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Ashmore

Good things come in threes

By Jan Dehn

Good things come in threes. Emerging Markets (EM) bonds and currencies offer excellent value after a little panic among some retail and fast money investors as the 10-year US Treasury bond yield breaches 3%. Real yields are very high, currencies are competitive and the growth picture is solid. The Dollar trajectory has not changed either, in our view. External debt also offers a good entry point now. In EM specific news: Argentina's monetary policy U-turn, peace in the Koreas, financial sector liberalisation in China, liberalisation of bond market access in India, stabilisation of oil production in Mexico, tighter liquidity in Turkey but with higher inflation and bond index inclusion for Dominican Republic.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	-1.01%
MSCI EM Small Cap	11.3	–	-1.86%
MSCI Frontier	10.7	–	-1.42%
MSCI Asia	11.6	–	-0.80%
Shanghai Composite	10.6	–	0.36%
Hong Kong Hang Seng	7.3	–	0.11%
MSCI EMEA	9.7	–	-1.67%
MSCI Latam	12.7	–	-0.59%
GBI-EM-GD	6.12%	–	-1.35%
ELMI+	4.36%	–	-0.88%
EM FX spot	–	–	-1.12%
EMBI GD	6.04%	307 bps	-0.75%
EMBI GD IG	4.76%	179 bps	-0.59%
EMBI GD HY	7.47%	451 bps	-0.92%
CEMBI BD	5.70%	277 bps	-0.38%
CEMBI BD IG	4.75%	182 bps	-0.34%
CEMBI BD Non-IG	6.86%	392 bps	-0.44%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.4	–	0.00%
1-3yr UST	2.48%	–	0.03%
3-5yr UST	2.80%	–	0.04%
7-10yr UST	2.96%	–	-0.01%
10yr+ UST	3.13%	–	0.29%
10yr+ Germany	0.58%	–	0.52%
10yr+ Japan	0.05%	–	-0.12%
US HY	6.26%	333 bps	-0.39%
European HY	2.85%	371 bps	-0.07%
Barclays Ag	1.94%	-102 bps	-0.72%
VIX Index*	15.41	–	-1.47%
DXY Index*	91.55	–	0.60%
EURUSD	1.2127	–	-0.68%
USDJPY	109.18	–	0.43%
CRY Index*	201.39	–	-0.53%
Brent	74.2	–	-0.70%
Gold spot	1319	–	-0.47%

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

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- **The yield on the 10-year US Treasury bond broke 3% last week:** We see three reasons why the bout of volatility associated with this event is an opportunity. First, pricing is attractive. Emerging Markets already offered good value before last week's bout of risk aversion and now the attractiveness is even greater. Besides, EM markets already price in far higher yields than we are likely to see in the US market for some time. Second, the economic fallout from higher yields is likely to be higher in developed economies than in EM, where we may not see any at all. Third, a scenario with a lower Dollar and relatively contained real yields in the US is still the most likely medium-term trend and the large Quantitative Easing (QE) trades of the recent years are unwound. We see the recent risk aversion moves in the market as technical and momentum-driven in nature rather than fundamentally or value-driven. We also expect EM selling to be relatively short-lived. We believe that investors should therefore do themselves a favour and buy into weakness in order to lock in even greater future upside. The following paragraphs explain these arguments in greater detail.

1. **EM local markets are now very attractive:** The broad-based pull back in EM last week in response to the rise in US Treasury yields has left EM currencies down 34bps versus the Dollar, but local currency bonds still up a modest 1.8% in Dollar terms year to date. All the price action can be attributed to investor behaviour, because there have been no major changes in the fundamental outlook for EM (other than further disinflation, which has actually rendered valuations in EM local markets even more attractive).[1] For example, the nominal yield for EM local currency bonds, which are 85% investment grade and have just five years of duration, now sits at 6.12%. This translates into a real yield of 278bps compared to 178bps in April last year. Moreover, our analysis indicates that there is nothing in the recent price action which would lead us to expect anything other than some 50% in return in Dollar terms over the 2017-2021 period for this market. The other reason for regarding these bonds as attractive is that they price in a great deal more US Treasury market tightening than

[1] See *'EM inflation hits a new cycle low'*, Weekly investor research, 23 April 2018.

