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WEEKLY INVESTOR RESEARCH

Ashmore

Five factors supporting EM

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Emerging Markets (EM) performed well in Q1 2018 in the context of heightened risk aversion, trade wars and other nasty news. We explain the five factors currently supporting EM, in our view. This week's research also covers Saudi Arabia's inclusion in the FTSE Russell EM stock market index, the latest election-related news in Brazil and China's response to America's declaration of a trade war.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	-1.03%
MSCI EM Small Cap	11.2	–	1.00%
MSCI Frontier	11.1	–	-0.21%
MSCI Asia	11.5	–	-0.80%
Shanghai Composite	10.6	–	0.94%
Hong Kong Hang Seng	7.2	–	-3.45%
MSCI EMEA	9.5	–	-2.38%
MSCI Latam	12.4	–	-0.58%
GBI-EM-GD	6.01%	–	0.05%
ELMI+	3.71%	–	0.13%
EM FX spot	–	–	-0.25%
EMBI GD	5.79%	305 bps	0.74%
EMBI GD IG	4.55%	180 bps	0.58%
EMBI GD HY	7.17%	444 bps	0.88%
CEMBI BD	5.51%	282 bps	0.23%
CEMBI BD IG	4.55%	187 bps	0.25%
CEMBI BD Non-IG	6.68%	398 bps	0.21%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.0	–	-0.22%
1-3yr UST	2.27%	–	0.12%
3-5yr UST	2.58%	–	0.30%
7-10yr UST	2.76%	–	0.78%
10yr+ UST	2.98%	–	1.89%
10yr+ Germany	0.52%	–	0.21%
10yr+ Japan	0.03%	–	-0.19%
US HY	6.20%	360 bps	0.02%
European HY	3.14%	387 bps	0.08%
Barclays Ag	–	250 bps	0.60%
VIX Index*	23.02	–	1.99%
DXY Index*	89.87	–	0.84%
EURUSD	1.2331	–	-0.60%
USDJPY	106.06	–	0.68%
CRY Index*	193.38	–	-2.88%
Brent	68.0	–	-2.98%
Gold spot	1339	–	-0.47%

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

Emerging Markets

So far this year, EM local markets are beating developed markets in currencies, stocks and bonds. EM currencies are up 2.11% versus the Dollar, EM stocks are up 1.26% versus -2.98% for the S&P 500 and EM local currency government bonds are up 4.44% in Dollar terms versus -0.65% for US 5 year Treasury bonds (see table at the end of this document). The EM outperformance in local markets is likely to be a 'pain trade' for many investors, because it has taken place in circumstances, which normally induce sell-offs in EM, including bouts of quite severe risk aversion, heightened US stock market volatility and a growing risk of trade wars.

Yet, the outperformance in EM local markets is not a new thing. Rather, it is a continuation of a trade, which began more than two years ago to which we first drew attention in September 2015.[1] EM local currency bonds have returned 29.6% in Dollars since the start of 2016, while EM equities have clocked up about 50% return. EM FX is now up 8.3% against the Dollar since Q1 2016, which is the third year of outperformance in a row. The strength of EM FX is particularly impressive given the backdrop of sustained fundamental events in support of the Dollar, including stronger than expected US growth and new highs on an almost daily basis in the US stock market during H2 2017. The Trump tax reform was also supposed to be Dollar positive, since it was designed to induce repatriation of hundreds of billions of Dollars of corporate balance sheet money. To add insult to injury to the Dollar, even the higher real rates in the US over the last year have failed to support the Dollar.

Clearly, there has been an important turning point in the market relative to the bearish years for EM between 2010 and 2015. We see five factors currently driving the outperformance of EM local markets, which we explain below. However, before doing so, it is important to appreciate the role played by the broader global financial backdrop, especially the role of Quantitative Easing (QE). In our view, markets and large sections of the financial media still fail to give adequate recognition to the full impact of central bank asset purchases on financial markets in recent years. We believe that QE distorted valuations in global financial markets severely, so severely in fact that many of the traditional linkages between fundamental drivers of markets (such as growth rates, interest rates and market sentiment, etc.) and asset prices have weakened significantly. Intuitively, think of it this way: if investors have bought so many Dollars already that they are limit long Dollars

[1] See *'The View from Kilimanjaro: EM FX in a QE world'*, The Emerging View, September 2015.

