156

By Jan Dehn

There are now 156 individual bond markets formally represented within the four main EM fixed income benchmark indices. In addition, 91% of the asset class has yet to be formally entered into these benchmark indices. Amidst all the noise from Turkey and Argentina is it easy to forget that these two countries make up less than 5% of EM's large and diverse bond market. Buying into general EM weakness when troubles are confined to just two countries gives extremely good odds of making money on the trade.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	0.60%
MSCI EM Small Cap	10.8	–	1.08%
MSCI Frontier	10.4	–	-1.74%
MSCI Asia	11.5	–	1.17%
Shanghai Composite	9.6	–	-0.14%
Hong Kong Hang Seng	7.0	–	0.98%
MSCI EMEA	9.4	–	-1.09%
MSCI Latam	11.3	–	-1.08%
GBI-EM-GD	6.62%	–	-1.54%
ELMI+	5.17%	–	-0.92%
EM FX spot	–	–	-1.42%
EMBI GD	6.56%	370 bps	-0.55%
EMBI GD IG	4.77%	190 bps	0.09%
EMBI GD HY	8.67%	582 bps	-1.23%
CEMBI BD	6.17%	335 bps	-0.05%
CEMBI BD IG	4.83%	201 bps	0.10%
CEMBI BD Non-IG	7.92%	509 bps	-0.23%

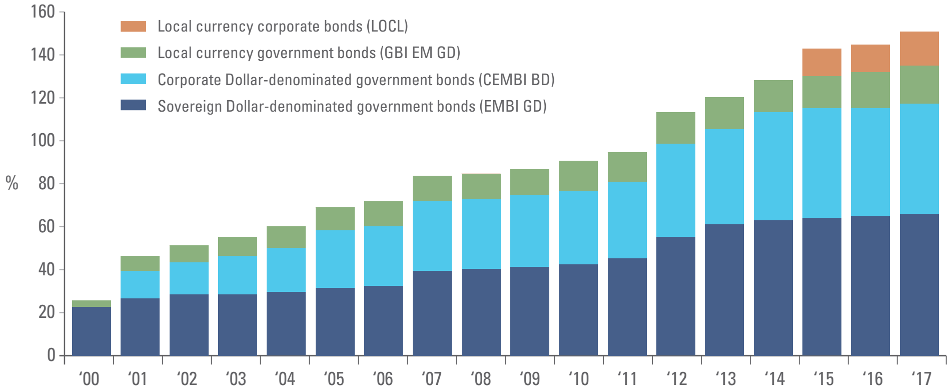
Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	0.98%
1-3yr UST	2.63%	–	0.04%
3-5yr UST	2.74%	–	0.00%
7-10yr UST	2.86%	–	-0.11%
10yr+ UST	3.02%	–	-0.55%
10yr+ Germany	0.34%	–	0.11%
10yr+ Japan	0.12%	–	-0.11%
US HY	6.27%	338 bps	0.08%
European HY	3.48%	413 bps	-0.12%
Barclays Ag	2.04%	-82 bps	0.01%
VIX Index*	12.86	–	0.87%
DXY Index*	95.05	–	0.27%
EURUSD	1.1611	–	-0.57%
USDJPY	110.96	–	-0.11%
CRY Index*	192.96	–	0.88%
Brent	77.8	–	2.11%
Gold spot	1202	–	-0.74%

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

Emerging Markets

Amidst all the noise over Argentina and Turkey, it is easy to forget that the Emerging Markets (EM) fixed income universe now comprises 156 individual indexed bond markets (Figure 1). Moreover, these 156 indexed markets only make up about 9% of the total EM fixed income universe, which today measures USD 24trn, or 22% of global fixed income. There is a tendency to lump all these disparate markets together during bouts of risk aversion, and even to extrapolate onto the majority what is happening in the few. Much of this dumbing down happens, because herd instincts are still strong among investors, wherefore many easily fall prey to speculation about contagion and other nonsense. However, Turkey and Argentina's markets are just six out of the 156 indexed markets in the EM bond universe – and far from the largest – so they are by no means representative of the EM asset class. The remaining 96% are for the most part doing fine. Buying into general weakness in the EM asset class caused by problems in just two countries gives investors extremely good odds of making money on the trade.

Fig 1: **Number of EM bond markets formally represented in the four main fixed income benchmark indices**



Source: Ashmore, JP Morgan, ICE.

Continued overleaf

Emerging Markets

This Weekly summarises developments mainly in 'the rest of EM', that is, the ones whose boring robust economic fundamentals and sensible economic policies ensure that they never make the headlines.

