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Ashmore

Sugar highs and lows

By Jan Dehn

We comment on recent developments in Argentina and draw attention to the disconcerting parallels with US macroeconomic policies. The Weekly also presents a perspective on the recent market volatility. The Snippets section summarises the most recent Emerging Markets (EM) country-specific news and the Global Backdrop section summarises the main developments in the US, Europe and the UK over the last week.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	-1.85%
MSCI EM Small Cap	10.9	–	-1.50%
MSCI Frontier	10.4	–	-3.14%
MSCI Asia	11.7	–	-1.70%
Shanghai Composite	10.5	–	-1.31%
Hong Kong Hang Seng	7.2	–	-2.27%
MSCI EMEA	9.2	–	-3.34%
MSCI Latam	10.8	–	-1.80%
GBI-EM-GD	6.65%	–	-1.89%
ELMI+	4.83%	–	-1.05%
EM FX spot	–	–	-1.42%
EMBI GD	6.47%	354 bps	-0.60%
EMBI GD IG	4.92%	199 bps	0.12%
EMBI GD HY	8.25%	533 bps	-1.34%
CEMBI BD	6.03%	313 bps	-0.11%
CEMBI BD IG	4.91%	201 bps	0.02%
CEMBI BD Non-IG	7.40%	450 bps	-0.28%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.8	–	0.07%
1-3yr UST	2.55%	–	-0.06%
3-5yr UST	2.80%	–	-0.08%
7-10yr UST	2.93%	–	0.09%
10yr+ UST	3.06%	–	0.60%
10yr+ Germany	0.40%	–	-0.15%
10yr+ Japan	0.04%	–	0.10%
US HY	6.23%	332 bps	0.45%
European HY	3.40%	409 bps	0.47%
Barclays Ag	2.01%	-92 bps	-0.30%
VIX Index*	12.72	–	0.37%
DXY Index*	94.86	–	1.25%
EURUSD	1.1608	–	-1.49%
USDJPY	110.45	–	0.38%
CRY Index*	195.78	–	-3.61%
Brent	74.5	–	-2.59%
Gold spot	1279	–	-1.69%

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

Emerging Markets

One Twitter user commented last week that it "seems impossible, but Argentina's peso was able to collapse even further despite the USD 50bn IMF bailout. Why is anyone still lending this government any money?"

The answer, of course, is that asset prices go up as well as down. Lending to Argentina's government may not have been particularly lucrative this year, but it has been extremely profitable at other times, often for sustained periods. The chart below shows returns to Argentina's USD government bonds in the JP Morgan EMBI Global Diversified index compared to the total return on US government bonds of similar duration.

Clearly, investing in Argentina's sovereign bonds – emphatically an exercise in lending money to the government – has at times been very lucrative. For example, an investment in Argentina's government bonds since the Developed Markets Crisis of 08/09 rewarded investors with returns, which, to the Twitter user cited above, must sound truly mindboggling: 584% in USD terms, or 23% per annum. This compares to a total return of just 27% on US government bonds, or about 3% annualised over the same period, despite QE. The point is not to say that Argentina is a better place to invest in bonds than the US. Indeed, US bonds have actually marginally outperformed Argentinian government bonds in terms of total return terms since the inception of the EMBI Index in December 1993, although only just. US bonds delivered 214% return over this period, while Argentina delivered 192%, despite suffering the world's then largest default in 2001 with haircut of 70%. Rather, the point is that despite Argentina's recent currency trouble, Argentina has been an improving credit for some time and prices for Argentinian government bonds have actually been too low for long periods, relative to what is justified by Argentina's indisputable and recurring problems of achieving macroeconomic stability. This protracted and gross mispricing is precisely what has made investing in Argentina – and in EM bonds in general – so lucrative for so long. Profound ignorance, deep prejudices, regulatory biases or a combination of all three explain the persistent mispricing of EM assets.

Whatever the Twitter user's specific ailment, it has clearly stood in the way of harvesting very generous returns by lending to the government of Argentina.