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is likely to take place for some time. As column 4 in Figure 1 shows, the EM local currency bond yield is currently a mere 0.59% lower than in late 2006, when the Fed hiking cycle last peaked. In comparison, the Fed funds rate is still 3.54% lower than in late 2006, while yields on US 2-year, 5-year and 10-year bonds are 2.18%, 1.72% and 1.59% lower than in late 2006, respectively. Even the real 10-year US Treasury yield is still materially lower today (-1.81%) than in late 2006, while the US yield curve is still 0.59% steeper than in late 2006. The alternative way to illustrate how much tightening is already in the price in EM bonds markets is to calculate what US yields ought to be right now, given current yields in EM and assuming a constant relationship between the two markets over time. Column 1 in Figure 1 shows this. Yields in EM today imply a Fed funds rate of 4.78%, a US 10-year yield of 5.00% and the real 10-year yield of 1.47% as well a 0.12%s inversion of the Treasury curve. Only the 2-year US bond today looks cheap relative to EM valuations (2.49% versus a GBI-implied yield of 2.27%). Does this imply that the Fed is heading for a policy mistake caused by too rapid tightening?

Fig 1: **Valuations in EM and US fixed income: Today versus the last peak in the Fed hiking cycle**

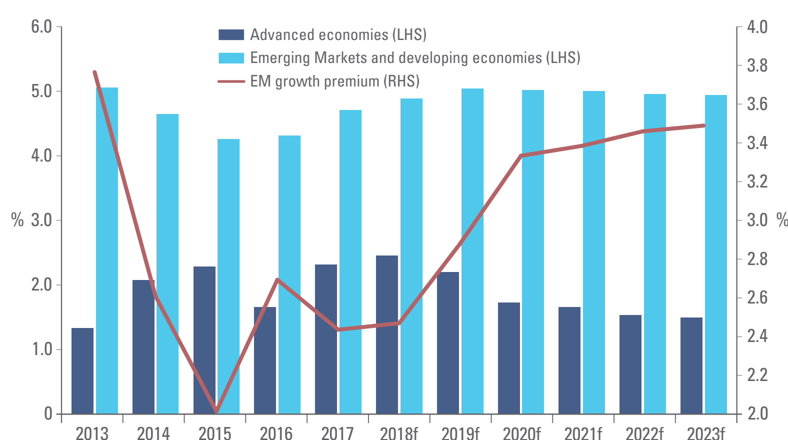
Market	Rates implied by current valuations in GBI EM GD (%)	Market today (%)	Market in December 2006 (%)	Absolute change since December 2006 (%)
JPM GBI EM GD		**6.12**	**6.71**	**-0.59**
Fed funds rate	4.78	1.70	5.24	-3.54
US 2-year note	2.27	2.49	4.67	-2.18
US 5-year note	4.13	2.82	4.53	-1.72
US 10-year bond	5.00	2.97	4.56	-1.59
Real 10yr rate	1.47	0.57	2.39	-1.81
2s10s spread	-0.12	0.48	-0.11	0.59

Source: Ashmore, Bloomberg, JP Morgan. Data as of COB 26 April 2018.

2. Fundamentals in developed economies will be more sensitive to rising real yields than EM fundamentals: EM countries are in a strong position to handle rising US treasury yields. First, as noted above, local bonds already price in far tighter conditions. Second, the growth outlook is strong. IMF expects the EM growth premium over developed economies to rise from 2.4% today to 3.5% by 2023 due to a combination of reforms, greater external competitiveness due to lower inflation and cheaper currencies as well as stronger domestic demand on the back of easier financial conditions. Thirdly, EM has proven its resilience. Remember that EM countries just passed important stress tests in the shape of the Taper Tantrum, a 50% fall in commodity prices and a 45% rally in the US dollar. These shocks in turn induced a further shock, namely that EM bonds yields increased to an astonishing 7.25% on several occasions in the last few years. This is higher than the 6.7% yield on EM bonds prior to 2008/2009. Inflation declined over this period too, so the interest rate shock in EM was real.[2] In comparison, the move in the Treasury curve has so far been rather mundane.

