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Ashmore

Update on market dynamics a month into 2018

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Emerging Markets (EM) local fixed income markets have had a roaring start to 2018. We explain why. In country-specific news, as far as election budgets go, India's was remarkably prudent. Industrial production surged in Brazil. Mexico's growth rate was solid in Q4 2017. USA's increasing use of sanctions against Russia and other countries may ultimately undermine America's influential position in the global financial system. In the US itself inflation poses a threat in markets, which have rallied far beyond sustainable valuations on the back of years of hyper-easy monetary policies – and the Fed funds rate still remains deep in negative real rate territory.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.8	–	-3.31%
MSCI EM Small Cap	11.9	–	-3.03%
MSCI Frontier	11.5	–	-2.21%
MSCI Asia	12.4	–	-2.90%
Shanghai Composite	11.9	–	-2.70%
Hong Kong Hang Seng	7.7	–	-1.35%
MSCI EMEA	10.3	–	-4.57%
MSCI Latam	12.9	–	-3.14%
GBI-EM-GD	6.07%	–	-0.69%
ELMI+	3.95%	–	-0.52%
EM FX spot	–	–	-0.66%
EMBI GD	5.44%	258 bps	-0.84%
EMBI GD IG	4.27%	140 bps	-1.03%
EMBI GD HY	6.63%	380 bps	-0.67%
CEMBI BD	5.23%	243 bps	-0.37%
CEMBI BD IG	4.32%	153 bps	-0.48%
CEMBI BD Non-IG	6.35%	354 bps	-0.23%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.1	–	-3.82%
1-3yr UST	2.15%	–	-0.05%
3-5yr UST	2.60%	–	-0.39%
7-10yr UST	2.87%	–	-1.38%
10yr+ UST	3.12%	–	-3.07%
10yr+ Germany	0.77%	–	-1.82%
10yr+ Japan	0.09%	–	-0.09%
US HY	5.92%	324 bps	-0.68%
European HY	2.55%	332 bps	-0.52%
Barclays Ag	–	250 bps	-0.72%
VIX Index*	17.31	–	6.23%
DXY Index*	89.24	–	-0.07%
EURUSD	1.2462	–	0.65%
USDJPY	109.97	–	0.93%
CRY Index*	198.35	–	-2.17%
Brent	68.0	–	-2.15%
Gold spot	1333	–	-0.53%

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

Emerging Market

Update on EM fixed income market dynamics a month into 2018: The case for EM fixed income hinges on three powerful drivers: technicals, fundamentals and valuations. While volatility is inevitable – these are markets after all – we expect pullbacks in EM to be relatively shallow, short-lived and confined to episodes of risk aversion triggered by events in developed markets as long as these drivers remain in place. Consider each in turn:

a) Positioning: Technicals heavily favour EM after years of outflows into developed markets. Despite the fact that EM outperformance versus US markets began as far back as Q1 2016, institutional investors have been slow to respond to the turning point. We believe that so far only one third of the institutional money, which left EM between 2010 and 2015 has returned. This means that EM assets remain heavily under-owned, while developed market assets remain heavily over-bought. Indeed, the imbalance in positioning in EM versus developed markets is so extreme that basic fundamental drivers in many cases make little or no impression on markets. One obvious example is the US dollar, which has been falling despite strong data, new highs in the US stock markets, Fed hikes, rising bond yields and a massive tax cut designed to encourage billions of Dollars to flow back to the US. The mirror image of Dollar weakness is the resilience of EM currencies. Despite the bout of severe risk aversion triggered by higher than expected US wage inflation on Friday, EM currencies are up more than 3% ytd versus the US dollar. As of this morning EM local currency bonds have outperformed US bonds of the same duration by 5.2% ytd in Dollar terms. Much of this outperformance is technically driven.

b) Valuations: Valuations also strongly favour EM bonds. As of close of business on Friday 2 February, the yield on EM local currency bonds (based on the JP Morgan GBI EM GD index) was 6.1%. This is a high yield for bonds with less than 5 year duration of which more than 80% of issuers are investment grade. Moreover, inflation in the countries making up the index averages less than 4%, so yields are attractive in real terms too. EM currencies have at least 10% further upside from here over the next few years, in our estimation. This means that EM local currency bonds should easily generate an average of 10% return in Dollars per year for the next few years, an important factor to bear in mind as inflation concerns destroy value in the overbought developed bond markets all of which are heavily down ytd.

