.43%	2.96%	6.68%
MSCI EMEA	-7.22%	-13.18%	-2.70%	2.70%	-1.20%
MSCI Latam	-4.82%	-7.48%	-4.01%	7.66%	-1.95%
GBI EM GD	-4.02%	-8.50%	-6.19%	2.66%	-2.06%
ELMI+	-2.31%	-4.82%	-2.33%	2.05%	-1.21%
EM FX Spot	-3.36%	-8.29%	-8.16%	-3.25%	-7.58%
EMBI GD	-1.62%	-4.38%	-1.84%	4.95%	5.06%
EMBI GD IG	-0.53%	-2.79%	-0.76%	3.76%	4.40%
EMBI GD HY	-2.73%	-6.08%	-3.09%	6.34%	5.71%
CEMBI BD	-0.92%	-2.37%	-0.56%	4.20%	4.63%
CEMBI BD IG	-0.05%	-1.14%	-0.11%	3.23%	4.19%
CEMBI BD Non-IG	-1.98%	-3.86%	-0.97%	5.78%	5.22%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.70%	7.21%	18.46%	12.73%	13.16%
1-3yr UST	0.22%	0.25%	-0.07%	0.49%	0.58%
3-5yr UST	0.50%	-0.46%	-1.27%	0.64%	1.09%
7-10yr UST	0.88%	-1.68%	-2.51%	0.75%	2.00%
10yr+ UST	1.28%	-3.20%	-1.68%	1.90%	4.85%
10yr+ Germany	1.75%	4.63%	4.15%	3.79%	6.55%
10yr+ Japan	-1.09%	-0.05%	0.63%	4.02%	4.54%
US HY	0.28%	1.54%	3.53%	6.51%	5.45%
European HY	0.16%	0.20%	1.63%	4.66%	5.89%
Barclays Ag	-0.38%	-2.00%	-1.23%	2.47%	0.95%
VIX Index*	14.73%	33.33%	-5.09%	9.12%	19.58%
DXY Index*	2.04%	4.73%	3.67%	0.04%	17.99%
CRY Index*	-1.46%	-1.12%	6.73%	-3.10%	-33.46%
EURUSD	-2.72%	-5.26%	-3.45%	2.01%	-14.24%
USDJPY	-1.47%	-2.18%	0.56%	-11.43%	12.25%
Brent	-2.32%	8.46%	39.21%	47.36%	-33.96%
Gold spot	-1.56%	-7.52%	-6.02%	8.06%	-8.83%

*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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