By contrast, we see vulnerability in developed economies. Governments failed to use easy monetary conditions in recent years to reform the public finances or make serious investments in infrastructure. Productivity declined. Inequality increased. Populism is on the rise, including protectionism and irresponsible fiscal policies. As central banks in developed economies attempt to normalise monetary policies the cost of servicing debt will eat into consumer spending and hurt investment spending. For example, Moody's estimates that the US federal government's debt burden and the interest-to-revenues ratio will rise by 30% and 15% over the next decade, respectively.

Fig 2: **Growth rates in EM and developed markets are set to diverge significantly in coming years**



Source: Ashmore, IMF.

[2] For a very recent update on EM inflation see *'EM inflation hits a new cycle low'*, Weekly investor research, 23 April 2018.

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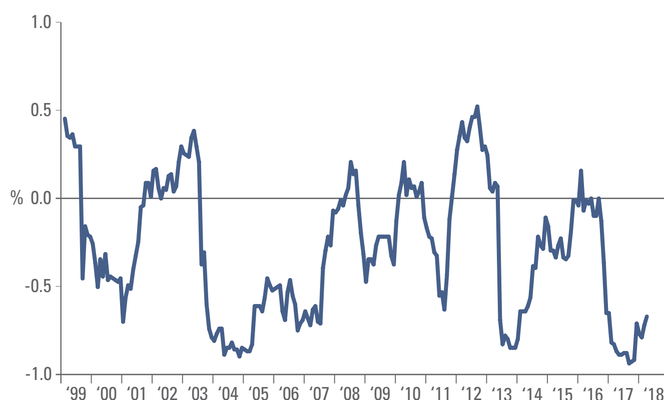
3. The direction of travel for the Dollar remains down, which should also help to keep real yields contained: The key question in global macroeconomics is who will finance the expanding US fiscal deficit? Trump's tax cut will require the US Treasury to issue bonds to the tune of 7%-8% of US GDP over the next few years. Either Americans or foreigners will buy these bonds. American pension funds and insurance companies will only buy the bonds if real yields rise, but while this may support the Dollar temporarily, as it is doing now, rising real yields will soon hurt the stock market and the wider economy. Alternatively, foreign central banks could buy the bonds. EM central banks today control more than USD 8.5trn of FX reserves, mostly invested in US assets. However, they are already close to limit-long Dollar assets, so they can only buy more if their reserves go up. This requires the Dollar to fall, which prompts EM central banks to intervene and thereby acquire the means to buy more Treasuries. In short, given the fiscal situation the US outlook is either one of weaker domestic conditions in the US due to higher real yields or a weaker Dollar. We think the latter is scenario is more likely, not least, because it is more appealing to politicians.

In conclusion, the kneejerk sell-off in EM in response to the yield on the US 10-year bond hitting 3% is an over-reaction with little basis in fundamentals or valuations. The move is likely to be relatively short-lived due to technicals. Retail, banks and fast money have led this move, but they are not as large as they used to be in EM. Besides, institutional investors remain underweight and locals are strong holders. Investors, who wish to play the current negative sentiment towards EM from the bearish side, can buy Chinese government bonds, which, as always, do well during bouts of risk aversion.[3] However, we think the better trade is add into temporary weakness for what is after all a very strong outlook for local markets over the next few years.

How to trade EM external debt during bouts of risk aversion: The analysis above refers to local bonds, which make up 85% of EM funding and therefore matters more to the overall financing picture in EM than Dollar-denominated bonds. Still, external debt remains a popular asset class, so how should investors approach bouts of pessimism about duration and risk as far as external debt is concerned? With respect to volatility in the Treasury market, a bias towards short duration seems sensible for the next few years as yields slowly normalise in the Treasury market, except for credits with big fat spread cushions. Correlations between the total return in EM external debt and changes in yields in the 10-year US Treasury are quite volatile as Figure 3 shows, but notice that over time the average correlation is extremely low (0.13). In other words, only a very small part of the change in 10-year yields ultimately feeds into EM external debt performance, so it pays to remain invested, and even to add during spikes in US yields.

Fig 3: **Correlations: EMBI GD total return and changes in the US 10-year bond yield (rolling 12m correlations of monthly data)**



Source: Ashmore, Bloomberg. Data as of COB 26 April 2018.