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then, clearly, the Dollar will not rise even when conventional fundamental drivers of the Dollar rise, since there are no buyers left. Similarly, when there are no more sellers of EM assets, say, because foreigners are already heavily underweight after years of selling down their EM positions, then clearly EM local markets are not going to sell off even when something scary happens. In short, extreme positioning has neutered, for now, conventional fundamental drivers and reaction functions in the markets.

The myth that QE was good for EM continues to survive to this day. Specifically, many investors still cling to the notion that a search for yield in EM took place during the QE years. This view is incorrect. The yield/spread on offer in EM was grossly insufficient to induce flows to EM in the context of the spectacular capital gains on offer in the QE economies. QE policies had a *direct* impact on developed market securities and no *direct* impact on EM, because the four major QE central banks[2] only bought their own government bonds and did not buy a single EM bond. By contrast, QE policies had a massive *indirect* impact on EM, because they induced a giant portfolio shift out of EM and into developed markets across the world's largest institutional investors. This portfolio shift took place, when, after an initial lag, pension funds, insurance companies, central banks, sovereign wealth funds and other large pools realised that QE would be extremely supportive of US markets. They responded by buying US dollars and US stocks on the view that the US would bounce back strongly in response hyper-easy monetary policies, especially since US banks had been recapitalised early in the crisis. Investors also put money into Europe, but in different assets and for a different reason. Investors took the view that Europe would not grow and therefore would not have inflation either, so bonds were the place to receive the trillions of Euros worth of bond purchases undertaken by the European Central Bank. These three QE-sponsored trades – the Dollar, US stocks and European bonds – were enormously lucrative. US stocks rallied 300%, the Dollar rallied 45% against EM currencies and German long bonds delivered returns of more than 80%. In comparison with such spectacular capital gains, the yields on offer in EM simply held no sway. Thus, between 2010 and 2015, investors pulled about a third of their capital out of EM in order to chase capital gains in the QE-sponsored economies. The result was a severe tightening of financial conditions in EM in the middle of the largest monetary policy easing experiment in global financial history. Financial conditions in EM only began to ease after the Fed made its first interest rate hike in December 2015 at which point the smartest investors realised that the QE trades were past their best and that EM was the only market on earth to have cheapened outright during the QE years. Flows slowly began to return.

It is against this backdrop of unwinding QE trades that we see five specific factors driving EM local markets, namely valuations and technicals, growth, improving credit fundamentals and tail winds from the deterioration of economic policy in the US in particular. Consider each in turn:

1. Valuations and returns: It took five years for investors to pull their money from EM and it is likely to take at least five years for the money to return (this may prove optimistic; after all, getting investors to pull money out of EM is usually a lot easier than getting them to allocate to EM). Over this five-year period, we expect the yield on EM local currency bonds to average about 6% against a backdrop of about 4.5% EM inflation. This implies positive real yields of about 1.5% for EM local government bonds (which have c. 4.5 year duration and are 80% investment grade), which is entirely within normal ranges for real yields and hence realistic. Meanwhile, we see about 20% upside for EM currencies over this period, given the incredibly low starting point for EM currencies reached in early 2016. Between yield and FX, we therefore expect about 50% return in Dollars for EM local currency bonds, or 10% return in Dollar per year sustained over five years. We do not currently see any other government bonds in the world, which can beat this expected performance.

2. Technicals: Fast money is largely out of the EM asset class, banks have very small balance sheets after Dodd-Frank, hedge funds appear still not to have figured out how to trade the reversal of QE and institutional investors only began to allocate in H2 2017. Indeed, we estimate that only between 20% and 25% of the institutional money, which left EM between 2010 and 2015 has so far returned. In Brazil, an important local market, foreigners only own about 10% of the local bonds compared to 30% during typical EM local currency bull markets. The strong technicals in EM local markets are also evident from the benign price action in response to a series of 'scary' events in 2016 and 2017, including: (a) excessively aggressive expectations of Fed hikes in early 2016; (b) Brexit in June 2016; (c) the Turkish attempted coup in July 2016; (d) Trump's election in November 2016; (e) numerous North Korean fear moments in 2017; (f) the Trump tax cut of late 2017; (g) the spike in VIX in late January of 2018 and (h) Trump's Trade War. Granted, EM local markets will eventually become more sensitive to bouts of risk aversion, but investors will have to buy the bonds first before they can sell them, so for now light positioning clearly exerts a dampening effect on the price action to the downside during risk aversion events.

