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Ashmore

Turning Japanese[1]

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The situation in Eastern Ukraine is reaching another critical stage, which can now usher in genuine de-escalation or yet another round of self-destructive economic retaliations between the West and Russia. Indonesia looks better than the latest current account number would suggest. Malaysia is scorching hot. Uncertainty erupts in Brazil after a presidential candidate is killed in a plane crash. Speculation grows that a sale of CITGO in Venezuela is linked to on-going arbitration court cases; we do not think the two are directly linked. There's a new PM in Iraq, but it is all about oil. China reported a massive trade surplus. No progress in talks with holdouts in Argentina. Less than spectacular data in India, but there are good reasons to discount the numbers somewhat.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,075	–	1.34%
MSCI EM Small Cap	1,095	–	1.19%
MSCI FM	697	–	-0.41%
GBI EM GD	6.58%	–	0.50%
ELMI+	3.09%	–	0.36%
EMBI GD	5.16%	279 bps	0.85%
EMBI GD IG	4.37%	195 bps	1.01%
EMBI GD HY	6.97%	481 bps	0.55%
CEMBI BD	5.13%	303 bps	0.69%
CEMBI BD HG	4.28%	217 bps	0.61%
CEMBI BD HY	7.00%	494 bps	0.85%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1955	0.99%
VIX Index	13.15	-7.59%
5 year UST	1.56%	-6 bps
10 year UST	2.36%	-7 bps
US HY	5.70%	0.78%
European HY	4.88%	0.79%
EURUSD	1.3390	0.03%
USDJPY	102.46	0.28%
Brent	100.90	-2.65%
Copper	319.27	-1.87%
Gold	1302.62	-0.41%

Additional benchmark performance data is provided at the end of this document.

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- Russia – Ukraine: The biggest development in the crisis engulfing Ukraine and Russia is that the main theatre of conflict has moved from the international stage (sanctions, mutual recriminations between EU/US on the one hand and Russia on the other, etc.) to the ground in Eastern Ukraine, where Ukrainian forces have made considerable gains against pro-Russian separatists and where Russia has dispatched a large aid convoy towards the conflict area. Sceptics view the convoy as a pre-text for a subsequent invasion. Optimists regard this gesture, plus the fact that Ukraine is making gains on the ground and the 'radio silence' from the main super powers, as a sign of important diplomatic efforts behind the scenes; after all, costs are now mounting for both the EU and Russia and there will be voices that will be making the point that Ukraine is simply not worth it. That is, Europe and Russia risk throwing the baby out with the bathwater. Both optimists and sceptics could yet be proven right: even serious talks behind the scenes can be derailed by events on the ground and therefore spark yet another round of escalation, as the downing of the Malaysian airliner showed.
- Indonesia: A larger than expected current account deficit raised eyebrows this past week. The Q2 deficit widened to 4.3% of GDP, broadly in line with consensus and narrower than at this time last year, but nevertheless the widest of the year so far. For many, current account deficits are like red rags to a bull, which is often entirely unjustified because they are usually adjusted very quickly, when required. Adjustment does not appear to be necessary in this case, however. The Rupiah is nearly 20% cheaper than at this time last year, inflation has collapsed to 4.6%, while domestic bond yields are more than 8%. This means that real rates in Indonesia are among the highest in the world. This is going to keep foreign investors interested in financing Indonesia while keeping a lid on domestic demand pressures. Sure, the widening of the current account deficit was somewhat larger than expected, but was partly seasonal, partly due to falling export prices. Importantly, there were no signs of a surge in imports (other than the seasonal effects associated with Ramadan). Monetary policy is today far more credible than at this time last year, while FX reserves are 20% higher than last year. So this one print shouldn't change anyone's mind about Indonesia's fundamentals. Besides, there are reasons to

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[1] *"Turning Japanese"* is the title of a song by British band 'The Vapors'. According to the songwriter, the expression is a reference to the angst of turning into something you didn't expect to. It does not refer to Japan per se.