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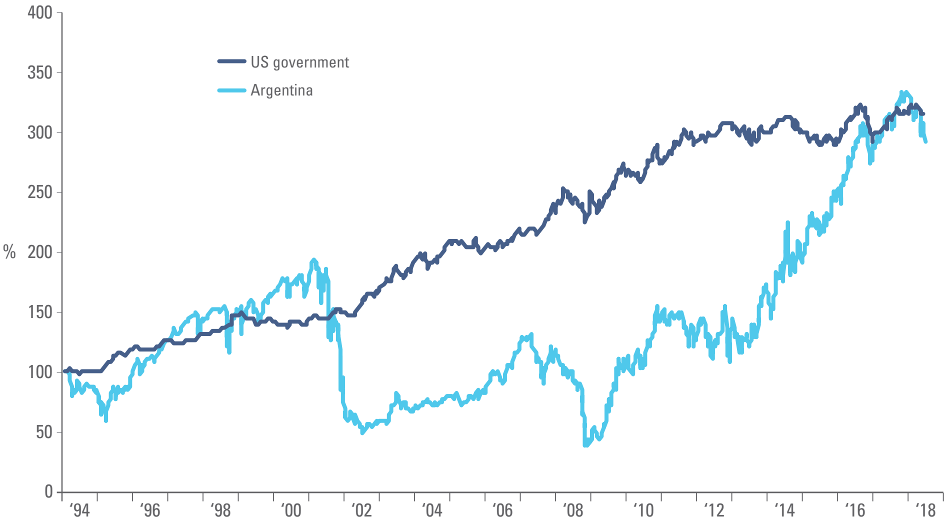
Emerging Markets

Fig 1: **US and Argentina government bonds: Total return (Index 31 Dec 1993=100)**



Source: Ashmore, Barclays, JP Morgan, Bloomberg

Anyway, that is all history. What is more interesting is that Argentina's current instability also offers some insights, which are relevant to investors in other markets. This is clear once one recognises the true nature of Argentina's current malaise; this is *not* a debt crisis. Argentina may default in the future, but not now, because the debt stock is simply too small.[1] Instead, Argentina's current predicament is one of macroeconomic imbalance, which in turn is the direct result of policies, which are disturbingly similar to those currently pursued in the United States.

Specifically, the Peso's plunge is the direct consequence of Macri Administration's erstwhile policy mix since taking office, of combining tight monetary policies with loose fiscal policies (the government's decision to pursue this particular combination of policies reflected a desire to crush inflation while avoiding a recession). Sadly, this policy mix gives rise to two specific problems: hot money inflows and crowding out of real investment. Instead, the policy created a currency sugar high, which could not be sustained and thus ended with a spectacular crash.

There are, disturbingly, many similarities between the policy framework of Argentina prior to the current crash and the US today. First, both countries emerged from deep crises. Second, both countries relied heavily on demand side stimulus during the recovery. Third, both countries continued to stimulate demand even after reaching full employment. Fourth, both countries were unable or unwilling to undertake supply-reforms in a bid to raise productivity growth. Fifth, both countries became more populistic as full employment approached and soon turned to protectionism and other heterodox policies, particularly as overheating led to a loss of competitiveness. A new round of US tariffs on Chinese imports only last week illustrates this point. Sixth, both countries combined tight monetary and loose fiscal policies. Much as the Peso became overvalued due to hot money inflows, the recent surge in the Dollar is driven by hot money. Sure, growth expectations are higher, but all the expected growth is due to fiscal stimulus, i.e. demand side spending. However, the economy is already at full employment and nothing constructive is taking place on the supply-side. Indeed, protectionism and a projected large increase in debt will actually weaken the supply-side of the economy, in our view. Into this mix, throw Fed hikes against a backdrop of already flashing late cycle warning signals. The Dollar may be surging, but in this surge, markets are sowing the seeds of a future Dollar crash, just as the Peso has now adjusted meaningfully lower.

Despite the protracted lack of sponsorship of EM right now, particularly in FX, we remain positive on the outlook. Nothing meaningful has changed in the EM fundamental investment case since our latest updates other than valuations, which have actually moved in a way, which increases the attractiveness of the investment proposition of the asset class.[2] We therefore have a strong conviction that, at present valuations, the main EM fixed income asset classes, that is local currency bonds, sovereign USD-denominated bonds and USD-denominated corporate bonds, should easily be able to deliver returns of 50%, 30% and 25% in Dollar terms over the next five years, respectively.