3. Growth: The commencement of allocations to EM local markets by institutional investors in H2 2017 should have a very benign effect on EM growth going forward, because EM countries are severely finance constrained. EM only commands 20% of global fixed income compared to EM's share of global GDP of between 40% and 60% (depending on your choice of methods for calculating GDP). Inflows have powerful effects on finance-constrained economies. They help to ease domestic financial conditions, and thus stimulate domestic demand. Domestic demand comprises 75% of EM GDP. Domestic demand froze solid between

[2] Bank of England, Bank of Japan, the Federal Reserve and the European Central Bank.

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2010 and 2015, but is now thawing. We expect continuing positive EM growth surprises in the coming years due to inflow. There will be a positive feedback loop from inflows into local markets to growth and then back to further inflows since investors like to invest in countries where growth is improving.

4. Better earnings and credit fundamentals: Stronger economic growth will obviously be supportive for corporate earnings against a backdrop where EM multiples remain significantly lower than in developed markets. Stronger growth also means better fiscal revenues and fewer government outlays. Lower fiscal deficits in turn leads to less supply, so debt to GDP ratios improve. Stronger EM currencies will also encourage syndicate desks to shift issuance to local markets from the Dollar markets. Corporates will find it easier to refinance, so default rates should come down. In short, even through local markets should do better than Dollar markets there will also be fundamental improvements, which will support the Dollar denominated government and corporate bond markets in EM.

5. Tail winds from the US courtesy of the fiscal mess: The Trump tax cut is enormous, but unfunded. The US Treasury will have to find buyers for some 7-8% of GDP worth of US government bonds in the coming years in order to finance the rapidly growing fiscal deficit. There are only three sets of institutions, which buy US government bonds in size, namely the Fed, US pension funds and insurance companies, and foreign central banks. Unfortunately, there are no obvious buyers among these institutions. First, the Fed is no longer buying as its asset purchase programme goes into reverse; in fact, the Fed may even become a supplier of duration. Second, US pension and insurance companies have more US bonds than they would like due to regulation. Third, foreign central banks are already limit long Dollars. How, then, will US Treasury Secretary Mnuchin place so many additional bonds? There are two financing options. One is to place the bonds domestically with US pension and insurance companies, but this will require substantially higher yields. Unfortunately, the US stock markets are hypersensitive to higher real yields as the recent price action has shown, so if all the bonds have to be placed at home a stock market crash cannot be ruled out, which in turn could threaten economic expansion as well. The other option is to place the bonds overseas, but this requires the Dollar to fall further. If the Dollar falls significantly EM FX reserves will grow, since EM central banks, which today control nearly 80% of the world's FX reserves, tend to intervene to slow appreciation of their currencies. Intervention boosts their reserves, which incrementally tend to be invested in US Treasuries. We estimate that a 10% fall in the Dollar could generate trillions of Dollars of fresh demand for US Treasuries, thus helping to keep real yields low and thereby protecting both the US stock market and the US economy. We expect that the weaker Dollar path will be preferred to the higher real yields path.

We expect that these five drivers – valuations and returns, technicals, growth, better earnings and credit fundamentals and the deteriorating US fiscal picture – will sustain the positive sentiment towards EM local markets for several years. Early movers into this trade can still claim to be ahead of 80% of the herd.

