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Ashmore

Hyperbole

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Profit taking in EURUSD has morphed into profit taking in EM FX. Neither fundamentals nor value considerations support a sustained moved against EM currencies. This is the best entry point in EM fixed income for at least a couple of years, in our view.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	-2.09%
MSCI EM Small Cap	11.3	–	-1.55%
MSCI Frontier	10.6	–	-2.82%
MSCI Asia	11.6	–	-1.58%
Shanghai Composite	11.0	–	2.03%
Hong Kong Hang Seng	7.3	–	-0.83%
MSCI EMEA	9.6	–	-2.41%
MSCI Latam	12.0	–	-5.50%
GBI-EM-GD	6.23%	–	-2.22%
ELMI+	4.90%	–	-1.28%
EM FX spot	–	–	-1.56%
EMBI GD	6.25%	329 bps	-1.23%
EMBI GD IG	4.87%	190 bps	-0.75%
EMBI GD HY	7.81%	486 bps	-1.71%
CEMBI BD	5.83%	291 bps	-0.59%
CEMBI BD IG	4.83%	192 bps	-0.36%
CEMBI BD Non-IG	7.05%	413 bps	-0.88%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.4	–	0.96%
1-3yr UST	2.51%	–	0.02%
3-5yr UST	2.80%	–	0.04%
7-10yr UST	2.96%	–	0.00%
10yr+ UST	3.13%	–	-0.29%
10yr+ Germany	0.54%	–	0.14%
10yr+ Japan	0.05%	–	0.29%
US HY	6.29%	341 bps	0.05%
European HY	2.97%	375 bps	-0.11%
Barclays Ag	1.97%	-99 bps	-0.48%
VIX Index*	15.01	–	-0.48%
DXY Index*	93.08	–	0.63%
EURUSD	1.1872	–	-1.01%
USDJPY	109.09	–	-0.70%
CRY Index*	203.14	–	1.89%
Brent	75.6	–	3.43%
Gold spot	1311	–	0.56%

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

Emerging Markets

- **Discussion of the recent price action:** A vicious bout of profit taking in the EUR after its very strong performance versus USD last year has now morphed into similar profit taking in Emerging Markets (EM) currencies versus the Dollar. There may be some limited merit in taking profits in EM local markets. After all, our view is that EM local currency bond markets can sustainably deliver returns of 10% in USD terms per year, over the five-year period from 2017-2021, so markets have arguably got a little bit ahead of themselves in the past five quarters. For example, in 2017 EM local markets returned in excess of 15% in USD terms and they were up another 5% in USD terms at the start of this year. Hence, a pullback has now materialised and the question is what investors should do now?

Many investors with little or no exposure to the asset class have worried in the course of the last couple of years that they had missed the rally in EM. Many have been waiting for a pullback to get in. Unfortunately, deeply negative media hyperbole nearly always accompanies pullbacks in markets, which can make it difficult to muster up the courage to invest. In particular, the media loves to extrapolate from the few to the many and from the short-term developments to the long-term trends. It is moment like this, however, during bouts of violent moves in the markets, that the differences between commentators and journalists on one hand, and investors on the other, become most pronounced. While the media paints doomsday forecasts, real investors get excited by the sudden abundance of opportunities. Hyperbole, to the investor, is a blessing. It helps to increase the value of the opportunity.

Our view is that the recent pull back in EM has restored significant value and material upside potential to an EM fixed income asset class, which already looks set to significantly outperform developed market assets in the years ahead. We see nothing in the recent unwind of EM positions, which in any way changes the benign outlook for EM. Moreover, the market moves are now rapidly moving into 'overdone' territory. Investors should be particularly careful now not to get sucked into long USD positions only to find themselves whiplashed within a matter of days, weeks or, at most, months. We believe that this is the time to buy EM, not to sell. Indeed, we see the current sell-off as one of the best entry points to EM fixed income in several years. While momentum may carry markets a bit lower in the next few sessions there are two very strong arguments for taking an optimistic view at this point and beginning to nibble at the opportunities.

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Emerging Markets

The first reason is that causes of the pullback in EM are not really EM related at all. Besides the profit taking motive explained above, the surge in the Dollar has been supported by the rise in the 10 year US Treasury yield, a temporary slowdown in growth and inflation in Europe, the geopolitical situation in Syria and Iran as well as uncertainty arising from the US government's decision to abandon free trade in favour of protectionism. More broadly, high levels of unease prevail as to where returns in developed economies are going to come from in the years ahead as the primary driver of those returns, easy money, is withdrawn. Uncertainty often creates temporary demand for USD. None of these developments are EM related.

