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WEEKLY INVESTOR RESEARCH

Ashmore

EM corporate HY default rates fall below 1% for the first time since 2012

By Jan Dehn

EM corporate high yield (HY) default rates have fallen below 1% for the first time since 2012. Over the last 12 months EM HY corporates have defaulted 2.6 times less than their US cousins. However, EM spreads have widened this year, while spreads have narrowed in the US HY space. This implies that relative value has shifted sharply in favour of EM HY corporate bonds. The falling default rate also shows that there is no widespread credit stress in EM. Argentina announces changes its economic team and a brand new approach to fighting inflation. MSCI announces plans, which, if approved, will take the share of China in the MSCI EM equity index to an eye-watering 40%. In Brazil, Bolsonaro reminds everyone that he is no great fan of democracy. Mexico hires a solid economist as vice-president of the central bank and a Turkish bank passes an important test by rolling a USD 1bn syndicated loan. Meanwhile, outside of EM the Fed no longer thinks the Fed funds rate is 'accommodative' and in our view, Italy's populist budget underscores the general truth that developed economies are the most fiscally irresponsible on the planet .

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.8	–	-0.29%
MSCI EM Small Cap	10.6	–	-1.04%
MSCI Frontier	10.8	–	-1.57%
MSCI Asia	11.4	–	-0.69%
Shanghai Composite	10.1	–	3.43%
Hong Kong Hang Seng	7.5	–	2.09%
MSCI EMEA	9.1	–	1.04%
MSCI Latam	11.6	–	1.21%
GBI-EM-GD	6.62%	–	0.98%
ELMI+	5.37%	–	0.20%
EM FX spot	–	–	0.47%
EMBI GD	6.41%	335 bps	0.73%
EMBI GD IG	4.79%	172 bps	0.59%
EMBI GD HY	8.29%	524 bps	0.87%
CEMBI BD	6.12%	310 bps	0.48%
CEMBI BD IG	4.94%	192 bps	0.34%
CEMBI BD Non-IG	7.66%	463 bps	0.67%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	-0.51%
1-3yr UST	2.83%	–	0.07%
3-5yr UST	2.96%	–	0.11%
7-10yr UST	3.07%	–	0.17%
10yr+ UST	3.22%	–	0.21%
10yr+ Germany	0.49%	–	0.33%
10yr+ Japan	0.14%	–	-0.12%
US HY	6.24%	316 bps	0.17%
European HY	3.29%	405 bps	-0.50%
Barclays Ag	2.15%	-92 bps	-0.52%
VIX Index*	11.94	–	-0.26%
DXY Index*	95.01	–	0.82%
EURUSD	1.1610	–	-1.17%
USDJPY	113.93	–	1.00%
CRY Index*	195.31	–	0.53%
Brent	83.0	–	2.20%
Gold spot	1191	–	-0.65%

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

Emerging Markets

Default rates for EM (Emerging Markets) corporate junk bonds have fallen below 1% for the first time since 2012. According to data compiled by Bank of America Merrill Lynch, the default rate for EM corporate high yield bonds fell to just 0.99% at the end of August 2018. EM corporate junk bonds are the lowest rated segment of the credit rating spectrum in the sense that, unlike sovereigns, corporates cannot raise taxes or pass laws and high yield corporates have a higher average default rate than IG (Investment Grade) corporates. However, investing is not about absolute levels of riskiness, but rather about identifying situations where known risks are mispriced relative to actual performance. On that metric, EM HY now looks very attractive, especially in comparison with US HY bonds. US HY default rates are currently 2.6 times higher than EM HY bonds. EM high yield spreads have widened by more than 100bps in 2018, while US HY bond spreads have tightened by 5bps this year. US HY corporates are also more leveraged than their EM counterparts. In our view this implies that relative value has shifted sharply in favour of EM HY bonds this year.

Figure 1 illustrates this point by depicting a line made up of the sum of (a) the EM-US default rate differential and (b) the EM-US spread differential. The line moves higher when default rates fall in EM relative to US default rates and when spreads for EM bonds widen relative to US HY bonds. Thus, a rising line implies more value for EM bonds versus US bonds. On this metric, the value of EM HY bonds relative to US HY bonds is on par with levels only seen coming out of 2008/2009, at the height of the European debt crisis and during the collapse of commodity prices in H2 2014.