The non-headline grabber was erstwhile 'fragile five' country India, whose real GDP growth rate surged to 8.2% yoy in Q2 2018. The consensus 'only' expected 7.8% yoy growth. The key driver of Indian growth in Q2 was domestic demand with financials and construction also playing a very big role in the stronger than expected growth number. Domestic demand has been slow to react to the Modi Administration reforms and recent stimulus measures, but the Indian consumer is now finally waking up, which bodes well for overall growth. Domestic demand in general is going to be an important theme in EM in the coming years. Exports to developed markets, especially the US, are going to face challenges due to protectionism and eventually weaker developed market currencies versus EM currencies, so EM countries, which can rely more on consumption as a source of growth will do well. The shift to consumption is already evident in China and other large EM economies, such as Indonesia, Brazil and India.

Case in point: China increased monthly personal income tax exemptions from RMB 3,500 to RMB 5,000 per person, which should add about 0.7% to growth, thus easily offsetting any GDP impact of Trump's tariffs via exports. Chinese economic activity looks stable and robust. The August Caixin PMI is sitting at 50.6, which was close to expectations (50.7), while the NBS PMI index was stronger than expected (51.3 vs 51 consensus). China also continues to move forward with financial liberalisation. It was announced last week that Chinese regulators have cleared the last remaining hurdles for the inclusion of Chinese bonds in the Bloomberg Barclays Global Aggregate Index, including enabling block trading and delivery versus payment settlement. Income tax on foreigner holdings of Chinese bonds will also be waived for three years.

Indonesia, another important Asian investment destination, is well placed for domestic demand-led growth after releasing lower than expected inflation data. Inflation in August was just 3.2% yoy, which was less than the Bloomberg expectation of 3.3% yoy, despite the pressure on EM currencies over the past six months. Investors often think that currency weakness leads to higher inflation in EM, but such pass-through is often not evident, because credible central bank policies have successfully anchored inflation expectations. Indeed, in Thailand core inflation also declined to just 0.7% yoy in August from 0.8% yoy in July, while headline inflation inched up to just 1.6% yoy due to higher energy prices. Thailand is maintaining low inflation despite solid domestic demand (4.6% yoy in July) and strong export growth (8.3% yoy in July). Sri Lanka, a country, which has conventionally been running relatively high inflation, saw core inflation ease to 3.7% yoy in August from 3.9% yoy in July. In general, inflation remains very low in EM apart from Argentina and Turkey. The 18 countries in the JP Morgan GBI EM GD index today have roughly 4% inflation on average, but only 3% if one excludes Argentina and Turkey. This is down from 5% on average in 2011.

There is no sign of damage from US tariffs in Korea, one of Asia's most export-oriented countries. In fact, in August the yoy rate of growth of Korean exports accelerated to 8.7% from 6.2% in July. Imports were also strong (9.2% yoy) and Korea's trade balance was a robust surplus of USD 6.9bn, unchanged from last month. Industrial production actually returned to positive territory in July (+0.9% yoy) after dipping in June (-0.4% yoy). Against this backdrop, the Bank of Korea kept the policy rate unchanged at 1.5%, evidently the fiscal authorities in Seoul are contemplating a fiscal stimulus. The Korean government's debt to GDP ratio is just 39%. In Hong Kong, retail sales expanded at a solid yoy rate of 7.8%.

Meanwhile, in Latin America, where there is more spare capacity than in Asia, markets have now likely seen the last echo of the truckers' strike in May as Brazil's Q2 GDP print came at a marginally softer than expected at 1.0% yoy. However, higher frequency economic indicators continue to point to a robust pick up in domestic demand, which should see growth prints improve in the coming quarters and especially after the election in October. For example, the stronger underlying economic performance is now showing up in Brazil's fiscal data, which delivered a much smaller than expected primary deficit in July (BRL 3.4bn versus BRL 6.9bn expected), mainly due to stronger revenues. The seasonally adjusted rate of unemployment also declined to 12.2% in July from 12.3% in June. In Chile, job growth continues to expand strongly with a 2.3% yoy pick up in July, but manufacturing production slowed though mainly due to calendar effects. Mexican credit growth remained robust in July (6.3% yoy). Ecuador was able to tap its 2020 and 2022 bonds to the tune of USD 1.2bn, which goes a long way towards meeting the country's financing requirements this year.

In Eastern Europe, Poland's economy delivered rocksteady inflation of 2.0% yoy in August, unchanged from July. Inflation is likely to decline in the coming months due to base effects. The low inflation rate relative to the central bank's 2.5% inflation target puts Poland in a very strong position to support growth, if required. However, for now it does not appear likely that growth stimulus is required, because the country racked up a strong 5.1% yoy growth rate in Q2 2018. Across Poland's South Eastern border, in the Czech Republic, the economy expanded 0.7% qoq in Q2 2018, up from an earlier flash estimate of 0.5% qoq. Czech Republic is currently on track to deliver +3% real GDP growth rates in both 2018 and 2019.

