Issued: 8 January 2018

Ashmore

Picking up where we left off

By Jan Dehn

Emerging Markets (EM) have picked up where they left off last year – with solid performance. Fundamentals look good too, in most countries. We summarise the main developments in EM over the holiday period.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.8	–	4.12%
MSCI EM Small Cap	12.1	–	3.42%
MSCI Frontier	11.3	–	2.19%
MSCI Asia	12.4	–	3.89%
Shanghai Composite	11.6	–	2.89%
Hong Kong Hang Seng	7.4	–	4.52%
MSCI EMEA	10.5	–	3.01%
MSCI Latam	12.6	–	5.37%
GBI-EM-GD	6.06%	–	1.78%
ELMI+	3.51%	–	1.01%
EM FX spot	–	–	1.28%
EMBI GD	5.21%	272 bps	0.53%
EMBI GD IG	4.04%	153 bps	0.13%
EMBI GD HY	6.43%	396 bps	0.89%
CEMBI BD	5.05%	262 bps	0.25%
CEMBI BD IG	4.18%	175 bps	0.06%
CEMBI BD Non-IG	6.23%	380 bps	0.49%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.9	–	2.10%
1-3yr UST	1.96%	–	-0.06%
3-5yr UST	2.28%	–	-0.16%
7-10yr UST	2.47%	–	-0.28%
10yr+ UST	2.80%	–	-0.83%
10yr+ Germany	0.42%	–	-0.41%
10yr+ Japan	0.06%	–	-0.03%
US HY	5.54%	322 bps	0.78%
European HY	2.60%	327 bps	0.57%
Barclays Ag	–	253 bps	-0.10%
VIX Index*	9.56	–	-1.48%
DXY Index*	92.20	–	0.07%
EURUSD	1.1990	–	-0.18%
USDJPY	113.15	–	0.46%
CRY Index*	193.45	–	0.40%
Brent	67.8	–	1.38%
Gold spot	1320	–	1.31%

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

Emerging Markets

Both EM countries and EM fundamentals have begun 2018 on a positive note. Figure 1 shows the performance of the main EM and developed markets in 2018 and the previous two years. So far, EM has performed strongly in 2018, especially in local markets. The strong performance of local markets is a continuation of last year and is entirely in keeping with the 'Kilimanjaro View' of how EM FX should perform in a QE world.[1] The Kilimanjaro View holds that Quantitative Easing (QE) created large distortions in currency markets in favour of the US dollar between 2010 and 2015 by inducing enormous changes in asset allocation by institutional investors in favour of US markets and against EM local markets in particular. However, the first Fed hike of December 2015 in effect signalled the end of this trade. 2016 was a transition year and in 2017 the QE trades began to go into reverse. The unwinding of QE will begin to undo the distortions created in FX markets, but unwinding QE will be a multi-year process. The unwinding of QE will favour EUR over the USD, European stocks over US stocks and US bonds over European bonds, but the bigger trade will be to go long EM local markets versus the QE markets, since EM were the only markets to cheapen outright during the QE period. While there will be volatility along the way, especially in response to political events in developed economies, we expect tailwinds in EM for many years to come as capital begins to flow back to EM. Capital inflows will in turn have positive fundamental effects, since most EM countries are severely finance constrained. The combination of stronger markets and better fundamentals was pronounced in 2017 and we see 2018 as the second year of a five year process of net inflows of capital to EM (it took five years for the money to leave). The outlook for EM is particularly positive for stocks and bonds denominated in local currencies. For further details on the outlook for EM stocks, bonds and currencies this year and beyond please see the following two outlook publications:

- See Equity Outlook 2018: Emerging Markets The Emerging View, 2 January 2018
- See 2018 EM fixed income outlook The Emerging View, 14 December 2017

[1] See '*The View from Kilimanjaro': EM FX in a QE world*, The Emerging View, 25 September 2017.