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Emerging Markets

c) **Fundamentals:** There is a powerful fundamentals story unfolding in EM. Of course, EM economies already began to outgrow developed economies a couple of years ago, but this was mainly on the back of surging exports. Now that fresh finance is flowing back to EM's capital-starved local markets, it is likely that domestic demand will add to the growth momentum. In EM domestic demand is three times larger than exports as a share of GDP. This means that inflows could trigger a steady flow of positive growth surprises over the next few years. Against this backdrop it is worth remembering that EM central banks are generally not prone to taking risks on inflation, so they will likely respond to stronger domestic demand by hiking rates. In fact, we think EM central banks may lead, rather than lag the global hiking cycle. If so, the combination of higher interest rates and growth rates will only further enhance the attractiveness of EM currencies. Finally, we note that EM central banks may eventually intervene to slow the pace of appreciation, which will push EM central bank reserves higher.

- **India:** The government presented the fiscal year 2018/2019 Budget, which has two distinct features. One is that the current path of fiscal consolidation is maintained with the fiscal deficit expected to decline from 3.5% of GDP in fiscal year 2017/2018 to 3.3% and decline further in outer years. The other is that spending is tilted in favour of lower income and rural populations. In other words, this is an election budget intended to help Prime Minister Modi secure a win in the May 2019 general election. We like this budget. We think it reduces both the risk of fiscal profligacy leading up to the election and increases the odds of political continuity. In other news, the government announced that the finance ministry and the Reserve Bank of India are in discussions to increase limits for foreign investment limits in domestic government bonds. The government is also planning to buy back some INR 570bn of debt before the end of the fiscal year. The PMI manufacturing index moderated to 52.4 in January from 54.7 in December, but the services PMI picked up to 51.7 from 50.9 over the same period.

- **Brazil:** The economy continues to strengthen. Industrial production rose at the rapid pace of 4.3% yoy in December 2017, well ahead of expectations (3.4% yoy). The trade surplus was solid at USD 2.8bn in January, close to the consensus expectation of USD 2.9bn. Unemployment ended the year at 11.8%, a modest improvement from 2016 (12%), but we expect the labour markets are lagging and should pick up significantly with the rise in domestic demand over the next year. Growth is needed, because a pension deficit last year cost the government a whopping 3% of GDP, underlining the importance of passing a pension reform soon.

- **Mexico:** Real GDP growth was 1.8% yoy in Q4 2017, better than expected (1.6% yoy). The improving growth story helped the government to significantly outperform its own public sector borrowing requirement target of 2.5% of GDP for 2017; the outturn was in fact a much smaller deficit of just 1.1% of GDP last year. Remittances from overseas workers were 11.2% higher in December 2017 than in the same month of 2016.

- **Russia:** The US Treasury published a new list of potentially 'sanctionable' Russians with ties to President Vladimir Putin, but refrained from imposing sanctions on sovereign bond issues due to potential unintended consequences. The US hopes to put pressure on Putin by threatening business people in Russia. However, the increasing use of politically motivated sanctions is a double-edged sword, which may ultimately undermine the influence of the US in the global financial system as more and more countries now have access to independent financing (from their own bond markets or from other countries, such as China). In other news, the Russian economy expanded 1.5% in real terms in 2017, bouncing back from -0.2% real GDP growth in 2016.

- **Ecuador:** The central bank's international reserves rose by USD 3.3bn to USD 5.8bn last week. Presidential term limits will be re-instated. Members of the so-called Citizen's Participation Council, a highly political institution put in place by former President Rafael Correa, can now be removed or replaced by current President Moreno. These were the main results of the referendum, which was held at the weekend. The result provides a major political victory for Moreno, a reformer, while hurting chances of a comeback for Correa, a populist.

- **Venezuela:** US Secretary of State Rex Tillerson has proposed applying sanctions to Venezuelan oil exports. Tillerson's statement comes ahead of upcoming elections planned for March or April of this year. The Venezuelan government and members of the opposition are currently in talks with the Dominican Republic in a bid to agree the modalities of the election. Tillerson will hope for support for sanctions from Latin American countries, but they have traditionally been opposed to US interventions of this kind on account of the long history of US-sponsored coups in the region.