The main development in the last few months has obviously been a significant pullback in valuations in EM. This is the first pullback in EM after two years of unrelenting rally. What makes this pullback so interesting from an investment perspective is that it has been caused almost entirely by a massive U-turn in EURUSD, thus

[1] One of the reasons for Argentina's record of serial defaults is that the country's constitution affords too much power to the provinces. They habitually borrow too much and the debt inevitably ends up on the books of the sovereign. Without a major constitutional amendment, Argentina will default again, but only once it has become sufficiently indebted to do so.

[2] See *'The best entry point for External debt in more than two years'*, Market Commentary, May 2018 and *'Outlook for EM and global backdrop'*, The Emerging View, May 2018.

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Emerging Markets

setting it apart from the pullback in 2013 and placing it more into the camp of the pullback seen in response to the European Debt Crisis in 2011. EURUSD was given additional negative momentum last week by a hawkish Fed and a dovish ECB, but this is categorically not an EM driven sell-off. Recall the backdrop: EURUSD rallied more than 20% from trough to peak between late 2016 and early 2018. However, softer growth and lower than expected inflation in Europe in Q1 has led to a sharp repricing of expectations for monetary tightening by the ECB, while strong fiscally-driven demand growth in the US and a hawkish Fed under new Fed Chairman Powell has put markets in the mood to test how far they can push the Dollar higher. The move could continue over the summer, but probably not much beyond. The reason is that marginal surprises in monetary policies are probably going to start to shift to the ECB over the next year. After all, the market is close to having priced a normalisation of US monetary policy, while ECB normalisation is only about to begin.

The violent volatility in EURUSD quickly became a pretext for profit-taking in EM local markets, which delivered nearly 16% return in Dollar-terms in 2017 following a 10% return in Dollar in 2016. This pace of return was arguably too rapid. Our view is that given where yields and currencies are trading in EM, the sustainable pace of return in local bond markets is close to 10% per annum. Hence, a 5%-6% pullback after 2017 was always a possibility. However, the pullback has now extended to about 10%, which is clearly taking valuations back into attractive territory. For example, the yield on the GBI EM GD index is now 6.6%, which means that bonds pay 340bps real yield. This is extremely attractive for 5-year bonds that are 85% investment grade rated. As the latest Dollar euphoria slowly runs out of steam over summer and investors come back from the beach, they will be met with a very attractive investment proposition. In addition to high yields and low inflation, EM currencies have now pulled back to the point that the full 20% upside potential for the next five years has been restored. Growth rates in EM are on track to rise versus developed markets growth rates every single year for the next half a decade and, encouragingly, equity earnings in EM stocks are looking solid, which is clear evidence that this sell-off has no fundamental basis. We also strongly believe that the Dollar will have to fall over the next few years in order to push up EM FX reserves to enable EM central banks to pick the bonds required to finance the massive expansion of the US fiscal deficit. The alternative of placing the bonds with US pension funds and insurance companies will require such a rise in real yields as to almost guarantee a major equity market correction and an associated recession from which the US would struggle to re-emerge.

A review of the outlook for EM would not be complete without a discussion of EM, of course. The financial media has been preoccupied with three perceived vulnerabilities in recent times, namely rising election-related risks, macroeconomic challenges in Argentina and Turkey and, on cue, renewed fears of a hard landing in China. We discussed Argentina above, so in the following let us briefly touch on the other issues.

- First, Chinese hard landing concerns are predictable during bear markets in EM. After all, investors still wrongly believe that if China goes down the tubes then it will drag the rest of EM with them. This is patently untrue, because China trades more with developed economies than with EM, and EM's commodity dependence has declined dramatically in recent years. Even so, China concerns can still trigger nervousness from weak hands or prejudiced minds, wherefore market makers still habitually try to breathe fresh life into the China hard landing story every time EM wobbles. Sure, fixed asset investment retreated in May, but this reflects deliberate prudence by the government with respect to new credit creation, wherefore the slowdown is particularly pronounced in infrastructure spending. What we find far more interesting – and encouraging – is that manufacturing activity continues to improve, which indicates that China is successfully moving from conventional growth via factor accumulation in the private sector to total factor productivity growth in the private sector.