Continued overleaf

Emerging Markets

Finally, we note in passing that Malaysia's government budget was in surplus to the tune of MYR 0.8bn in July following an even larger surplus in June (MYR 4.2bn). This fiscal result is particularly impressive bearing in mind that the new Mahatir Administration cut GST effective 1 June. In Africa, the Nigerian economy delivered 1.5% yoy growth in Q2 2018, down from 2.0% yoy in Q1 2018.

Among EM's few trouble spots, Argentina looks set today to issue new fiscal measures to try to restore investor confidence following failed attempts at gradual adjustment after more than a decade of extreme populism under successive Peronist Administrations. Last week the central bank hiked the policy rate to an eye watering 60%. The Macri Administration clearly faces difficult choices. It can either cannibalise its own base in Greater Buenos Aires by imposing general fiscal measures, or it can seek to target taxes at the two thirds of the population, who live in the provinces of Argentina. Argentina's recurring fiscal problems are rooted in the country's Constitution, which guarantees that the central government is too weak to withstand spending pressures, let alone reverse them. While IMF disbursements can help the government to buy some time, the IMF is powerless to solve the constitutional problem. That is why Argentina is a serial defaulter.

Global backdrop

The global backdrop remains negative. President Trump is once again threatening an escalation of his trade war against China as well as Europe. Tariffs are taxes, which raise costs for US consumers and producers just as July's PCE inflation report shows that core inflation has reached the Fed's 2.0% yoy target. It therefore seems likely that fiscally-assisted Q2 2018 growth print of 4.2% qoq will be the peak of this business cycle. Housing, the shape of the yield curve and consensus expectations all point to slower US growth rates going forward. Meanwhile, in Italy the market's focus is shifting to the new populist government's first Budget, which, if consistent with election promises, could result in a ratings downgrade for the sovereign. On the other hand, the rate of unemployment in the Eurozone declined to 8.2% in July, which is nearly 1% lower than a year ago. This may help to take a bit off the edge of the drive towards populism in Europe.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.68%	-6.99%	-0.34%	11.87%	5.43%
MSCI EM Small Cap	-2.07%	-9.14%	-0.63%	8.87%	4.95%
MSCI Frontier	-5.38%	-12.60%	-5.80%	4.57%	3.50%
MSCI Asia	-1.01%	-4.81%	3.01%	13.45%	8.36%
Shanghai Composite	-5.12%	-15.72%	-16.98%	-3.21%	7.80%
Hong Kong Hang Seng	-1.26%	-3.72%	0.11%	7.96%	6.08%
MSCI EMEA	-7.70%	-13.63%	-7.11%	4.39%	-0.52%
MSCI Latam	-8.33%	-10.89%	-11.51%	9.33%	-1.29%
GBI EM GD	-6.09%	-10.47%	-10.05%	3.23%	-1.33%
ELMI+	-3.02%	-5.51%	-4.22%	2.69%	-0.90%
EM FX Spot	-4.99%	-9.84%	-10.82%	-2.76%	-7.16%
EMBI GD	-1.73%	-4.49%	-3.37%	5.05%	5.60%
EMBI GD IG	0.25%	-2.03%	-1.27%	4.38%	5.13%
EMBI GD HY	-3.74%	-7.06%	-5.63%	5.81%	6.05%
CEMBI BD	-1.08%	-2.53%	-1.52%	4.62%	4.88%
CEMBI BD IG	0.20%	-0.90%	-0.49%	3.56%	4.52%
CEMBI BD Non-IG	-2.62%	-4.49%	-2.68%	6.45%	5.37%

Continued overleaf

Ashmore

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	3.26%	9.94%	19.65%	16.09%	14.50%
1-3yr UST	0.33%	0.37%	-0.08%	0.51%	0.64%
3-5yr UST	0.59%	-0.38%	-1.54%	0.59%	1.27%
7-10yr UST	1.11%	-1.45%	-3.06%	0.73%	2.38%
10yr+ UST	1.58%	-2.92%	-2.76%	2.38%	5.13%
10yr+ Germany	1.47%	4.35%	3.17%	3.78%	6.99%
10yr+ Japan	-1.18%	-0.13%	0.09%	3.82%	4.40%
US HY	0.74%	2.00%	3.40%	7.00%	5.62%
European HY	0.14%	0.19%	1.44%	4.87%	5.89%
Barclays Ag	0.10%	-1.52%	-1.36%	2.44%	1.34%
VIX Index*	0.00%	16.49%	26.95%	-49.79%	-22.58%
DXY Index*	-0.09%	3.18%	2.41%	-1.40%	15.41%
CRY Index*	0.00%	-0.47%	6.64%	-2.79%	-34.10%
EURUSD	0.07%	-3.28%	-2.40%	4.39%	-11.84%
USDJPY	-0.05%	-1.54%	1.13%	-7.59%	11.44%
Brent	0.52%	16.38%	47.53%	53.55%	-32.73%
Gold spot	0.08%	-7.73%	-9.76%	6.83%	-14.87%

*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.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Other locations
Lima
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper