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WEEKLY INVESTOR RESEARCH

Ashmore

Shoot a bullet now

By Jan Dehn

Investors have consistently been able to add hundreds of basis points of alpha by actively buying into Emerging markets (EM) assets, in months when the VIX index spikes by 10 points or more. Risk aversion episodes, such as last week's VIX spike, have therefore been excellent entry points for EM investors. Buying EM during VIX spikes means adding at a time when markets over-react to the downside, thus exploiting one of the most irrational investment practices. That is to sell everything in EM as a knee jerk reaction in response to risk-off episodes, regardless of their nature or origin. EM assets are not mispriced like developed market assets, while the technical and fundamental backdrops are strong and improving. We believe that investors should consider scaling into the market in a phased manner, starting with a first bullet right now and stand ready to fire more bullets if prices fall, say, ten percent further.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.3	–	-5.72%
MSCI EM Small Cap	11.4	–	-6.29%
MSCI Frontier	11.3	–	-2.70%
MSCI Asia	11.8	–	-6.15%
Shanghai Composite	11.3	–	-3.36%
Hong Kong Hang Seng	7.1	–	-5.25%
MSCI EMEA	9.9	–	-5.39%
MSCI Latam	12.7	–	-2.92%
GBI-EM-GD	6.10%	–	-0.58%
ELMI+	3.82%	–	-0.58%
EM FX spot	–	–	-0.72%
EMBI GD	5.51%	273 bps	-0.88%
EMBI GD IG	4.31%	150 bps	-0.85%
EMBI GD HY	6.76%	399 bps	-0.90%
CEMBI BD	5.26%	254 bps	-0.35%
CEMBI BD IG	4.32%	161 bps	-0.31%
CEMBI BD Non-IG	6.41%	368 bps	-0.40%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.9	–	-4.47%
1-3yr UST	2.08%	–	0.06%
3-5yr UST	2.50%	–	0.02%
7-10yr UST	2.77%	–	-0.23%
10yr+ UST	3.04%	–	-1.04%
10yr+ Germany	0.74%	–	0.09%
10yr+ Japan	0.08%	–	0.22%
US HY	6.09%	345 bps	-0.90%
European HY	2.75%	353 bps	-0.54%
Barclays Ag		251 bps	-0.29%
VIX Index*	22.68	–	9.14%
DXY Index*	90.24	–	1.11%
EURUSD	1.2272	–	-1.14%
USDJPY	109.55	–	0.33%
CRY Index*	192.85	–	-4.52%
Brent	65.8	–	-4.66%
Gold spot	1318	–	-2.01%

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

Emerging Market

Last week the S&P 500 equity options volatility index, VIX, also known as the 'fear gauge', spiked by more than 35 points from 13 to 50 as the fallout from higher than expected wage inflation spooked the US stock market. Volatility also spilled into other markets, including EM.

The extreme sensitivity of the US equity market to a mere sniff of inflation indicates that this and other developed markets have not priced in the risks of higher inflation or the associated monetary tightening. EM assets are not similarly mispriced and the reaction in EM markets is of the knee-jerk-risk aversion variety, which is caused mainly by investor behaviour. The sell-off is an opportunity to add exposure to EM assets, which, in addition to better valuations, are also supported by improving technicals and fundamentals. Since the duration of the sell-off cannot be exactly gauged, we believe that investors should scale into the market in a phased manner, starting with a first bullet now. Investors should be ready to fire two more bullets if prices fall, say, ten percent further.

Risk aversion episodes, such as last week's VIX spike, have been excellent entry points for EM investors. Investors have consistently been able to add nearly 300bps of alpha in fixed income and more than 250bps of alpha in equities by actively buying into EM assets in months, when the VIX index has spiked by 10 points or more. To illustrate this, Figure 1 shows the additional return on offer in various EM fixed income and equity asset classes for investors, who specifically buy during VIX spikes. The 'active' strategy shows returns, when investors enter the market during +10 points VIX spikes, while the 'passive' strategy is a counter-factual, which shows index returns. The 'alpha' column indicates the alpha (in bps) specifically available to investors, who deliberately enter the EM market during VIX spikes.

The results are compelling. On average, EM fixed income investors increase their average annual return by 299bps by entering EM bond and currency markets during bouts of risk aversion, while equity investors enhance

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Emerging Markets

their average annual return by an average of 253bps.[1] These results are based on analysis of all the VIX spikes, which have occurred over the full period for which index data exists for the strategies in question (years of index data in the 'period' column).

Figure 1: **Comparing returns to active versus passive strategies during bouts of risk aversion (+10 points spikes in the VIX index)**

Strategy	Alpha of 'active' vs 'passive'	'Active' return	'Passive' return	Period
	bps	%	%	Years
Fixed Income	**299**	**11%**	**8%**	**–**
External debt (EMBI GD)	234	12%	9%	24
External debt IG (EMBI GD IG)	*304*	*11%*	*8%*	*24*
External debt HY (EMBI GD HY)	*216*	*13%*	*11%*	*24*
Corporate debt (CEMBI BD)	296	10%	7%	16
Corporate high grade (CEMBI BD HG)	*221*	*9%*	*7%*	*16*
Corporate high yield (CEMBI BD HY)	*599*	*15%*	*9%*	*16*
Local currency bonds (GBI EM GD)	246	10%	8%	15
FX forwards (ELMI+)	*276*	*9%*	*6%*	*24*
Stocks	**253**	**7%**	**5%**	**–**
Equities (MSCI EM)	383	7%	4%	24
EM small cap (MXEFSC Index)	501	9%	4%	24
Frontier Equities (MXFM Index)	-126	5%	6%	16

Source: Ashmore, Bloomberg, JP Morgan, MSCI.

Why does buying EM during VIX spikes – i.e. in the middle of bouts of risk aversion, when many investors are typically inclined to sell – generate so much additional return? The answer is that, while very few VIX spikes have any material or lasting negative implications for EM fundamentals, they almost always trigger panic selling among weaker hands/less informed investors. A strategy of buying EM during risk-off episodes means entering the asset class at a time when markets are over-reacting to the downside. It exploits one of the most irrational investment practices, namely to knee-jerk sell everything in EM in response to risk-off episodes, regardless of their nature or origin.

While spikes in VIX offer excellent entry points the broader case for EM right now is also very strong for the following reasons:

- EM valuations are attractive in absolute terms and relative to valuations in developed markets with yields and spreads well wide of past tights.
- EM technicals remain very supportive with strong inflows, especially from underweight institutional investors.
- EM fundamentals are strong and improving with growth picking up and domestic demand, which makes up 75% of EM GDP, now starting to play a greater part in the growth story.
- EM assets have priced in far more Fed tightening than the Fed is likely to deliver over the foreseeable future, especially in local markets.
- EM countries have demonstrated fundamental robustness by facing down multiple external shocks over the past few years. These include the Taper Tantrum, a 45% Dollar rally, a halving of commodity prices and higher borrowing costs with remarkably few defaults or balance of payments problems.

However, the current case for EM is not just predicated on EM strength. It also rests on the now very evident vulnerabilities in developed markets. These vulnerabilities stem from the fact that valuations have been pushed to such elevated levels after years of Quantitative Easing (QE) that they now offer very little protection against even small negative surprises. Developed market central banks are likely to tighten monetary policies gradually, so erstwhile capital gains in these markets can easily turn into capital losses against a backdrop of very low or even negative yields. In other words, the outlook for total return in these markets going forward is challenging, at best. By contrast, EM was the only asset class to cheapen outright during the QE period, which is why EM assets now offer realistic prospects for both capital gain and yield against the improving fundamental and strong technical backdrop. EM assets are not just the most attractive investment proposition on offer today; they are arguably also the safer choice.

[1] The only EM asset class, where there is no positive benefit from entering the asset class during VIX spikes is Frontier Equities. We attribute this to two factors. First, the MSCI Frontier Markets index represents Frontier Markets even more badly than other EM indices with a few quite unrepresentative countries dominating the index. Second, Frontier Markets have much less participation from fast money, retail, banks and hedge funds, whose behaviour typically causes the irrational pricing of EM assets during VIX spikes. As Figure 1 shows the difference in returns between active and passive strategies in the twelve months after VIX spikes is therefore much smaller in Frontier Equities than in other asset classes.

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Emerging Markets

VIX spikes are rare gifts, so it is important that investors exploit them to the full when they occur. Figure 2 lists all the VIX spikes of 10 points or more in a single month since 1990. There have only been sixteen such events over this period of nearly three decades. Almost all the VIX spikes have been caused by problems in developed markets, not in EM. In fact, this year it is 20 years ago an EM event last caused a major VIX spike.

Figure 2: **Major risk aversion events**

Date of VIX spike	VIX spike trigger event
April 1994	Fed hikes
October 1997	Asian crisis
August 1998	Russian crisis
October 2000	Fear of slowing US economy
September 2001	9/11
July 2002	Fear of slowing US economy
June 2006	Hike triggers recession fears
August 2007	BNP Paribas gates
September 2008	Lehman
May 2010	Greece
March 2011	Japan earthquake
August 2011	US debt ceiling and Eurozone crisis
October 2014	Rate hike fears
August 2015	Fed hike fears
June 2016	Brexit
February 2018	US inflation fears

Source: Ashmore, Bloomberg.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-6.25%	1.56%	30.59%	9.22%	4.86%
MSCI EM Small Cap	-6.43%	-0.99%	23.63%	7.64%	4.75%
MSCI Frontier	-3.17%	2.38%	25.51%	6.90%	7.95%
MSCI Asia	-6.62%	0.42%	32.34%	9.94%	8.10%
Shanghai Composite	-3.17%	1.93%	8.98%	5.06%	9.30%
Hong Kong Hang Seng	-6.45%	8.35%	34.09%	6.64%	5.40%
MSCI EMEA	-5.92%	-0.14%	21.33%	5.06%	-0.23%
MSCI Latam	-3.70%	8.98%	24.94%	8.52%	-1.87%
GBI EM GD	-1.28%	3.14%	15.09%	3.48%	-1.13%
ELMI+	-0.99%	1.87%	10.47%	3.51%	-0.38%
EM FX Spot	-1.18%	2.32%	6.22%	-2.79%	-6.61%
EMBI GD	-1.05%	-1.09%	6.56%	6.29%	4.70%
EMBI GD IG	-0.95%	-1.61%	5.09%	3.82%	3.36%
EMBI GD HY	-1.13%	-0.61%	8.04%	9.26%	6.25%
CEMBI BD	-0.43%	-0.36%	5.72%	5.72%	4.49%
CEMBI BD IG	-0.37%	-0.58%	4.42%	3.71%	3.73%
CEMBI BD Non-IG	-0.49%	-0.05%	7.58%	9.01%	5.52%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-4.52%	0.94%	19.92%	11.73%	14.60%
1-3yr UST	0.10%	-0.22%	-0.05%	0.49%	0.51%
3-5yr UST	0.10%	-0.88%	-0.42%	0.76%	0.86%
7-10yr UST	-0.24%	-2.40%	-0.54%	0.29%	1.24%
10yr+ UST	-1.68%	-4.85%	2.44%	-0.05%	3.15%
10yr+ Germany	-0.23%	-1.76%	-1.94%	-0.44%	5.19%
10yr+ Japan	0.10%	-0.11%	2.64%	3.83%	5.16%
US HY	-0.95%	-0.35%	5.07%	5.65%	5.46%
European HY	-0.57%	-0.38%	4.69%	4.99%	6.88%
Barclays Ag	-0.37%	-1.04%	4.16%	2.99%	3.75%
VIX Index*	67.50%	105.43%	100.89%	31.17%	68.00%
DXY Index*	1.24%	-2.04%	-9.99%	-4.71%	12.53%
CRY Index*	-2.29%	-0.52%	0.77%	-14.23%	-35.92%
EURUSD	-1.14%	2.22%	14.87%	8.45%	-8.39%
USDJPY	0.33%	-2.79%	-2.54%	-8.03%	17.00%
Brent	-4.66%	-1.56%	19.58%	13.89%	-43.85%
Gold spot	-2.01%	1.15%	6.82%	6.82%	-21.15%

*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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