As far as risk aversion is concerned, investors should be equally, if not even more, ruthless. External sovereign debt has paid investors an average spread of 359bps over Treasuries per year over the past 20 years after controlling for default-related losses, including the recent Venezuelan default (Figure 4). This despite enormous bouts of global risk aversion over the past twenty years due to repeated bubbles in developed economies. The most interesting observation is that these bouts of developed market crises do not cause defaults in EM. The lower panel in Figure 4 lists the actual sovereign defaults in EM sovereign debt over the past two decades; all the defaults are idiosyncratic tales of woe, none due to global factors. Specifically, Argentina's first default in 2001 was a result of the country's inconsistent macroeconomic policies. Ecuador's default in 2008 was a willingness to pay issue. Ivory Coast missed two coupons in 2011 due to a civil war. Belize 2012 was a very badly managed credit. Argentina's second default in 2014 was in fact only an interruption in payments due to an order issued by a retiring US judge. Ukraine was unable to pay in 2015 due to war with Russia and rampant

[3] For more on Chinese bonds in EM portfolios see *'How Chinese bonds can enhance your portfolio'*, The Emerging View, 16 March 2018.

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corruption. Mozambique was unable to pay in 2017, because it had taken on too much debt. Venezuela's default this year is a case of extremely bad governance. Hence, while the risk in external is country-specific, not global, investors should resist the temptation to sell EM during sentiment shocks. Instead, they should ruthlessly exploit bouts of risk aversion to add to positions, while continuing to monitor individual credits for self-inflicted problems.

Fig 4: **Payouts to US 10-year bonds and EM bonds net of defaults (1998-2018)**

	Payout to investors (bps)	
	1998-2018	Average per annum
EM 'risk free spread'	7,545	359
EM net of defaults (bps)	15,027	716
US 10yr bond (bps)	7,483	356
Default episodes (cost in bps)		
Argentina 2001	483	
Ecuador 2008	125	
Ivory Coast 2011	61	
Belize 2012	10	
Argentina 2014	92	
Ukraine 2015	63	
Mozambique 2017	7	
Venezuela 2018	154	

Source: Ashmore, Bloomberg, JP Morgan. Data as of COB 26 April 2018.

- Argentina: After the government's bad decision in December 2017 to reduce the inflation target even before gaining control of inflation expectations, the central bank was last week forced to hike rates by a whopping 300bps to 30.25% as the currency began to fall precipitously.[4] Argentina continues to run nearly 10 times higher inflation than other EM countries in the GBI EM GD index. The decision to reduce the inflation target was therefore a serious policy failure for which the country is now punished. Argentina needs to learn from Brazil in terms of how to break a deeply entrenched inflation dynamic: hike rates until the economy slows enough for inflation to die and until the current account improves. This obviously requires pain, but there is not magical way to escape the laws of economics, something Argentina often struggles to fathom. The one ameliorating factor in Argentina right now is that the country finds itself in a position of relative economic strength. For example, real GDP growth in February was materially stronger than expected, rising at a yoy rate of 5.1% compared to 4.1% yoy in January. The trade deficit in March was also a bit smaller than expected (USD 611m versus USD 1.1bn expected).

- South Korea: The leaders of the two Koreas declared their intention to end formally the Korean War this year. Kim Jong Un also indicated his support for complete denuclearisation and international inspection of test sites. The two Korea's should eventually unify, just like Germany did after the fall of the Berlin Wall, but none of the two leaders have yet broached the subject of who should get a P45.[5] A unified Korea would require much reduced US military presence in the South and result in even greater Chinese influence in East Asia. Japan will become more isolated. In other news, industrial production was lower than expected in March (-4.3% yoy versus the -1.6% yoy consensus expectation), but retail sales were strong (7.0% yoy). Real GDP growth was 2.8% yoy in Q1 versus 2.9% yoy expected.

- China: The government's latest reform was published at the weekend. The Chinese government will now allow foreign investors to take majority stakes in domestic financial firms, including asset management firms (the foreign ownership cap increased to 51% from 49%). The liberalisation of the asset management industry in China plays a central role in the country's economic reform program. Asset management firms are expected to become the main price setters for and buyers of loans and other illiquid assets, which currently sit on the balance sheets of Chinese banks. As such, asset management firms will assist in the process of transforming China's largest banks into more Western style banks and ultimately global players, which in turn forms part of the process of opening up China's economy to the outside world. Improved competition in the asset management industry should also result in the emergence of better retail fixed income products, which will reduce the size of the shadow banking system. In economic news, industrial profits moderated to 3.1% yoy in March from 10.8% yoy in February, while official PMI in April was stronger than expected at 51.4. This is the highest reading for April in nearly five years. Non-manufacturing PMI rose to 54.8 (vs. 54.5 expected) from 54.6 in March.

[4] See our discussion of the decision to change the inflation target here: *'Picking up where we left off'*, Weekly investor research, 8 January 2018.
[5] P45 is a certificate given to UK employees at the end of a period of employment.

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- India: The government liberalised access to the Indian bond market for foreign investors overnight following a meeting over the weekend between Prime Minister Modi and Chinese leader Xi Jinping. The changes include removal of minimum tenor rules for foreign holdings of government bonds, an increase in permitted overall foreign holdings across types of fixed income and removal of auction quotas for government bonds. There are still some caps in place, especially in terms of how much a single foreign investor can hold in corporate bonds, but this is unambiguously positive news, in our view.

- Mexico: Pemex, the national oil company, announced that oil production is no longer declining following deep reforms, which allow private investment in the Mexican oil sector. The economic news was also good. The rate of unemployment declined to 2.94% in March versus 3.10% expected and retail sales delivered a solid monthly increase of 1.6% (up from 0.5% mom in January). The yoy rate of consumer prices inflation declined to 4.7% in the first half of April compared to 5.0% yoy in March, while the trade surplus was USD 1.9bn in March compared to an expectation of just USD 0.3bn.

- Turkey: The Turkish central bank tightened monetary policy by increasing the rate on liquidity by 75bps to 13.50%. This hike in the cost of liquidity was greater than anticipated (50bps). Sadly, the policy instrument to control liquidity has so far not been effective in anchoring inflation expectations and we do not expect this move to anchor inflation expectations either. Indeed, this morning the Turkish central banks raised its 2018 inflation forecast from 7.9% to 8.4%.

- Index news: The Dominican Republic enters the JP Morgan local currency government bond benchmark index (GBI EM GD) today with an estimated index weight of 0.09%. This brings the number of countries in the GBI EM GD to 19 countries. The inclusion of Dominican Republic follows the country's recent issue of a 2023 8.9% local currency government bond.

Snippets:

- **Brazil:** The March current account surplus was USD 0.8bn, which was materially better than expected (-USD 0.1bn). Household and credit growth expanded 0.6% in the month of March. Unemployment ticked up to 13.1%, mainly for seasonal reasons.
- **Chile:** Finance Minister Felipe Larrain signalled further austerity in comments to the media last week.
- **Colombia:** Centre-right candidate Ivan Duque maintained a healthy lead of 10% over leftist Gustavo Petro in two separate polls published last week ahead of the presidential election on 27 May 2018. The central bank cut the policy rate by 25bps to 4.25%.
- **Peru:** Real GDP growth accelerated to 3.0% yoy growth in Q1, according to the government.
- **Philippines:** S&P changed the outlook for the sovereign credit rating to positive from neutral. Philippines is rated investment grade (BBB) by S&P.
- **Poland:** Retail sales surged 17.8% in March versus 16.6% mom expected.
- **Russia:** The fiscal deficit of the federal budget shrank to 0.8% of GDP in March from 1.1% of GDP in February. The deficit was 3.1% of GDP a year ago. The central bank left the policy rate unchanged at 7.25%, which is equivalent to nearly 5.5% in real terms, given the core CPI inflation rate of 1.8%.
- **Singapore:** Industrial production was 5.9% higher in March than in the same month the previous year. The market expected 5.7% yoy.
- **Taiwan:** Industrial production expanded at a strong pace of 3.1% yoy in March, rebounding from a weak print in February (-2.2% yoy). Q1 2018 GDP growth was 3.04%, which was marginally slower than anticipated (3.20%)
- **Venezuela:** The ICC arbitration court granted an award of USD 2.04bn to ConocoPhillips as compensation for expropriation of property by PDVSA, the Venezuelan national oil company.

Global backdrop

President Macron of France was pessimistic about the chance of preventing the US from withdrawing from the Iran nuclear accord. However, the promise of withdrawal now carries less of a threat, because Trump's strategy of issuing big threats in a bid to intimate, then U-turning in the hope of striking the same deal on better terms, is becoming well-known. Intimidation is gradually becoming less effective and concessions declining or not granted at all. Case in point: the US government clarified that Rusal, a Russian aluminium producer, may avoid sanctions after all if the company changes its ownership structure. US investigators made fresh allegations that Huawei, the Chinese mobile phone provider, has breached US rules on doing business with Iran. This too is likely to be a precursor for some kind of deal. We note in passing that only 6.5% of Huawei's business emanates from the Americas (north and south combined). In US economic news, GDP growth slowed to 2.3% qoq annualized in Q1 2018 from 2.9% qoq annualised in Q4 2017, while employment costs increased significantly to 0.8% qoq (sa) in the quarter from 0.6% last quarter. In Europe, ECB President Mario Draghi acknowledged recent slower economic growth in the Eurozone and suggested that a planned decision to tapering QE could wait a bit longer the previously thought.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.13%	0.26%	21.05%	5.59%	5.33%
MSCI EM Small Cap	-1.01%	-0.83%	16.31%	4.05%	4.37%
MSCI Frontier	-3.53%	1.42%	21.80%	5.48%	7.33%
MSCI Asia	-0.51%	0.12%	22.45%	6.23%	8.28%
Shanghai Composite	-2.71%	-6.77%	-0.30%	-9.80%	9.78%
Hong Kong Hang Seng	0.58%	3.06%	22.32%	-2.90%	6.24%
MSCI EMEA	-2.26%	-3.09%	13.40%	1.87%	0.66%
MSCI Latam	-0.50%	7.57%	19.29%	6.11%	-1.20%
GBI EM GD	-2.53%	1.81%	8.96%	3.59%	-1.69%
ELMI+	-1.75%	0.72%	6.43%	2.29%	-0.62%
EM FX Spot	-2.37%	-0.34%	1.94%	-3.16%	-6.93%
EMBI GD	-1.36%	-3.08%	1.54%	4.53%	3.88%
EMBI GD IG	-1.29%	-3.68%	0.66%	2.31%	2.44%
EMBI GD HY	-1.43%	-2.53%	2.35%	7.14%	5.56%
CEMBI BD	-0.59%	-1.70%	1.97%	4.15%	3.83%
CEMBI BD IG	-0.74%	-2.07%	0.89%	2.51%	3.03%
CEMBI BD Non-IG	-0.40%	-1.23%	3.44%	6.64%	4.88%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.21%	0.44%	13.97%	10.45%	13.34%
1-3yr UST	-0.19%	-0.34%	-0.35%	0.29%	0.46%
3-5yr UST	-0.67%	-1.41%	-1.52%	0.22%	0.61%
7-10yr UST	-1.41%	-3.25%	-2.74%	-0.33%	0.51%
10yr+ UST	-2.46%	-5.67%	-0.48%	-0.13%	1.88%
10yr+ Germany	-1.04%	0.05%	-1.50%	-1.32%	4.55%
10yr+ Japan	-0.12%	0.89%	1.56%	3.97%	4.28%
US HY	0.63%	-0.23%	3.38%	4.91%	4.83%
European HY	0.65%	0.10%	3.79%	4.34%	6.16%
Barclays Ag	-1.57%	-0.23%	4.19%	2.28%	1.01%
VIX Index*	-22.83%	39.58%	42.42%	5.91%	13.98%
DXY Index*	1.55%	-0.63%	-7.57%	-3.23%	11.99%
CRY Index*	3.08%	3.88%	10.82%	-12.24%	-30.11%
EURUSD	-1.60%	1.02%	11.27%	8.05%	-7.91%
USDJPY	2.73%	-3.11%	-2.38%	-8.54%	12.04%
Brent	5.58%	10.95%	43.42%	11.10%	-27.53%
Gold spot	-0.48%	1.20%	4.94%	11.34%	-10.70%

*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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