Emerging Markets

believe exports could pick up going forward due to the pipeline of mining exports. Growth is still expected to exceed 5% this year and there is a new government about to start work soon. The Constitutional Court is due to rule by 22 August that the recent presidential election was free and fair, at which point the Jokowi administration can actually begin its work. Jokowi has already committed to adjusting fuel prices – this is important in order to anchor fiscal credibility early in the new government's term. While higher fuel prices may temporarily push up inflation, the central bank (and markets) should recognise that this is one-off effect, which will not undermine longer-term credibility of monetary policy, while it is in fact very positive for Indonesia longer term from a fiscal perspective. Bank Indonesia's decision this week to keep rates unchanged at 7.5% was nevertheless important, because it shows that the central bank is mindful of the external balances, even with inflation falling. For all of these reasons, the outlook for Indonesian fundamentals continue to look solid, while the risks – there are always risks – are not principally fundamental in nature. What then are the risks? Other than those associated with the Constitutional Court ruling and the precise timing of fuel subsidy changes, there are two principal risks. One is positioning, the other is global sentiment. The two are obviously linked, because foreigners hold significant volumes of Indonesian bonds due to a combination of high yield, a sense that the external balances have improved, optimism about Jokowi and a recognition that policy credibility has been enhanced in Jakarta. Even so, foreign investors are a fickle lot. When they get frightened – which is not unheard of and the reasons could well be entirely unrelated to Indonesia – their trading activity could create temporary volatility in Indonesian asset prices. This would not have much, if any, impact on Indonesia's fundamentals, however, and in any case it would be temporary, and render the market with both better valuations and stronger technicals. For these reasons, we think investors should use any temporary volatility caused by 'the herd' to add to positions in Indonesian bonds.

- Malaysia: GDP growth accelerated in Q2 to 6.4% yoy from 6.2% in Q1 and significantly exceeded expectations of 5.8% growth. This is equivalent to 7.5% growth in the quarter. Investment and exports were the main drivers, while imports actually declined so Malaysia was also able to record a better than expected balance of payments number for Q2. The current account surplus was 6.1% of GDP, while FDI flows surged. The upside surprise on growth now makes the central bank in Kuala Lumpur look like a superstar, because it raised rates in July. Given the strength of the economy the hiking cycle is likely to continue. Like many other EM countries, Malaysia's government has a keen eye on medium term growth challenges. The government's medium term strategy hinges on a USD 444bn investment program to raise productivity levels and enable the economy to gradually transition to more domestic demand led growth drivers without creating inflation.

- Brazil: An echo of the giant sucking sound that was the World Cup still resonates through the Brazilian economy. Retail sales for June declined 0.7% mom, at least in partly an indication that Brazilians turned their attention to football rather than conspicuous consumption. There is now likely to be a modest rebound in retail spending over the next few months, but a strong rebound seems unlikely. Aside from the loss of credibility of the economic team, which has had a detrimental impact on business confidence, uncertainty increased sharply this week when Eduardo Campos, presidential candidate for the PSB party, was killed in a plane crash. Campos was not expected to win, but his death could now thrust Marina Silva, his erstwhile vice-presidential candidate, into the position as PSB presidential contender. In many ways, Marina is a more formidable political force than Campos. She is widely regarded as honest and principled. She is from the North East and she commands a strong following (she polled 20% of the vote in the first round of the previous presidential election). She is left of centre and could take votes from President Dilma Rousseff, but her economic policies are expected, for the most part, to be better than those of the current administration, so she could also win support from the centre-right. The uncertainty caused by Campos' death will begin to decline once new polls are published. For now, the main implication of Campos's demise is that it turns this election into a potential three rather than a two-horse race.

- Venezuela: The World Bank's arbitration court (ICSID) has closed proceedings in the case of Exxon and the Republic of Venezuela arising from the nationalisation of Exxon's assets in Venezuela in 2007. What the ruling is and what award the court grants Exxon, if any, remains to be disclosed within the next 4-6 months. A claim by Conoco, another oil company, whose assets were several times larger than those of Exxon, is expected next year. The potential liability for the Republic of Venezuela could run into several billions of US dollars. In both cases, however, the Republic can seek annulment, adding years to the process. Once these options are exhausted, the ICSID judgement will be recognised by the US courts. For this reason, there is now speculation that Venezuela is trying to sell its US operations (the company is called CITGO). Venezuela may seek to do so simply as a business transaction, but there is also speculation in some quarters that Venezuela wants to reduce its number of potentially attachable assets in the US in case the Exxon and Conoco judgements go against the Republic. Others then speculate further that this strategy is motivated by a desire to default. Perhaps. However, there are powerful counter arguments. First, the loss of CITGO's assets – estimated to be worth some USD 7bn – would only be of marginal importance to bond holders and to the Republic. After all, Venezuela's GDP is just under USD 300bn, while the country's debt stock is about USD 150bn (49% of GDP). More importantly, the real cost of defaulting for Venezuela would be the loss of access to working capital for PDVSA, the national oil company. PDVSA would soon be unable to continue operations without access to a steady stream of Dollar working capital.