- Second, Turkey's situation is really quite unique and known and understood by all decent EM asset managers. The blowout in TRY is entirely self-inflicted. Turks go to the polls to elect a new parliament and a president, so election-related uncertainty compounds the price action for now. However, the central bank has begun to face up to the challenges and Turkey's political outlook should settle down after 24 June or, at the latest, after a second round within the following month.

- Finally, elections. Colombia, Turkey, Brazil, Mexico. By October all these elections will be out of the way. Markets should quickly come to terms with Andres Manuel Lopez Obrador ('AMLO') in Mexico, partly because MXN has adjusted, partly because AMLO will pursue conventional macroeconomic policies. Colombia's next president is Ivan Duque, who defeated leftist Gustavo Petro with a clear margin in a run-off election at the weekend. Duque is a former senior official at the Inter-American Development Bank, who will maintain Colombia's sensible economic policies and not, contrary to some fears, dismantle the peace accord with the FARC, in our view. Arguably the most interesting of the elections is that in Brazil, which will not take place until October. Markets have recently been increasingly worried about the fact that mainstream candidates are polling very poorly compared to the far-right Jair Bolsonaro and the environmentalist Marina Silva. We think the only real issue at stake is pension reform and that it is ultimately irrelevant who wins. The winner will, regardless of political hue, have to reform the pension system or face a major fiscal crisis in their first term in office. Once the pension reform has been completed, Brazil will be free to experience a sustained cyclical upswing.

In conclusion, the market sold in May and went away, but make sure to be back in September for returns to remember.

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Emerging Markets

- **China:** The US government announced 25% tariffs on USD 50bn of Chinese imports. America's abandonment of erstwhile adherence to the principle of free trade bodes poorly for US medium term growth. It will also greatly assist China in establishing its own reputation as the emerging global leader when it comes to economic policies. China immediately announced retaliation, but importantly only in proportion to US tariffs. China will continue to push for freer trade with other countries.

Snippets:

- **Argentina:** Following a run on the currency, the government replaced Central Bank governor Federico Sturzenegger with Luis Caputo. Caputo's main merit is that he is a trader, so he will understand well what needs to happen to stabilise the currency, though this effort will be wasted without adequate attention to the fiscal situation. Inflation was 2.1% mom in May versus 2.5% mom expected.
- **Brazil:** Economic activity expanded at a rate of 3.70% yoy in April. Broad retail sales expanded strongly in April (1.3% mom after 1.1% mom in March).
- **Chile:** The central bank upgraded the economic outlook in light of recent upside surprises in economic performance.
- **Colombia:** The 2018 Medium Term Fiscal Plan shows that the government targets a decline in the fiscal deficit from 3.1% of GDP in 2018 and 2.4% of GDP in 2019. The latter will require a fiscal reform after the upcoming election is out of the way.
- **Ecuador:** Congress has given green light for a prosecuting judge to seek a criminal indictment against former President Rafael Correa for alleged involvement in kidnap. Belgium-based Correa denies any knowledge of the matter.
- **Egypt:** The rate of CPI inflation declined to 11.4% yoy in May from 13.1% yoy in April.
- **India:** The rate of CPI inflation increased marginally to 4.9% yoy in May from 4.6% yoy in April. The current account deficit narrowed to USD 13bn in Q1 2018 from USD 13.7bn in Q4 2017. USD 13bn is roughly 1.9% of Indian GDP. Net FDI inflows in April were 202% higher than a year ago. FDI flows can be notoriously lumpy.
- **Mexico:** Industrial production expanded at a slow 0.2% yoy rate in April.
- **Nigeria:** The rate of CPI inflation declined to 11.6% yoy in May from 12.5% yoy in April.
- **Peru:** The government announced that it is working to allow all local currency denominated bonds to settle via Euroclear.
- **Philippines:** The current account deficit narrowed to just USD 208m in Q1 2018 from USD 3.3bn in Q4 2017.
- **Poland:** The rate of core inflation declined to just 0.5% yoy in May from 0.6% in April.
- **Romania:** The rate of CPI inflation edged up to 5.4% yoy in May from 5.2% yoy in April.
- **Russia:** The Central Bank of Russia left the policy rate unchanged at 7.25%, thus ending the most recent easing cycle.
- **Singapore:** Retail sales expanded at a modest yoy rate of 0.4% in April.
- **Venezuela:** President Maduro replaced Vice-President Tareck El Aissami with Constituent Assembly Head Delcy Rodriguez. This change does not mark a new direction in policy.