So how long can these conditions be expected to weigh on EM sentiment? Tough to say with any precision. However, it is abundantly clear to us that the bounce in the USD is not sustainable. First, investors are already very long USD assets. Second, the US economy is running at full employment and accommodation is being withdrawn, so the growth outlook is uncertain to negative. Third, even the very modest rise in 10 year yields to 3%, which, against a backdrop of 2% PCE inflation, hardly constitutes a harrowingly high real yield is already impeding the US stock market rally. Most importantly, the US can only finance its ballooning fiscal deficit without hurting the stock market through materially higher real yields if it places the majority of bonds with foreign central banks – and that requires a lower Dollar.

The second reason for being optimistic about EM here is that the case for investing in EM remains extremely solid. Valuations are very good. For example, the real yield on offer for 85% investment grade, five-year government bonds in EM, that is, the local currency bond market, is now close to 300bps. This is not only a higher real yield than the long-term historical real yield, but also dramatically better than anything on offer in developed markets of similar credit quality and duration. The pain has mainly been in FX, not in bonds, however, which testifies to the strong technical bond position in local markets. The flipside of the currency move is that EM currencies, from current levels, have between 15% and 20% upside versus the Dollar over the next three to four years, in our view. Real effective exchange rates are also very competitive. In external sovereign Dollar bonds, which is an extremely diversified USD 1trn asset class comprising 67 countries, the yield is now in excess of 6% and spreads are wide of 300bps compared to 170bps in 2007 before the financial crisis and 210bps in 2010. This makes EM external debt extremely attractive, particularly versus the Barclays-Bloomberg Global Ag.[1] Most importantly, EM markets now price in far more rate hikes than the Fed will deliver for a long time, so beyond the initial knee-jerk reaction in the market we see nothing worrisome about EM bonds from a valuation perspective if US 10-year Treasury yields sit at 3% or even drift higher.

EM growth is also solid. EM countries have significantly improved their external balances over the last few years on the back of rising net exports made possible through a combination of reforms, lower currencies and strong inflation discipline (EM inflation declined from 5.25% in 2011 to 3.2% today). The IMF is projecting the EM growth premium, i.e. how much faster EM countries grow relative to developed economies, to rise from 2.4% today to 3.5% by 2023 against a backdrop of outright declining rates of growth in developed economies.

Not all is rosy in EM, however. A couple of colourful EM countries, Argentina and Turkey, stand out as vulnerable, but this is entirely due to self-inflicted problems, whereas the situation in EM more broadly remains solid. Why are Turkey and Argentina in the crosshairs?

Turkey finds itself in focus because the government has been pursuing bad macroeconomic policies for a long time. Much is due to President Erdogan himself, who is keen to point out at every opportunity that high interest rates cause high inflation (he appears to have adopted this view after observing that high interest rates often coincide with high inflation). Due to this warped understanding of basic economies, Erdogan repeatedly applies pressure on the central bank to keep rates low, especially when inflation rises. The result that inflation rises even more, that domestic credit growth is too strong and that the current account position is in a precarious state.

Argentina's problems are also entirely self-inflicted. Last week, the central bank was forced to hike interest rates dramatically to defend a rapidly weakening Peso. While there is no doubt the Administration of President Mauricio Macri is a major improvement on its predecessor, the government of Cristina Kirchner, Macri's Administration made a serious mistake in December, when it raised the inflation target. In all other countries, governments would generally only consider raising the inflation target if there was a serious threat of serious deflation. After all, the point of a higher inflation target is to give the central bank room to ease monetary policies to fight deflation. Not so in Argentina. Here, the government raised the inflation target despite still running inflation in excess of 20% and despite having never managed to get inflation expectations under control in the first place. The underlying reason for the failure to control inflation lies with the fiscal authorities, however. They have consistently insisted on lavish spending to avoid a recession during the monetary adjustment period. However, the resulting combination of high fiscal spending and high real interest rates attracted a lot of hot money (which is now leaving head over heels), but failed to stimulate real investment since the large volumes of government debt issuance crowded out the private sector. Argentina's government has yet to get its head around the fact that demand needs to be cut dramatically if inflation expectations are to be decisively broken and the current account deficit materially reduced.

[1] See '*The best entry point for External debt in more than two years'*, Market Commentary, 3 May 2018.

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- **The point is this:** Of all the 79 investable countries in EM, only Turkey has a president who believes that high interest rates cause inflation. Of all the 79 investable countries in EM, only the Argentinians believe that nearly two decades of excess demand stimulus can be reversed without fiscal adjustment. No other countries in EM look or behave remotely like Turkey and Argentina. Hence, to the extent that herd-like behaviour and meaningless extrapolation of the experiences of Argentina and Turkey to the rest of EM leads weaker hands to capitulate on their EM positions with the result that currencies move lower and yields move higher, this is clearly something that stronger, wiser investors should aim to exploit.