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- Iraq: Nouri al-Malaki has stepped down as Prime Minister after losing backing from Iraq's external allies, Iran and his own party. His divisive rule was a source of serious divisions right at the heart of government, which so weakened the country that Islamic State, an armed group, was able recently to occupy vast swathes of Northern Iraq after suffering military defeat at the hands of Syria's Bashar al-Assad. Iraq's political situation is extremely difficult. The country has a classic zero-sum political problem, meaning that the country is divided into a few large communities that each hope to secure total power (this stands in sharp contrast to most EM countries, whose governments represent a much broader range of vested interests, wherefore no single group can even entertain the possibility of securing total power). Deputy Speaker Haidar Abadi has now been asked to form a new government. Despite the utter chaos in Northern Iraq, the government is unlikely to run out of money or stop debt service. This is because Southern Iraqi fields account for 2.5m of the 3.0m barrels of oil produced each day and they are not under threat from Islamic State or government instability, barring a dramatic further escalation (not our base case).

- China: China's strong export numbers last month provide welcome support as the economy continues to transition through broader structural changes, including a liberalisation of interest rates and a switching of resources towards less sophisticated domestic sectors. Growth is on track to deliver a 7-8% real expansion this year, but industrial production, rising 9% yoy in July and fixed asset investment, up 14.8% yoy, were both marginally slower than in June, though retail sales were unchanged YTD in June (+12.1%). Broad money supply slowed to 6.7% yoy from 8.9% yoy, while narrow money (M0) rose marginally from 5.3% yoy to 5.4% yoy. These numbers indicate a slowing in financial intermediation, i.e. the amount of credit making its way into the broader economy via the banking system. Marginal total social financing – meaning the amount of credit generated not only by the banking system but also by the shadow banking system – declined dramatically, but the central bank noted that there were special factors at play. The growth in total outstanding social financing only slowed marginally from 16.7% yoy to 15.9% yoy.

- Argentina: Talks between holdouts and the government have not delivered results, following Judge Griesa's blockade of Argentina's ability to service exchange bonds, which triggered a formal default last month. Over the past week, this has led to growing concern in some quarters that the risk of acceleration is rising. It only takes 25% of holders of any of the affected bond series to accelerate, which in turn could trigger cross-default to USD 29bn of bonds. As a result, sovereign spreads widened from 690 last week to about 770bps at the time of writing, though this remains below the average spread over the past 12 months of 860bps.

- India: Taken at face value, India delivered a genuinely unpleasant set of macroeconomic numbers this past week. Industrial production, at 3.4% yoy, fell well short of the expectation of 5.6% yoy, while CPI inflation in July spiked to 8% from 7.5% in June. However, these numbers should be discounted somewhat. The industrial production number was dominated by more volatile items, while core production was up 4% yoy, well above the 2.9% yoy rate of the past six months. The inflation number may also be due to temporary effects, notably volatile food prices. After all, wholesale prices actually moderated significantly from 5.43% yoy in June to 5.19% in July. In general, we expect the central bank to manage inflation risks with a high degree of sophistication and based on a recent joint press conference between Finance Minister Jaitley and Central Bank governor Rajan suggests that both men are on the same page regarding the importance of maintaining price discipline.

  In an unrelated development, the Reserve Bank of India proposed a further liberalisation of access for long-term investors to India's quota-protected domestic bond market. This is good news, but in our view the authorities are still too cautious. The proposal to let Sovereign Wealth Funds and central banks greater access is similar to China's early stage capital account liberalisation, which also began with the restrictive QFII and CIBM schemes aimed mainly at official sector institutions, but then gradually granted a broader range of institutional investor access via the more liberal RQFII scheme on a selective basis.

  So far, India is maintaining the quota system, so its markets will not be eligible yet for inclusion in the main benchmark indices. We think India will continue to gradually liberalise market access and eventually qualify for index inclusion. There are many ways this could be done. In addition to removing quotas, India could issue specific benchmark bonds that are not subject to quotas, which could then be included in the indices. India would then limit foreign involvement in accordance with their pace of issuance, or, indeed buybacks. We think it is positive that India now clearly recognises that there are differences between institutional investors. They are not all hedge funds and short term investors. Many are many long-term institutional investors, whose introduction to the Indian market would be very healthy for many reasons.