Snippets:

- **Argentina:** Industrial production increased at a rate of 0.3% yoy in December, well ahead of expectations (-0.6% yoy).
- **Chile:** The central bank left the policy rate unchanged at 2.5%.
- **China:** The Caixin Index of small and medium company manufacturing PMI was 51.5 in January, same as in December. The Caixin services PMI rose to 54.7 in January from 53.9 in December. The PMI for larger companies softened to 51.3 from 51.6.
- **Colombia:** The central bank cut the policy rate by 25bps to 4.5% while signalling that there will be no further cuts in the foreseeable future.
- **Czech Republic:** The Czech National Bank raised the policy rate by 25bps to 75bps.
- **Hungary:** The central bank left the policy rate unchanged and reiterated its commitment to maintain a dovish stance.

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Emerging Markets

- Indonesia: Headline inflation on a yoy basis was 3.25% in January versus 3.33% expected. This was down from 3.61% yoy in December. Meanwhile, real GDP growth was 5.2% in 2017, above expectations for an expansion of 5.1% for the year.
- Malaysia: The manufacturing PMI increased to 50.5 in January from 49.9 in December. A sharp reduction in spending in December enabled the government to meet its 3% of GDP deficit target for 2017.
- Kenya: The current account deficit widened to 7.1% of GDP in Q3 2017 versus 6.3% of GDP at the same time in 2016.
- Peru: The rate of CPI inflation was just 1.25% in January, down from 1.36% in December.
- Poland: Real GDP growth was 4.6% in 2017, a significant acceleration from the 2.9% real GDP growth rate in 2016.
- South Africa: If President Zuma has not resigned Parliament is likely to hold a no-confidence vote on 22 February. Politically speaking Zuma seems to be a dead man walking.
- South Korea: Exports surged to a rate of expansion of 22.2% yoy in January versus 8.9% yoy in December, but industrial production was softer than anticipated (-0.5% mom in December versus +0.1% mom expected). Headline inflation was 1.0% yoy in January versus 1.3% yoy expected.
- Taiwan: Q4 2017 real GDP growth was 3.3%, well ahead of the 2.5% real GDP growth rate expected by the market.
- Thailand: The rate of inflation in January moderated to 0.7% yoy from 0.8% yoy in December. The current account surplus in 2017 was USD 49bn, or 11% of GDP, which is the largest external surplus ever achieved in Thailand.

Global backdrop

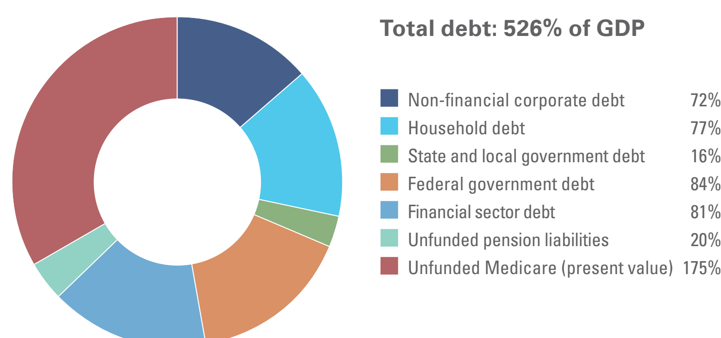
It is important for EM investors to keep an eye on US productivity growth. If US productivity was to suddenly increase significantly to the point where the economy could sustain a stable 5% real GDP growth per year, then many of the problems facing the US economy would quite simply go away. The Fed would be able to raise the Fed funds rate well into positive real territory without having to worry about triggering a recession or killing the stock market, stocks prices would no longer be overvalued and the government's debt burden would be sustainable. High trend growth would also allow the Dollar to rally, thus slowing or even reversing capital flows back into EM, at least for some time.

However, a productivity miracle of this magnitude looks unlikely, in our view. In fact, US productivity growth disappointed in Q4 2017, when it declined by 0.1% in qoq saar terms versus an expectation of an increase of 0.7%. Moreover, productivity growth was revised lower by 0.3% in qoq saar terms in Q3 2017.

We also do not see much hope for a productivity miracle going forward for a number of reasons: First, restrictions on immigration will undermine rather than improve the growth potential of the economy. Second, the Trump Administration's fondness for protectionist policies is sure to weaken America's growth potential. Finally, the US debt burden is already very high and set to rise much faster in the coming years due to the effects of the recently approved unfunded tax cut, which we regard as one of the most gratuitous examples of fiscal irresponsibility in any country in recent years.

Bear in mind that the US economy already sits on an enormous debt to GDP ratio of 526%, taking into account current unfunded pension liabilities and the present value of social security deficits (Figure 1).

Fig 1: **US debt stock**



Source: Federal Reserve, Bloomberg, Ashmore, debt data as at 7 December 2017, US GDP data as at Q4 2017.

