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Ashmore

EM growth beats expectations and negative market sentiment in Q3

By Jan Dehn

Third quarter GDP data from a quarter of the EM universe as well as the three main HIDC (Heavily Indebted Developed Countries) economies show that developed economies were more affected by tighter financial conditions over the summer than Emerging Markets (EM). This finding is of course diametrically opposed to most perceptions and indeed the market price action of the past few months, underlining once more the inefficiency of the asset class.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,020	-	2.81%
MSCI FM	574	-	0.32%
GBI-GD	6.67%	-	1.03%
ELMI+	4.08%	-	0.25%
EMBI GD	5.84%	311 bps	-0.02%
EMBI GD IG	4.90%	216 bps	0.19%
EMBI GD HY	9.50%	702 bps	-0.45%
CEMBI BD	5.62%	340 bps	-0.01%
CEMBI BD HG	4.79%	255 bps	-0.05%
CEMBI BD HY	7.57%	538 bps	-0.26%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,798	1.55%
VIX Index	12.19	-5.50%
5 year UST	1.35%	-7 bps
10 year UST	2.70%	-5 bps
10 year Bund	1.71%	-4 bps
EURUSD	1.3509	0.78%
USDJPY	99.97	0.73%
Brent	$108	2.19%
Copper	$323	-2.30%
Gold	$1284	0.19%

Emerging Markets

Sixteen EM countries – or about 25% of the investable universe of countries – issued Q3 GDP numbers in the past week. The backdrop for the data release are (a) a summer of severely negative market sentiment, major currency volatility, rising borrowing costs, and a widespread perception that EM economies are more vulnerable to tighter financial conditions than developed economies; and, (b) EM growth began to improve sequentially in Q2 after a dip in the last quarter of last year and in the first quarter of 2013. Higher frequency activity data released since Q2 has shown that EM growth has picked up despite global headwinds in asset markets, although there have been exemptions as one would expect in such a diverse universe of countries.

Against this backdrop, the Q3 data released this week broadly recapitulates theme of general improvement with notable exceptions from the past three months. On a simple average basis, EM countries grew 3.1% yoy in Q3 and beat expectations by 70bps yoy. The table below shows Q3 yoy growth rates as well as market expectations for the sixteen countries.

Country	Q3 real GDP growth (% change yoy)	Market expectations ('-' denotes no market expectation)
Sri Lanka	7.8	–
Kazakhstan	5.7	–
Indonesia	5.6	5.6
Malaysia	5.0	4.7
Chile	4.4	4.1
Uruguay	4.3	-
Latvia	4.2	3.8
Romania	4.1	3.5
Hong Kong	2.9	3.2
Poland	1.9	1.6
Hungary	1.7	0.8
Russia	1.2	1.4
Slovakia	0.9	0.9
Bulgaria	0.8	0.5
Estonia	0.4	1.4
Czech Republic	-1.6	-0.5

Source: Bloomberg, Ashmore Investment Management Limited.

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Emerging Markets

Meanwhile, there is no other country on the planet better than China to implement deep, broad, and long-term structural reforms. This past week, the blue print for the direction of China's reform agenda in the coming years was published following the conclusion of the Third Plenum.

While the initial press release was short on specifics (as one would expect from a general statement of intentions) details soon began to emerge that point to a highly ambitious reform agenda.

The direction of travel is nevertheless clear: China is going to accelerate the role of markets in resources allocation. This is unambiguously positive for China. The reforms set China on track to becoming a modern mixed economy that relies more on domestic led growth and consumption.

State involvement will be scaled back and concentrated in core areas typically reserved for the government, such as social services and security, while the state will retreat from production, while market forces will be left to determine prices in most sectors barring the most strategic.

Private participation will be introduced to state owned enterprises, which will be required to pay dividends. Land reform will establish property rights for farmers and it will be possible to buy and sell land. Social security will no longer be non-transferrable, so that rural-urban migration can become more permanent. The one child policy will be relaxed in what will eventually be hugely important in helping China cope with its ageing population.

Bond market development and interest rate liberalisation will continue as centre pieces in the reform agenda as the country gradually replaces exchange rate manipulation with interest rates as the most important instrument of controlling the temperature of the economy. As this new system is established the capital account will gradually be liberalised.