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Emerging Markets

The declining default rate for EM corporate HY bonds also underlines the point that the problems faced by Turkey and Argentina this year are not representative of the situation in the rest of EM. The decline in default rates is broad-based across all regions of EM and suggests that the general pullback in EM this year cannot be attributed to underlying credit stress. Our view is that the pullback is mainly profit taking after two strong years triggered by a temporary resurgence in the Dollar, which is now mostly over.

Fig 1: **Sum of default rate and spread differentials: EM vs US HY corporate bonds**

Source: Ashmore, BAML, Bloomberg.

- **Argentina:** Guido Sandleris has replaced Luis Caputo as Governor of the central bank. President Mauricio Macri brought in Caputo, who has a trading background, to deal with the immediate financing challenges of the last few months. Now that the IMF programme is on track, Sandleris, who has a fiscal background, is going to take over the more mundane phase of the adjustment process. Argentina's immediate problem is fiscal in nature and the economy as a whole is characterised by strong fiscal dominance, so it makes sense to have a fiscally trained person at the central bank. As such, we view the change in leadership at the central bank as a positive development. However, in a sign that domestic demand is still excessive relative to supply, the current account deficit narrowed only marginally to USD 8.3bn in Q2 2018 from USD 9.6bn in Q1 2018. The new IMF programme aims to break the inflationary impulse in Argentina by adopting a target of zero growth for the monetary base. The government has also adopted a band for the exchange rate, which is so wide as to not really be binding in all but the most volatile periods. Our main concern with the IMF programme is that Argentina's problem is essentially fiscal in nature and this IMF programme does not address the fiscal angle nor the required economic reforms nearly enough. As such, the combination of tight money, inadequately tight fiscal and neglect of the supply-side may eventually end up becoming a recipe for hot money inflows.

- **China:** MSCI, the equity index provider, has proposed to quadruple the inclusion factor for Chinese large- and mid-cap A shares in its benchmark EM equity index (from 5% to 20%). Stocks in the Shanghai start-up index called ChiNext may also be included. The increase in the inclusion factor implies that the total weight of Chinese equities in the MSCI EM rises to 32.2%. Longer-term, once the inclusion process is completed China should end up with roughly a 40% share of the index. MSCI, which has issued a request for investor feedback for its proposals, is expected to announce a final decision on 28 February 2019. In our view, it is a mathematical certainty that China will replace the US as the global economic and financial hegemon in the course of the next couple of decades due to higher growth rates, a larger population, a much stronger commitment to reforms and better overall macroeconomic policies. In other news, China continues to steadfastly liberalise its economy in conformity with the long-term policy objectives. Thus, last week the State Council announced that China will unveil further measures to encourage FDI into China. The State Council also announced that import tariffs will be cut to 7.5% from 9.8% last year. Industrial profit growth slowed to a still, very high 9.2% yoy in August, following an exceptionally strong July (16.2% yoy).

- **Brazil:** Jair Bolsonaro, erstwhile far-right populist front-runner in the race for the presidency in Brazil's upcoming election, has reinforced fears in some quarters that he has authoritarian tendencies by stating that he will not accept the election result if he loses. Left-winger Fernando Haddad of the PT party has been pulling ahead of Bolsonaro in at least one poll and may have a lower rejection rate than Bolsonaro. A low rejection rate is key in the second round of the election. Haddad belongs to the moderate wing of PT. He is an economist and former mayor of Sao Paulo, the main home of Brazil's financial markets. We expect a crucial pension reform to be passed regardless of who wins the election. In other news, FDI inflows beat expectations in August. The inflow of FDI was USD 10.6bn, which takes the 12m running inflow to USD 69.6bn. Meanwhile, the current account deficit was just USD 717m, which was lower than expected (USD 1.3bn).

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Emerging Markets

The current account deficit is running at an annual rate of USD 15.5bn and therefore comfortably financed by FDI. Net government debt declined to 51.2% of GDP in August from 52.2% of GDP in July. The rate of unemployment continued to decline and now stands at 12.1%. Household and corporate credit growth both showed solid growth in August.