We have seen this tendency to extrapolate from the few to the many in EM on several previous occasions. A few years ago, banks and the media latched onto the notion of the "Fragile Five", a marketing term coined by Morgan Stanley, to debunk the entire EM asset class. A few years before that Goldman Sachs coined the term 'BRICS' to induce flows the other way. In retrospect, these gimmicks were mere marketing tools, which should never be used as a guide to investing. Indeed, buying 'BRICS' was vastly inferior to investing in EM more broadly, and selling the 'Fragile Five' was equally silly, since all five survived the temporary bouts of market pessimism without balance of payment crises, IMF support or defaults. It is critical, especially at times such as these, to understand that banks and media make money from short-term flows and the associated hype, while institutional investors make money from identifying value. Their interests are never further apart than during bouts of market panic.

In conclusion, investors should view the current volatility in EM markets in the right perspective. Volatility is not a new thing in EM. Do not be surprised when it happens. Not a single EM country has defaulted due to bouts of market volatility in the past 20 years, which includes some very big dislocations including the US Subprime Crisis, Dotcom, the European debt crisis, etc. The drives of the current bout of risk aversion are entirely non-EM related and temporary in nature. The few vulnerable EM countries are the exception rather than the rule as the fundamental case for EM is much improved in recent years, solid in most. EM looks likely to deliver far better returns than developed economies in the coming years. Experienced EM investors expect volatility to happen. Even more experienced investors hope for it to happen, because they know it is the best time to enter the asset class. Bouts of volatility are always excellent entry points in EM and this one will be, too.

Snippets:

- **Argentina:** The central bank raised the policy rate to 40% and announced fiscal measures in response to an attack on the peso. See main text above for discussion of the macroeconomic situation in Argentina.
- **Brazil:** Industrial production in March expanded at a yoy rate of 1.3%, or 9% yoy adjusted for business days. This is a very strong print.
- **Chile:** The central bank left the policy rate unchanged at 2.5%. Retail sales growth was solid at 4.1% yoy in February, but manufacturing production declined at a rate of 2.4% yoy in March.
- **China:** Foreign net inflows to the Chinese onshore bond market reached a record high of CNY 66bn in April. The current account deficit was USD 28.2bn in Q1 2018, according to SAFE. As China turns to domestic demand led growth, the country will eventually run a permanent current account deficit, in our view. The Caixin services PMI increased to 52.9 in April from 52.3 in March. Caixin manufacturing also picked up to 51.1 from 50.0 in March.
- **Czech Republic:** The central bank left the policy rate unchanged at 0.75%.
- **India:** Services PMI improved in April supported by stronger new orders. The index increased to 51.4 in April from 50.3 in March. The Nikkei PMI rose to 51.6 in April from 51 in March.
- **Indonesia:** CPI inflation was 3.4% in April versus 3.5% yoy expected.
- **Malaysia:** Exports increased at a whopping 16.3% yoy pace in USD terms in March, up from 11.3% yoy in February. The fiscal deficit narrowed to MYR 11.5bn in March from MYR 20.2bn in the same month last year.
- **Mexico:** Voting intentions favour Andres Manuel Lopez Obrador to the tune of 48% according to a new poll by Reforma. Ricardo Anaya of PAN gained 4% to reach 30%, while Jose Antonio Meade of PRI slipped 1% to 17%. The election is on 1 July 2018. Manufacturing PMI moderated to 52.0 from 52.8.
- **Peru:** CPI inflation was -0.14% mom versus 0.05% expected in April. The low monthly print took yoy inflation to 0.49%.
- **Philippines:** Inflation was 4.5% yoy in April in line with expectations.
- **Russia:** Inflation remained unchanged in April at a modest 2.4% yoy. Manufacturing PMI accelerated to 51.3 in April from 50.6 in March.
- **South Africa:** The trade balance swung into surplus to the tune of ZAR 9.5bn in March from a deficit of ZAR 0.6bn in February. The market was only expecting a ZAR 3.8bn surplus. Exports were particularly strong.
- **South Korea:** The government is considering raising property taxes, according to local media. Exports declined at a rate of 1.5% yoy in April. The rate of CPI inflation was 1.6% yoy in April from 1.3% in March. Core inflation rose to 1.4% yoy from 1.3% yoy.

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- **Taiwan:** The PMI softened to 54.8 in April from 55.3 in March.
- **Thailand:** CPI inflation was 1.1% yoy in April versus 0.8% yoy in March. Core inflation was unchanged at 0.6% yoy. The trade surplus increased to USD 3.0bn in March from USD 2.3bn in February.
- **Turkey:** The rate of inflation increased to 10.8% yoy in April from 10.2% yoy in March. S&P lowered Turkey's foreign currency credit rating by one notch to BB-. For a discussion of macroeconomic policy in Turkey, see the discussion in the main article above.