Emerging Markets

Fig 1: **The Kilimanjaro Trades – update**

	% return (USD terms)			
Sub-asset class	**2016**	**2017**	**2018 ytd**	**2016-2018 ytd**
Government bonds				
EM local currency bonds	**9.94%**	**15.21%**	**1.78%**	**26.93%**
3-5yr UST	*1.33%*	*0.98%*	*-0.26%*	*2.05%*
EM external debt (USD)	**10.15%**	**10.26%**	**0.53%**	**20.94%**
7-10yr UST	*1.04%*	*2.59%*	*-0.47%*	*3.16%*
Corporate Credit				
EM corporate debt (USD)	**9.65%**	**7.96%**	**0.25%**	**17.86%**
EM HY (USD)	**16.21%**	**10.45%**	**0.49%**	**27.15%**
US HY	*16.96%*	*7.50%*	*0.73%*	*25.19%*
EU HY	*5.91%*	*6.18%*	*0.57%*	*12.66%*
Currencies				
EM spot FX	**0.54%**	**5.69%**	**1.28%**	**7.51%**
EM FX forwards	**3.57%**	**11.54%**	**1.01%**	**16.12%**
DXY Index	*0.53%*	*-9.87%*	*0.08%*	*-9.26%*
EURUSD	*-0.55%*	*14.12%*	*-0.12%*	*13.44%*
USDJPY	*0.58%*	*0.41%*	*0.41%*	*1.40%*
Stocks				
EM stocks	**11.27%**	**37.51%**	**3.68%**	**52.46%**
EM Small cap	**0.27%**	**33.90%**	**2.82%**	**36.99%**
Frontier Markets	**-1.28%**	**31.80%**	**2.19%**	**32.71%**
US stocks	*11.95%*	*21.82%*	*2.63%*	*36.40%*

Source: Ashmore, JP Morgan, MSCI, Bloomberg, data as at 8 January 2018.

In the rest of this report we summarise the main developments in EM over the recent holiday period.

- South Africa: The National Executive Committee of the South African ANC party is scheduled to meet 10-12 January 2018. The meeting may give some indication about the future of President Zuma following the election of Cyril Ramaphosa, a Zuma opponent, as president of the ANC. The effort to remove Zuma was aided at the margin by a ruling from the Constitutional Court that Parliament failed to hold the Executive to account, when Zuma was found to have violated the constitution in the Nkandla Case. The other focus remains the 2018/2019 Budget, which is due to be delivered at the end of February. A failure to correct recent fiscal deterioration may result in a credit ratings downgrade. The trade surplus was ZAR 13bn in November versus an expected surplus of just ZAR 1.3bn. The upside surprise was driven by exports.

- Brazil: The good economic news continues. The GDP proxy expanded at a pace of 2.9% yoy in October up from 0.7% yoy in September. Industrial production in November rose at a rate of 4.7% yoy versus 3.8% yoy expected. The trade surplus hit USD 5.0bn in December versus USD 4.2bn expected, taking the trade surplus to USD 67bn for 2017 as a whole, which is USD 19bn more than last year and the highest trade surplus ever in Brazil's history. The unemployment rate declined to 12% versus 12.1% expected. Fiscal balances also improved in November as the primary deficit declined to just BRL 0.9bn compared to BRL 39bn in the same month of 2016, while mid-month inflation in December was 0.35% mom, in line with expectations. Investors continue to eye 24 January, when a court will rule if former President Lula is eligible to run in the 2018 presidential election. In early February the government will attempt once again to pass the pension reform.

- Peru: Peru experienced a mini political crisis before Christmas, which President Petro Pablo Kuczynski (PPK) survived by striking a deal with the opposition. PPK survived an attempt to impeach him over alleged ties with corruption Brazilian construction company Odebrecht by promising to release former President Alberto Fujimori from prison on health grounds. In other news, inflation was 0.16% in December, taking the yoy print to 1.36%, which is well within the central bank's 2% +/- 1% target range.

- China: The Central Economic Work Committee resolved to focus economic policy on curbing financial risks, fighting poverty and bringing down inflation. Monetary policy will be neutral and fiscal policy will be loose to help the economy through deleveraging in other sectors. The government also announced that foreign investors will not have to pay income tax on profits provided profits are re-invested in China. The Caixin services PMI index rose to 53.9 in December from 51.9 in November. The Caixin manufacturing index also increased to 51.1 in December from 50.8 in November. The Caixin indices cover smaller companies than the official PMI index, which moderated slightly to 51.6 in December from 51.8 in November. The current account surplus was USD 40.5bn in Q3 2017, while the surplus on the capital account was USD 44.1bn. The level of FX reserves at the central bank increased for the eleventh month running, hitting USD 3.14bn versus USD 3.13bn expected.