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Global backdrop

Given the scale of the debt burden and Congress' apparent unwillingness to approve fiscal measures to reduce it, we think it is more likely that the US will inflate and devalue its way out of its competitiveness and debt problems. Indeed, this process may already have begun with Dollar weakness over the last year or so. Friday's higher than expected hourly earnings number (2.9% yoy versus 2.6% expected) clearly caught the markets wrong-footed. The Fed also suddenly looks behind the curve, because the Fed funds rate is still significantly negative in real terms.

The Fed is on schedule to hike in March, but it remains to be seen if it can get ahead of inflation. If not, the yield at the long end of the US Treasury curve will continue to rise as the market gets progressively more worried about inflation. Unfortunately, rising term yields pose a major threat to the mortgage market and housing, which is the single largest asset of most Americans. Stocks are also very sensitive to rising term yields as the reaction in the US stock market on Friday revealed.

Inflation raises a fundamental question: Will the Fed really pick a fight with inflation? Will it risk triggering a stock market crash and a recession from which the economy may struggle to re-emerge due to the lack of room for further monetary or fiscal easing? Or will the Fed opt to protect stocks, the economy and, arguably, Trump's political future.

Impaled upon the horns of this dilemma we believe the Fed will ultimately opt to protect the real economy and live with higher inflation. However, considerable volatility may ensue before the market discovers the Fed's true reaction function with respect to inflation.

We note in passing that the US Treasury will run out of money in March 2018 unless the debt ceiling is raised, according to the Congressional Budget Office.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.89%	6.28%	37.82%	11.45%	5.63%
MSCI EM Small Cap	-1.72%	3.99%	31.22%	9.61%	5.76%
MSCI Frontier	-1.38%	4.27%	28.49%	7.71%	8.42%
MSCI Asia	-1.78%	5.63%	40.70%	12.15%	9.07%
Shanghai Composite	-0.54%	4.70%	11.86%	5.40%	10.02%
Hong Kong Hang Seng	-0.17%	15.62%	45.22%	9.34%	6.13%
MSCI EMEA	-2.03%	3.99%	26.44%	7.45%	0.36%
MSCI Latam	-1.82%	11.10%	27.20%	9.76%	-1.82%
GBI EM GD	-0.50%	3.96%	16.28%	3.57%	-1.07%
ELMI+	-0.38%	2.49%	11.59%	3.91%	-0.30%
EM FX Spot	-0.46%	3.05%	7.13%	-2.51%	-6.57%
EMBI GD	-0.55%	-0.60%	7.64%	6.47%	4.75%
EMBI GD IG	-0.67%	-1.34%	5.97%	3.72%	3.40%
EMBI GD HY	-0.45%	0.08%	9.29%	9.91%	6.28%
CEMBI BD	-0.25%	-0.18%	6.21%	5.91%	4.50%
CEMBI BD IG	-0.34%	-0.55%	4.66%	3.73%	3.70%
CEMBI BD Non-IG	-0.14%	0.31%	8.40%	9.52%	5.54%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-2.16%	3.44%	23.53%	13.32%	15.15%
1-3yr UST	-0.02%	-0.33%	-0.05%	0.32%	0.50%
3-5yr UST	-0.23%	-1.20%	-0.45%	0.29%	0.83%
7-10yr UST	-0.96%	-3.10%	-0.70%	-0.68%	1.18%
10yr+ UST	-2.63%	-5.78%	2.21%	-1.82%	3.11%
10yr+ Germany	-1.16%	-2.67%	-2.33%	-1.00%	5.05%
10yr+ Japan	-0.06%	-0.27%	2.13%	3.46%	5.11%
US HY	-0.40%	0.20%	5.97%	6.17%	5.52%
European HY	-0.18%	0.01%	5.28%	5.29%	6.94%
Barclays Ag	-0.55%	-1.22%	4.31%	2.61%	3.75%
VIX Index*	27.84%	56.79%	57.79%	2.73%	26.17%
DXY Index*	0.11%	-3.14%	-10.65%	-4.63%	12.26%
CRY Index*	0.49%	2.31%	2.66%	-11.12%	-34.78%
EURUSD	0.39%	3.81%	15.93%	8.58%	-8.26%
USDJPY	0.71%	-2.41%	-1.58%	-6.43%	17.44%
Brent	-1.56%	1.64%	19.64%	20.15%	-41.67%
Gold spot	-0.88%	2.32%	7.92%	5.41%	-20.31%

*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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