Global backdrop

Trade talks between senior US and Chinese officials appears to have gone badly. China issued a long list of counter-demands in response to US demands. China appears willing to 'stand up to the bully', which may turn out to be a sound decision. After all, it is becoming clear that US President Donald Trump's strategy is to use threats and intimidation to win concessions, but without the intention to actually follow through on his threats in case of non-compliance. The aftermath of the failure of these trade talks will now reveal if Trump has the stomach for the fight. We fully expect China to stand up to Trump. In fact, China has already cut back on agricultural and other imports from the US in response to the unilateral protectionist measures taken by the US against China. However, we do not expect China to adopt protectionist measures against third countries. We expect China to continue to support free trade and globalisation as the country aims to establish its own reputation as a global leader on policy matters. As such, America's retreat from global economic leadership actually furthers China's objective of replacing the US as the global economic and financial hegemon over the next couple of decades.

The situation on the Korean peninsula remains a bright spot on the geopolitical stage. South Korean President Moon Jae-in is set to meet US President Trump ahead of face-to-face talks between Trump and North Korean dictator Kim Jong-un. Kim indicated his willingness to denuclearise North Korea by 2020 and Trump indicated that the number of US troops stationed in the South could be scaled down. We think unification of the two Koreas is the eventual outcome, with much reduced US and Chinese military presence in the unified country. Ultimately, we see China increasing its economic influence in a unified Korea significantly.

Eurozone inflation moderated to 1.2% yoy in April from 1.3% yoy in March due, in part, to a moderation in growth in Q1, which is likely to prove temporary, since it was mainly caused by severe winter weather at the start of the year. The US Fed was marginally less hawkish than expected. The FOMC left the Fed funds rate unchanged at 1.75% and the statement indicated a willingness to let inflation run near the target for the time being as the economic outlook is no longer 'strengthening'. US data softened at the margin last week, including payrolls.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.09%	-1.13%	19.47%	6.46%	4.40%
MSCI EM Small Cap	-1.55%	-1.48%	15.86%	4.86%	3.72%
MSCI Frontier	-2.82%	-1.21%	17.42%	4.80%	6.26%
MSCI Asia	-1.58%	-0.25%	22.11%	7.63%	7.67%
Shanghai Composite	1.79%	-5.10%	3.16%	-6.88%	9.59%
Hong Kong Hang Seng	-2.96%	2.21%	25.39%	-0.94%	5.52%
MSCI EMEA	-2.41%	-5.51%	11.34%	1.62%	-0.73%
MSCI Latam	-5.50%	0.87%	10.71%	4.42%	-3.06%
GBI EM GD	-2.22%	-0.89%	5.84%	2.92%	-2.41%
ELMI+	-1.28%	-0.70%	4.96%	1.82%	-1.00%
EM FX Spot	-1.56%	-2.38%	-0.15%	-3.75%	-7.41%
EMBI GD	-1.23%	-4.37%	0.17%	4.44%	3.46%
EMBI GD IG	-0.75%	-4.40%	-0.08%	2.62%	2.21%
EMBI GD HY	-1.71%	-4.41%	0.33%	6.52%	4.92%
CEMBI BD	-0.59%	-2.36%	1.17%	4.03%	3.61%
CEMBI BD IG	-0.36%	-2.46%	0.44%	2.66%	2.89%
CEMBI BD Non-IG	-0.88%	-2.21%	2.18%	6.05%	4.53%

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Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.96%	0.58%	13.59%	10.83%	12.76%
1-3yr UST	0.02%	-0.31%	-0.24%	0.36%	0.46%
3-5yr UST	0.04%	-1.32%	-1.25%	0.48%	0.66%
7-10yr UST	0.00%	-3.08%	-2.23%	0.34%	0.70%
10yr+ UST	-0.28%	-5.44%	0.16%	1.55%	2.36%
10yr+ Germany	0.18%	0.20%	0.17%	-0.02%	4.71%
10yr+ Japan	0.29%	1.19%	1.80%	4.72%	4.36%
US HY	0.05%	-0.16%	3.42%	5.04%	4.58%
European HY	-0.11%	0.02%	3.24%	4.51%	5.91%
Barclays Ag	-0.48%	-0.74%	3.72%	2.33%	0.94%
VIX Index*	-5.78%	35.96%	53.63%	16.72%	18.56%
DXY Index*	1.35%	1.03%	-6.04%	-1.81%	13.65%
CRY Index*	0.57%	4.79%	14.04%	-11.35%	-30.14%
EURUSD	-1.71%	-1.11%	8.68%	6.01%	-9.74%
USDJPY	-0.23%	-3.19%	-3.68%	-8.91%	10.18%
Brent	0.63%	13.11%	53.30%	15.68%	-27.51%
Gold spot	-0.32%	0.64%	6.92%	10.33%	-11.05%

*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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