Continued overleaf

Emerging Markets

- India: The ruling BJP won state elections in both Gujarat and Himachal Pradesh. This puts Prime Minister Modi in a strong position to successfully contest the next general election in India in 2019. The manufacturing PMI index surged to 54.7 in December from 52.6 in November, while the services PMI rebounded to 50.9 in December from 48.5 in November. The statistical office issued a preliminary estimate of real GDP growth in the 2017 fiscal year of 6.5%. The government announced INR 500bn (0.3% of GDP) in additional supply of government bonds. In a first for India, a mortgage lender successfully issued USD 750m in social bonds targeting affordable housing. The bond was a so-called Masala bond, i.e. an INR denominated bond issued overseas.

- Argentina: The government relaxed the inflation target for 2018 to 15% from a prior target range of 8%-12%. The 2019 inflation target was also raised to 10% from 3.5%-6.5%. The relaxation of the inflation target is negative news and shows that the government is now prioritising winning the next presidential election over reforms. Moreover, it appears willing to sacrifice price stability in order to achieve this objective. The looser inflation target will force the central bank to cut rates (currently the policy rate is 28.75%). While this should support government popularity in the short term the failure to get inflation under control will undermine growth in the longer-term. Fiscal stimulus is also likely to increase from now on. The government recently passed bills, which reduce distortionary taxes. Thus, corporate taxes will decline to 25% from 35% over a period of five years. Financial investments will be taxed for the first time although non-residents will not be taxed except if they trade central bank notes (the central bank wants to use these notes for domestic liquidity management). Overall, the tax burden will decline by roughly 4% of GDP, according to local analysts. The Macri Administration has been running stimulatory fiscal policy from day one. At no point has the government been willing to undertake the decisive demand adjustment required to break the high inflationary expectations created under the previous Kirchner Administration. The government last week issued USD 9bn in new bonds and announced a further USD 15bn shelf at the SEC for future debt issuance. Real GDP growth is strengthening as a result with October economic activity rising at a 5.2% yoy rate versus 3.8% in September, but the trade deficit is also widening rapidly. Argentina's trade deficit was USD 1.5bn in November compared to a surplus of USD 124m in the same month last year.

- Poland: The European Union triggered the Article 7 process against Poland over greater Executive control over the Judiciary. The process which may ultimately result in the loss of Poland's voting rights within the EU. Poland together with Hungary is also exerting pressure against the EU over migration. France and Germany are keen to move forward with deeper institutional integration of the Eurozone countries. It might be a good idea to start with an overhaul of migration policy, which is the single most divisive issue in a heavily tribal Europe. Meanwhile, economic activity in Poland was strong in November as industrial output increased at a rate of 9.1% yoy.

- Pakistan: The Trump Administration attacked Pakistan for allegedly housing terrorists, threatening to withhold aid to the country. Pakistan claims that the US owes it USD 9bn in support of the 'war against terror'. China has in recent years become an important financier of Pakistan, including major investments in port infrastructure. Trump's stance with respect to Pakistan is likely to further diminish US influence in the region and strengthen China's, with no material impact on Pakistan country's ability or willingness to pay.

- Indonesia: The fiscal deficit for 2017 was 2.57% of GDP, which was lower than the market expected (2.8% of GDP) and the government's own target (2.9% of GDP). Revenues were stronger than expected due to solid domestic demand growth. CPI inflation drifted higher in December to 3.61% yoy from 3.3% yoy in November.

- South Korea: North and South Korea have agreed to direct talks for the first time in 20 years in order to reach agreement on participation of North Korea in the upcoming Winter Olympics. The strong performance of the external accounts in South Korea continued in December as the full year trade surplus reached USD 95.8bn compared to USD 89.2bn in 2016. The strong number was due to stronger than expected exports in December (16.4% yoy, up from 9.7% yoy in November). On the domestic front, inflation was marginally higher in December (1.5% yoy) than in November (1.3% yoy) and industrial production slowed to a pace of 0.2% mom in November, although services activity picked up strongly to 2.5% mom from -1.9% mom in October. The Bank of Korea verbally intervened overnight in response to persistent strengthening of the Korean Won.