- Turkey: The convention of the governing AK party will be held on 27 August. The convention will select a new party leader, who will also become the new prime minister to replace President-elect Erdogan. In economic news, the current account deficit widened marginally to USD 4.1bn in June from USD 3.5bn in May.

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Snippets:

- **Singapore:** Q2 GDP rose 2.4% yoy versus 2.3% yoy expected
- **Philippines:** Exports increased a strong 21.3% yoy in June, significantly more than the consensus forecast of 11% yoy.
- **South Korea:** July Unemployment Rate Falls to 3.4% versus 3.5% expected
- **Czech Republic:** Q2 GDP rose 2.6% yoy versus 3.0% yoy expected
- **Hungary:** Q2 GDP rose 3.9% yoy versus 3.5% yoy expected
- **Romania:** Q2 GDP rose 1.2% yoy versus 3.3% yoy expected
- **Bulgaria:** Q2 GDP rose 1.6% yoy versus 1.2% yoy in Q1
- **Poland:** Q2 GDP rose 3.2% yoy in line with expectations
- **Thailand:** GDP rose 0.9% in Q2, well above the 0% reading expected. The upside surprise was caused by a recovery in business confidence following the military coup in May.

Monetary Policy Changes:

- **Chile:** Chile's central bank cut rates 25bps to 3.5%
- **South Korea:** Bank of Korea cut rates by 25bps to 2.5%

Global backdrop

It would appear that more and more of the world's financial markets are leveraged off the US treasury market. Ten year yields once again dipped below 2.4% last week, briefly touching 2.32% on Friday, while German yields dropped below 1% for the first time prompted by softer retail sales and a rise in claims for unemployment in the US and negative quarterly growth in Germany, respectively. In Japan, real GDP growth plunged an impressive -6.8% from last quarter. The whole world, it seems, is turning Japanese.

This global backdrop is a precarious one, not so much from a fundamental perspective as from a valuation point of view. Even modest rises in yields already adversely impacted stock markets and, given how far yields eventually have to rise, this does not bode well for the outlook for equities, particularly since the 4% handle on growth in Q2 is already in the price and is likely to be the fastest quarterly growth number we will see in the US economy this year.

Asset prices have reached these levels because developed economies responded to the crisis – itself the consequence of excessively loose policies in the past – by dramatically loosening policies. At the same time, there was little appetite for addressing the underlying structural challenges.

There are of course important differences between developed countries: the US stands apart from Europe by having recapitalised its banking system, which gives the US a decent chance at generating inflation and escaping its crippling debt burden as soon as households return to spending.

Europe, on the other hand, will struggle to generate inflation and hence it is heading for higher real interest rates and a stronger EUR, both of which will only slow its economy further. And QE may not solve the problem. If the money merely circulates outside the real economy the ECB can print money till it is blue in the face with little effect on prices. Much like Japan. In our view, both EUR and JPY are likely to outperform the USD over the next few years amongst the currencies of the developed economies.

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.0%	9.3%	15.1%	5.0%	7.7%
MSCI EM Small Cap	0.7%	10.5%	13.8%	4.6%	9.1%
MSCI FM	-0.9%	21.1%	28.9%	15.7%	9.7%
S&P 500	1.40%	7.13%	20.11%	20.09%	16.67%
GBI EM GD	0.23%	5.11%	4.34%	0.82%	6.24%
ELMI+	0.17%	1.52%	1.90%	-0.63%	1.97%
EMBI GD	0.10%	9.21%	11.42%	7.17%	9.47%
EMBI GD IG	0.58%	8.95%	10.60%	5.62%	8.01%
EMBI GD HY	-0.77%	9.75%	13.12%	9.89%	11.74%
5 year UST	1.06%	2.76%	2.70%	1.23%	3.77%
7 year UST	1.64%	5.49%	5.09%	2.16%	5.34%
10 year UST	2.25%	9.29%	8.01%	3.67%	6.26%
CEMBI BD	0.23%	6.57%	9.15%	6.31%	8.51%
CEMBI BD HG	0.57%	6.98%	9.37%	6.07%	7.85%
CEMBI BD HY	-0.47%	5.66%	8.69%	7.12%	10.57%
US HY	0.96%	5.41%	10.33%	10.97%	12.84%
European HY	-0.08%	5.54%	11.55%	15.52%	14.91%
Barclays Agg	0.88%	4.91%	6.35%	1.46%	4.01%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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