Global backdrop

The Fed hiked 25bps to 1.75%-2.00% range for the Fed funds rate. US CPI inflation is 2.8% yoy, so the policy rate is still deeply negative despite full employment. Consumer sentiment was strong and industrial production was weak. Fed Chairman Jay Powell indicated that the Fed will continue to hike twice again this year with more hikes coming in 2019. The market has largely priced this trajectory. In Europe, ECB President Mario Draghi opted for caution by announcing that interest rates will not be changed for another year as asset purchases are phased out by December of this year. German Chancellor Angela Merkel's governing coalition is under pressure from within, due to internal divisions over the policy towards asylum seekers. The UK government had to make significant concessions to pro-European Tories in order to make progress on the EU Withdrawal Bill. Our view is that the net effect will be to bring about a version of Brexit, where, in order to achieve access to the EU market, Britain will have even less influence than when it was a fully-fledged member of EU.
Life can be ironic at times.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.46%	-3.02%	13.90%	7.59%	5.93%
MSCI EM Small Cap	-1.61%	-3.57%	11.26%	4.36%	4.85%
MSCI Frontier	0.71%	-7.02%	6.78%	3.27%	4.60%
MSCI Asia	0.21%	0.25%	17.21%	9.17%	9.44%
Shanghai Composite	-1.92%	-7.87%	-1.19%	-14.04%	9.54%
Hong Kong Hang Seng	-0.43%	2.66%	20.14%	-0.64%	8.10%
MSCI EMEA	-2.90%	-11.39%	6.01%	2.12%	-0.28%
MSCI Latam	-5.08%	-12.87%	-1.42%	1.52%	-3.11%
GBI EM GD	-2.80%	-6.39%	-2.49%	2.05%	-2.23%
ELMI+	-1.16%	-2.94%	0.78%	1.55%	-1.05%
EM FX Spot	-1.83%	-6.18%	-5.24%	-4.17%	-7.50%
EMBI GD	-1.10%	-5.14%	-2.21%	4.79%	4.39%
EMBI GD IG	-0.51%	-4.19%	-1.81%	3.41%	3.40%
EMBI GD HY	-1.71%	-6.18%	-2.74%	6.38%	5.58%
CEMBI BD	-0.32%	-2.77%	-0.18%	3.98%	4.27%
CEMBI BD IG	-0.18%	-2.37%	-0.67%	2.90%	3.65%
CEMBI BD Non-IG	-0.49%	-3.24%	0.60%	5.59%	5.09%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.84%	4.92%	16.51%	12.37%	13.62%
1-3yr UST	-0.16%	-0.12%	-0.15%	0.42%	0.51%
3-5yr UST	-0.43%	-1.13%	-1.59%	0.61%	0.85%
7-10yr UST	-0.65%	-2.66%	-3.42%	0.86%	1.23%
10yr+ UST	-1.01%	-4.15%	-2.27%	2.91%	3.59%
10yr+ Germany	-1.84%	1.70%	0.65%	3.56%	5.55%
10yr+ Japan	0.01%	1.42%	1.90%	5.02%	4.95%
US HY	0.98%	0.73%	3.09%	5.60%	5.34%
European HY	0.73%	-0.37%	2.01%	4.61%	6.21%
Barclays Ag	-0.70%	-1.71%	1.01%	2.52%	0.80%
VIX Index*	-17.56%	15.22%	22.54%	-3.56%	-23.42%
DXY Index*	0.93%	2.97%	-2.37%	0.87%	17.67%
CRY Index*	-3.48%	0.99%	13.13%	-12.64%	-31.65%
EURUSD	-0.73%	-3.31%	4.12%	2.19%	-13.32%
USDJPY	1.50%	-1.99%	-0.97%	-10.17%	15.86%
Brent	-4.01%	11.38%	57.23%	15.90%	-29.75%
Gold spot	-1.54%	-1.86%	2.79%	6.37%	-6.52%

*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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