- Venezuela: A US court ruled that Crystallex, a miner, was not entitled to attach CITGO assets in its bid to collect on a USD 1.2bn claim against Venezuela. CITGO is a PDVSA owned chain of petrol stations in the Eastern US. The US blacklisted four more allies of President Nicholas Maduro.

- Chile: The election of Sebastian Pinera as president has coincided with improving news about the economy. Economic activity picked up more than expected in November, rising at a pace of 3.2% yoy versus 2.9% yoy in October and 2.5% yoy expected. Also, retail sales increased at a pace of 5.6% in November compared to the Bloomberg forecast of 3.6% yoy and 3.7% yoy in October. Industrial production also performed, rising at a pace of 2.3% yoy in November, while labour force participation increased at a pace of 2.4% yoy in the three months to November.

Continued overleaf

Ashmore

Emerging Markets

Snippets:

- **Colombia:** President Juan Manuel Santos cut the government budget by COP 4trn in order to comply with the fiscal rule, which limits the fiscal deficit at 3.6% of GDP in 2017. The trade deficit narrowed to USD 628m in November from USD 727m in October.
- **Czech Republic:** The Czech National Bank left the policy rate unchanged at 0.5% in December.
- **Ecuador:** The real economy was 3.8% larger in Q3 2017 than in the same quarter the year prior, according to data issued by the central bank. This compares to 2.9% yoy growth in Q2 2017.
- **Hong Kong:** Retail sales were 7.6% higher yoy in November 2017 and exports beat expectations (7.8% yoy versus 6.0% yoy expected).
- **Indonesia:** The Fitch ratings agency upgraded Indonesia's sovereign credit rating to BBB with stable outlook.
- **Macedonia:** The Former Yugoslav Republic of Macedonia has mandated Citigroup, Deutsche Bank and Erste Group for a EUR-denominated seven-year benchmark. Macedonia is rated BB- (stable) by S&P and BB (negative) by Fitch.
- **Malaysia:** November CPI inflation was 0.7% mom. This left the yoy inflation print at 3.4%, in line with consensus expectations. Exports expanded at a rate of 14.4% yoy in November, while imports increased at a rate of 15.2% yoy resulting in a narrower trade surplus of MYR 9.95bn.
- **Mexico:** A former treasurer of the governing PRI party of President Enrique Pena Nieto was arrested on charges of funnelling public money towards political campaigns. The economy grew at a pace of 1.52% yoy in October versus 1.31% expected, but the Inegi Manufacturing PMI declined 0.4 points to 51.3 in December.
- **Philippines:** December CPI inflation was in line with expectations (3.3% yoy).
- **Russia:** Economic activity slowed in response to Russian compliance with the recently announced OPEC cuts. Industrial production was 3.6% lower in November 2017 than in the same month of 2016.
- **Saudi Arabia:** The government announced a fiscal deficit target of 7.3% of GDP for 2018. This represents a moderation of the highly stimulatory stance of 2017 (where the fiscal deficit was 8.9% of GDP). Saudi Arabia's debt stock is expected to rise to 21% of GDP. Public subsidies will be reduced on a gradual scale through 2025.
- **Singapore:** The real economy expanded at a rate of 3.1% yoy in Q4 2017 versus 2.6% yoy expected. The rate of CPI inflation increased to 0.6% yoy in November from 0.4% yoy in October. Industrial production was solid at 5.3% yoy in November.
- **Sri Lanka:** The rate of CPI inflation moderated to 7.1% yoy in December from 7.6% yoy in November.
- **Taiwan:** December's PMI was 56.6, up from 56.3 in November. Core inflation increased to 1.6% yoy in December from 1.3% yoy in November, partly due to higher tobacco taxes.
- **Thailand:** The Bank of Thailand left the policy rate unchanged at 1.5% against a backdrop of CPI inflation of 0.1% mom in December, which took overall 2017 inflation to just 0.7%. Exports were stronger than expected in November (13.4% yoy versus 7.2% expected).
- **Turkey:** CPI inflation was 11.9% yoy in December. Core inflation was 12.3% yoy. Expectations are for lower inflation going forward, but Turkey will struggle to crack inflation due to excessively easy monetary policies. Manufacturing PMI picked up strongly in December (54.9 versus 52.9 in November).

Global backdrop

The Trump tax cut will give a one-off boost to US stocks, but the impact on the economy will be minimal for four reasons. First, US companies are not constrained by taxes in terms of investment. Second, the consumption impact of the reform will be small because it favours rich people. Third, the stimulus happens at the top of the business cycle. Finally, the tax cut is financed by debt, which will lower US productivity and therefore the trend growth rate. Indeed, the tax cut puts the US government on track to run fiscal deficits to the tune of 5.0%-5.5% of GDP at the top of the business cycle, which suggests that investors should contemplate the size of the likely deficits when the economy eventually goes into recession. The effect of bigger deficits is a higher debt burden, which lowers productivity. This is important for monetary policy, because lower productivity reduces the Fed's long-term target interest rate, also known as r*. Hence, the tax reform should be seen as dovish for monetary policy beyond the temporary positive short term impact on stocks, in our view. Payrolls disappointed with only 148K new jobs in the US economy in December versus 193K expected. A wider than expected trade deficit detracted from Q4 2017 growth.

Beyond the approval of the Trump tax cut there were no major changes in the global backdrop. Inflation remains tepid in Europe (Eurozone core inflation was unchanged in December at 0.9% yoy) and in the US despite generally improving economic data in both regions. The European growth outlook continued to improve according to PMI indices in the region. Specifically, December saw Euro-area PMI surge to 58.1, while US ISM improved to 59.7 from 58.2 and the US trade deficit widened to USD 69.7bn in November. Stronger economic data helped to push WTI oil prices above USD 60 per barrel.

Continued overleaf

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.68%	3.68%	39.41%	11.40%	4.99%
MSCI EM Small Cap	2.82%	2.82%	35.02%	9.78%	5.68%
MSCI Frontier	2.19%	2.19%	32.73%	6.11%	9.27%
MSCI Asia	3.49%	3.49%	43.09%	12.35%	8.46%
Shanghai Composite	2.56%	2.56%	9.36%	2.32%	10.90%
Hong Kong Hang Seng	4.29%	4.29%	32.32%	3.81%	4.44%
MSCI EMEA	2.33%	2.33%	26.98%	8.40%	0.03%
MSCI Latam	5.02%	5.02%	26.92%	8.07%	-2.63%
GBI EM GD	1.78%	1.78%	16.81%	3.43%	-1.13%
ELMI+	1.01%	1.01%	12.05%	3.05%	-0.35%
EM FX Spot	1.28%	1.28%	6.89%	-3.54%	-6.71%
EMBI GD	0.53%	0.53%	9.40%	7.52%	4.61%
EMBI GD IG	0.13%	0.13%	8.08%	5.10%	3.26%
EMBI GD HY	0.89%	0.89%	10.74%	10.43%	6.19%
CEMBI BD	0.25%	0.25%	7.58%	6.39%	4.55%
CEMBI BD IG	0.06%	0.06%	5.82%	4.48%	3.76%
CEMBI BD Non-IG	0.49%	0.49%	10.15%	9.44%	5.62%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.63%	2.63%	23.33%	13.06%	15.71%
1-3yr UST	-0.11%	-0.11%	0.23%	0.56%	0.55%
3-5yr UST	-0.26%	-0.26%	0.42%	1.10%	1.01%
7-10yr UST	-0.47%	-0.47%	1.30%	1.20%	1.60%
10yr+ UST	-1.11%	-1.11%	5.16%	1.58%	3.76%
10yr+ Germany	-0.15%	-0.15%	-2.15%	1.82%	5.62%
10yr+ Japan	-0.09%	-0.09%	0.84%	3.58%	5.27%
US HY	0.73%	0.73%	7.37%	6.70%	5.77%
European HY	0.57%	0.57%	6.18%	5.90%	6.91%
Barclays Ag	-0.20%	-0.20%	5.07%	3.59%	3.86%
VIX Index*	-13.41%	-13.41%	-15.55%	-43.80%	-29.81%
DXY Index*	0.08%	0.08%	-9.81%	-0.19%	14.75%
CRY Index*	-0.22%	-0.22%	-0.05%	-14.36%	-34.34%
EURUSD	-0.12%	-0.12%	13.39%	1.67%	-8.34%
USDJPY	0.41%	0.41%	-2.48%	-5.44%	29.98%
Brent	1.38%	1.38%	18.72%	33.03%	-39.44%
Gold spot	1.31%	1.31%	11.74%	9.18%	-20.45%

*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

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