- Saudi Arabia: FTSE Russell, an index provider, approved Saudi Arabia for inclusion in its EM equity index starting in March 2019 following extensive economic and market-related reforms. Saudi Arabia will initially have a weight of 2.7% in the index, but the weight may rise to nearly 5% in the event of a successful IPO of Saudi Aramco, the national oil company. We think FTSE's early move also increases the odds that MSCI, another index provider, will include Saudi Arabia in its index later this year. The Saudi Tadawul stock market is by far the largest in the region and one of the largest equity markets in EM.[3]

- Brazil: A district-level Court of Appeals rejected former President Lula's appeal against a guilty verdict on charges of corruption, thus severely eroding his already rapidly fading hopes of running in the presidential election scheduled for later this year. The Supreme Court will rule later this week whether Lula can appeal his guilty verdict to the Supreme Court. Even if he gets the green light to appeal, however, Lula is unlikely to be able to run as a candidate in the election. In other news, the Executive Secretary of the Ministry of Finance, Eduardo Guardia, is rumoured to replace Henrique Meirelles as finance minister following the latter's announcement that he will run for president. We do not expect this appointment to result in any change in economic policy in Brazil. The central bank's monetary policy committee (COPOM) indicated in Minutes released last week that it may cut one more time and then pause. The trade surplus in March was USD 6.3bn, which takes the 12-month rolling trade surplus to USD 67bn.

- China: China announced counter-tariffs on US imports following US President Donald Trump's unilateral imposition of steel and aluminium tariffs some weeks ago. We expect that China will continue to respond in a proportionate and targeted manner to US protectionism, while maintaining a bias towards freer trade with third countries. For more details on US and Chinese relations, see the following three reports:
  - '*Trade war*' – Weekly investor research, 26 March 2018.
  - '*Chinese reforms and American populism*' – The Emerging View, November 2016.
  - '*Trump and EM*' – The Emerging View, January 2017.

In other Chinese news, the official headline PMI increased to 51.5 in March, well ahead of market expectations (consensus: 50.6), while the Caixin Manufacturing PMI moderated to 51.0 in March from 51.6 previously.

[3] Saudi Arabia has been working consistently on index inclusion since 2014. See for example *'Saudi Arabia: A USD 560bn opportunity'*, Occasional View, August 2014.

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Snippets:

- **Argentina:** The rate of real GDP accelerated to 4.1% yoy in January from 3.0% yoy in December, driven in large measure by domestic demand (retail sales). Industrial production also accelerated to a rate of 5.3% yoy in February from 2.6% yoy in January, while construction was 16.6% higher in February than the year before.
- **Chile:** Labour force participation increased by 0.7% to 60.1% in February as better economic prospects under President Sebastian Pinera's new government translated into stronger labour markets.
- **Costa Rica:** Carlos Alvarado Quesada is Costa Rica's next President. His election with a landslide increases the odds that the government will pass fiscal reform and implement a fiscal responsibility law.
- **Czech Republic:** The Czech National Bank kept the policy rate unchanged at 0.75%.
- **Ecuador:** The government announced a spending cut of USD 1bn.
- **Egypt:** President Abdel-Fattah al-Sissi was re-elected for a second term with some 92% of the votes cast. Egyptian local markets have performed strongly under the more stable government in Egypt in recent years.
- **India:** The March PMI moderated to 51 from 52.1 in February. The Reserve Bank of India allowed banks to spread mark to market losses over up to four quarters, which should support the bond market, which has seen yields rise for the past seven months.
- **Indonesia:** The yoy rate of headline CPI inflation was 3.4% in line with expectations. Core inflation was 2.7% yoy, also in line with expectations. Former Deputy Governor Perry Warjiyo was promoted to the post of Governor of Bank Indonesia. This signals continuity of monetary policy, in our view.
- **Malaysia:** The fiscal deficit for the first two months of 2018 was MYR 12.05bn, which is substantially lower than the deficit at the same time last year (MYR 14.8bn). The fiscal numbers suggest that the government has resisted the temptation to splurge ahead of an expected election within the next couple of months.
- **Peru:** President Martin Vizcarra appointed David Tuesta, a former banker, to the post of finance minister.
- **South Korea:** Exports were 6.1% higher in March than in the same month of 2017, falling slightly short of expectations (6.7% yoy). Industrial production in February increased 1.1% mom in seasonally adjusted terms versus an expansion of 0.9% mom sa in January. CPI inflation was 1.3% yoy in March versus 1.4% yoy in February.
- **Sri Lanka:** The yoy CPI inflation rate declined to 4.2% in March from 4.5% in February.
- **Thailand:** The rate of consumer prices inflation in March was lower than expected at 0.8% yoy (consensus: 1.0% yoy). The current account surplus increased to USD 6.2bn in February from USD 5.2bn in January.
- **Turkey:** Real GDP growth decelerated to 7.3% yoy in Q4 2017 from 11.3% yoy in Q3 2017. The current account deficit widened to 7.0% of GDP from 6.1% of GDP over the same period.
- **Vietnam:** Real GDP growth in Q1 2018 was 7.4%, which was faster than expected.