- Mexico: Jonathan Heath was appointed Vice-Governor of the central bank. Heath is familiar to countless investors, who will have met with him over the years in his capacity as an expert on the Mexican economy. Heath will bring strong and independent views to the central bank's key decision-making bodies. Heath's appointment underlines once again that the left-wing administration of Andres Manual Lopez Obrador is not going to sacrifice macroeconomic stability. Today, both left and right broadly follow orthodox economic policies. The main differences arise in terms of which interest groups they favour. Otherwise, it is goldilocks for Mexico. At 0.22% mom, inflation in H1 September was much lower than expected (0.32% mom, or 4.88% yoy compared to 5.0% last month), yet despite falling inflation economic activity was stronger than anticipated in July at 0.4% mom versus 0.1% mom expected. The unemployment rate also declined to 3.47% in August versus 3.53% expected. Private sector credit growth slowed to a still very solid 6.0% yoy in August from 7.8% yoy in July.

- Turkey: Akbank, an important Turkish bank, successfully rolled a syndicated loan of almost USD 1bn last week, albeit at more than 1% higher cost than at the same time last year. Still, this should be viewed as positive by the market, because it shows that Turkish banks can access foreign capital despite the economic crisis caused by the government's poor macroeconomic policies over several years.

Snippets:

- Chile: Manufacturing picked up sharply in August, rising at a 4.0% yoy pace versus just 1.6% yoy expected.
- China: NBS manufacturing PMI declined to 50.8 in September from 51.3 in August.
- Colombia: The monetary policy committee left the policy rate unchanged at 4.25%.
- Czech Republic: The central bank hiked the policy rate by 25bps to 1.5%.
- Ecuador: The government pre-paid a loan to China, which will give the country greater scope for selling oil on the free market.
- India: The government announced a meaningful fiscal spending cut of INR 700bn, but also imposed tariffs on USD 13bn of 'non-essential' imports. Unlike many other EM countries, India has a strong bent towards import-substitution policies, which is one of the reasons why India has fallen far behind China in terms of its economic development.
- Indonesia: The central bank hiked the policy rate by 25bps to 5.75%. CPI inflation slowed to 2.88 % yoy in September from 3.18% in August, well below expectations.
- Philippines: The central bank hiked the policy rate by 50bps to 4.5% and may hike further. The economy is late in the expansion phase and the central bank needs to reign in demand, so the interest rate hike should be viewed positively.
- Singapore: Industrial production was softer than expected in August pending the seasonal upturn in smartphone sales (3.3% yoy versus 4.7% yoy consensus).
- South Africa: President Cyril Ramaphosa indicated that a planned land reform will not involve any land grabs. Ramaphosa indicated that US President Donald Trump's criticism of South Africa's land reform were "clearly misinformed". We share Ramaphosa's view.
- Sri Lanka: The yoy rate of inflation dropped sharply to 4.3% in September from 5.9% in August.
- Thailand: CPI inflation moderated to 1.3% yoy in September from 1.6% yoy in August. Consumption spending and investment both rose strongly in August.
- Venezuela: The US government sanctioned Cilia Flores, who is a leading political figure in the government. Other leading officials were also sanctioned. Flores is married to President Nicholas Maduro. These sanctions will not change anything in Venezuela, but sanctions on oil might.

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Global backdrop

The attempt to appoint Judge Kavanaugh, a man with an alleged history of predatory sexual behaviour, to the US Supreme Court poses a threat to the integrity of the entire US court system, in our opinion.

In Italy, the government approved a populist budget with deficits far in excess of existing commitments to the European Union, thus underlining the general truth that developed economies are unwilling to control spending (and unable to undertake reforms unless a gun is pointed to the side of their head).

Meanwhile, the Fed hiked the range for the policy rate by 25bps to 2.00% – 2.25% in line with expectations. The Fed statement indicated that this level of interest rates is no longer considered 'accommodative', which is remarkable, because headline inflation is still well above the Fed fund rate, but perhaps the Fed is mindful that US housing continues to lose steam. In new data released last week, the yoy rates of growth of both the Case-Shiller 20-city composite index of house prices and the FHFA index both declined following weakness in other housing indicators. For example, there were meaningful downward revisions in the new home sales report for August. The yoy rate of inflation as measured by the Fed's favourite core PCE index also moderated marginally to 1.96% in August from 2.02% in July. The tax-cut assisted strong growth print of 4.2% qoq saar in Q2 2018 is most likely the peak in growth in this US business cycle. The rate of growth is expected to decline to a high 2% handle in Q3 2018, to fall further in 2019 and to decline to a 1% handle in 2020 with risks tilted to the downside due to the very late stage of the business cycle plus unambiguously bad macroeconomic policies in the US. It is no exaggeration to say that if an EM country had unleashed a fiscal stimulus of 7-8% of GDP at full employment and abandoned free trade in favour of rampant protectionism (like the US has done), it would have been downgraded many times by the ratings agencies already.

In a positive development, US, Canada and Mexico appear to be close to a trilateral trade agreement. How this trade deal differs from NAFTA remains to be seen, but even if the two deals are broadly similar at least the politicians will be able to say they fixed something (having torn it down earlier).

Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.54%	-7.49%	-0.50%	12.82%	4.00%
MSCI EM Small Cap	-3.31%	-12.15%	-3.97%	7.66%	2.95%
MSCI Frontier	-0.04%	-12.64%	-7.73%	5.36%	2.80%
MSCI Asia	-1.41%	-6.15%	1.67%	13.60%	6.93%
Shanghai Composite	3.67%	-12.63%	-13.72%	-0.46%	7.76%
Hong Kong Hang Seng	1.70%	-2.08%	5.10%	9.78%	5.32%
MSCI EMEA	1.86%	-12.03%	-1.63%	6.85%	-1.82%
MSCI Latam	4.71%	-6.68%	-8.77%	14.04%	-2.00%
GBI EM GD	2.59%	-8.15%	-7.40%	5.18%	-1.68%
ELMI+	1.09%	-4.48%	-2.57%	3.28%	-1.10%
EM FX Spot	1.63%	-8.37%	-8.37%	-1.37%	-7.28%
EMBI GD	1.51%	-3.04%	-1.92%	6.04%	5.38%
EMBI GD IG	0.26%	-1.78%	-0.80%	5.03%	4.58%
EMBI GD HY	2.83%	-4.42%	-3.17%	7.14%	6.26%
CEMBI BD	0.95%	-1.60%	-0.93%	5.38%	4.78%
CEMBI BD IG	-0.09%	-0.99%	-0.67%	3.72%	4.17%
CEMBI BD Non-IG	2.27%	-2.32%	-1.16%	8.13%	5.61%

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Ashmore

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.57%	10.56%	17.90%	17.32%	13.95%
1-3yr UST	-0.12%	0.24%	-0.04%	0.35%	0.55%
3-5yr UST	-0.53%	-0.91%	-1.49%	0.10%	0.94%
7-10yr UST	-1.31%	-2.74%	-2.99%	-0.29%	1.74%
10yr+ UST	-2.96%	-5.79%	-3.56%	0.57%	4.34%
10yr+ Germany	-1.51%	2.78%	3.48%	2.57%	6.44%
10yr+ Japan	-0.56%	-0.69%	0.14%	3.39%	4.03%
US HY	0.56%	2.57%	3.05%	8.15%	5.54%
European HY	-0.14%	0.05%	0.74%	5.64%	5.59%
Barclays Ag	-0.86%	-2.37%	-1.32%	1.98%	0.75%
VIX Index*	-1.49%	8.15%	25.55%	-47.05%	-23.17%
DXY Index*	-0.13%	3.13%	2.07%	-1.23%	18.55%
CRY Index*	0.08%	0.74%	6.67%	1.45%	-31.23%
EURUSD	0.05%	-3.29%	-1.05%	3.71%	-14.17%
USDJPY	0.20%	1.10%	1.03%	-5.00%	16.26%
Brent	0.33%	24.11%	44.23%	74.02%	-23.11%
Gold spot	0.03%	-8.56%	-6.29%	6.97%	-7.48%

*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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