Elsewhere, South Africa amended its trade balance calculations to include trade with Botswana, Namibia, Lesotho, and Swaziland. The inclusion results in a halving of South Africa's trade deficit year to date, and reduces the full year 2012 trade deficit from ZAR117bn to just ZAR35bn. These types of massive data revisions are not uncommon in Emerging Markets, where structural changes are often so rapid that data collection methodologies quickly get out of date. As for South Africa, this augmentation of the data suggests that the country is far less vulnerable in its external accounts than had been previously assumed.

In Venezuela the government has begun to pass an enabling law, which will confer further powers to the executive. This continues a process that began under former president Hugo Chavez of concentrating power into the hands of the president.

Finally, in Argentina, IMF Managing Director Christine Lagarde recommended against sanctioning Argentina for manipulating inflation data. This means that Argentina will likely continue to have access to multilateral funding, because most multilateral donors take their cue from the IMF in macroeconomic matters.

Global backdrop

Where Q3 growth in Emerging Market beat expectations, the situation in developed economies disappointed. This shows that a summer of modestly tighter financial conditions has hurt developed economies rather more than Emerging Markets. This is entirely logical given relative fundamentals, but in direct contradiction to how the markets have traded 'tapering', underlining once again the enormous inefficiencies of markets in EM.

Last quarter Europe's recovery was the cheer of the town as the largest economy in the world lifted itself out of recession. This week's release of Q3 growth data for Europe was therefore a stark reminder that cycles may come and go, but trend growth rates are far tougher to shift. The Eurozone's economy shrank by 0.4% yoy versus an expectation of a contraction of 0.3% yoy. On a qoq basis, output rose only 0.1%. France and Italy contracted, but Germany, Netherlands, Spain, Greece, and Portugal expanded. Tail risk fears remain low in Europe due to ECB support, but Europe's fundamental economic health is not great. The biggest problem is that the banking system is insolvent and that debts in most countries will be completely unsustainable if interest rates rise.

The pace of Japan's economic expansion halved in Q3 compared to Q2. The annualised qoq real rate of GDP growth fell to just 1.9% from about 3.8% in Q2. Equally concerning, there was little evidence from the breakdown of the data that investment and private consumption spending are picking up. Instead, the economy was mainly motored by public spending and speculative demand for housing. Our view is that this year's pickup in economic activity in Japan has largely been due to the huge fiscal and monetary stimulus unleashed by Prime Minister Shinzo Abe in a bid to win the July Senate elections. So far, very little has been achieved in terms of structural reform. This bodes poorly for the sustainability of Japan's recent growth stimulus.

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Global backdrop

US growth was of course also disappointing, despite the 2.8% headline print. Consumption and investment slowed and the stronger than expected headline number was entirely due to inventory accumulation, which bodes poorly for growth in Q4.

Inflation in the advanced economies is also still very subdued, although it is only a question of time before high money supply begins to feed into inflation expectations. In the US, the core PCE deflator in September was 1.1% yoy and in the Euro area core inflation was just 0.8% yoy in October. In the UK, 'core' inflation fell to 1.5% yoy last month, the weakest level since June 2009.

Against this backdrop, Fed Chairperson nominee Janet Yellen's nomination hearing this past week must have sounded like sweet music to the ears of policy makers across the HIDCs. Yellen stated that both inflation and the pace of economic recovery in the US are too weak, implying that monetary policy will remain highly accommodative. But she did not commit either way on tapering of QE, pointing out that the policy has been useful, but also that it cannot continue indefinitely.

Our view is that the Fed wants to move towards tapering to avoid bubbles, but that tapering risks a big sell-off in the long end of the US treasury curve, because the Fed has few means to control the long end. Higher long rates may yet force the Fed to U-turn on tapering again, because of the huge structural problems and massive debt levels in the HIDCs.

In our view, the question policy makers should be asking themselves before they think about tightening money policy again is this: How are we going to reduce the enormous stock of debt? One of the important lessons from a summer of failed tapering intentions is that only when the debt stock has been reduced in size can policy makers hope to raise rates without killing the economy.

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