Global backdrop

US core PCE inflation ticked up one tenth of one per cent to reach 1.6% yoy and looks set to reach 2.0% yoy over the next few months due to base effects. The Fed funds rate is still just 1.75%, so the Fed is currently allowing the US economy to operate at or near full employment with the real policy rate still significantly in negative territory. We know why. Stock markets have proven themselves extremely sensitive to fears of higher real rates, so if the Fed hikes too much then stocks could crash. A stock market crash has not prevented the Fed from hiking in the past, but today there is an obstacle to hiking rates, namely that the Fed does not have enough room to cure a recession. The average rate cut in a US recession in the past 40 years has been in excess of 500bps. In short, the Fed can just hope that inflation will not rise any faster than it is already doing.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.11%	1.26%	25.17%	8.52%	5.46%
MSCI EM Small Cap	0.37%	0.55%	19.31%	6.80%	4.97%
MSCI Frontier	-0.53%	4.59%	26.75%	6.92%	8.30%
MSCI Asia	-0.02%	0.57%	26.05%	9.06%	8.51%
Shanghai Composite	-0.18%	-4.34%	0.17%	-4.35%	9.85%
Hong Kong Hang Seng	-3.10%	2.47%	21.46%	2.82%	5.99%
MSCI EMEA	-0.23%	-1.08%	20.47%	4.58%	0.69%
MSCI Latam	-0.49%	7.57%	19.12%	8.85%	-1.47%
GBI EM GD	0.00%	4.44%	12.99%	4.94%	-0.68%
ELMI+	0.13%	2.65%	8.85%	3.58%	-0.08%
EM FX Spot	0.03%	2.11%	4.70%	-1.85%	-6.33%
EMBI GD	-0.05%	-1.79%	4.25%	5.48%	4.63%
EMBI GD IG	-0.01%	-2.44%	2.77%	2.94%	3.20%
EMBI GD HY	-0.09%	-1.21%	5.71%	8.58%	6.27%
CEMBI BD	-0.04%	-1.16%	3.62%	4.84%	4.14%
CEMBI BD IG	-0.02%	-1.36%	2.38%	3.04%	3.41%
CEMBI BD Non-IG	-0.06%	-0.90%	5.38%	7.66%	5.06%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-2.23%	-2.98%	11.44%	9.94%	12.76%
1-3yr UST	0.06%	-0.10%	0.03%	0.40%	0.52%
3-5yr UST	0.09%	-0.65%	-0.25%	0.54%	0.83%
7-10yr UST	0.12%	-1.75%	-0.30%	0.22%	1.11%
10yr+ UST	0.05%	-3.25%	3.27%	0.37%	3.22%
10yr+ Germany	0.01%	1.12%	0.19%	-1.01%	5.15%
10yr+ Japan	-0.02%	0.98%	2.53%	4.05%	4.16%
US HY	-0.09%	-0.95%	3.69%	5.10%	4.95%
European HY	0.02%	-0.52%	3.97%	4.26%	6.43%
Barclays Ag	0.05%	-1.37%	3.02%	2.62%	3.45%
VIX Index*	15.27%	108.51%	85.95%	56.92%	62.00%
DXY Index*	-0.31%	-2.45%	-10.61%	-6.91%	8.65%
CRY Index*	-1.02%	-0.25%	4.80%	-10.51%	-33.26%
EURUSD	0.06%	2.72%	15.57%	12.40%	-4.04%
USDJPY	-0.21%	-5.88%	-4.36%	-10.86%	13.99%
Brent	-3.19%	1.73%	28.07%	23.80%	-36.49%
Gold spot	1.04%	2.74%	6.81%	11.29%	-14.07%

*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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