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WEEKLY INVESTOR RESEARCH

Ashmore

No nonsense Nabiullina

By Jan Dehn

The world's toughest central banker hikes rates again. India's political season kicks off in style. China's economic data is mixed, but stronger investment and financing data offer more than a glimmer of hope for growth next year. Peruvians approve of anti-corruption measures. Sri Lanka's political crisis may be heading for a resolution. AMLO presents his 2019 Budget in Mexico. JP Morgan issues new information on the scheduled inclusion of five Middle-East countries in the EMBI GD in January next year. Growth differentials strongly favour EM over developed economies in the next few years, while the big clear and present danger in markets today is the situation in the UK regarding Brexit.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.5	–	-0.95%
MSCI EM Small Cap	10.2	–	-0.73%
MSCI Frontier	9.8	–	-1.25%
MSCI Asia	11.1	–	-0.52%
Shanghai Composite	9.6	–	-0.47%
Hong Kong Hang Seng	7.6	–	-0.10%
MSCI EMEA	8.6	–	-2.05%
MSCI Latam	11.5	–	-1.54%
GBI-EM-GD	6.67%	–	-1.01%
ELMI+	5.38%	–	-0.72%
EM FX spot	–	–	-0.94%
EMBI GD	6.80%	390 bps	0.59%
EMBI GD IG	5.01%	210 bps	0.71%
EMBI GD HY	8.89%	601 bps	0.47%
CEMBI BD	6.33%	350 bps	0.22%
CEMBI BD IG	5.11%	228 bps	0.32%
CEMBI BD Non-IG	8.04%	521 bps	0.08%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.7	–	-1.22%
1-3yr UST	2.74%	–	0.04%
3-5yr UST	2.73%	–	-0.02%
7-10yr UST	2.89%	–	-0.24%
10yr+ UST	3.15%	–	0.03%
10yr+ Germany	0.26%	–	0.03%
10yr+ Japan	0.04%	–	0.32%
US HY	7.31%	437 bps	0.11%
European HY	4.78%	554 bps	0.39%
Barclays Ag	2.13%	-76 bps	-0.32%
VIX Index*	21.63	–	-1.60%
DXY Index*	97.38	–	0.16%
EURUSD	1.1315	–	-0.36%
USDJPY	113.42	–	0.07%
CRY Index*	180.31	–	-3.84%
Brent	60.3	–	0.52%
Gold spot	1239	–	-0.48%

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

Emerging Markets

- **Russia:** Once again Elvira Nabiullina, the world's toughest central banker, defied expectations by hiking the policy rate in Russia from 7.50% to 7.75% (markets had expected her to leave the rate unchanged). Russian inflation is 3.8% yoy and economic fundamentals are extremely solid. The government is stable and strong and policy-making is orthodox. The main challenge facing investors in Russian bonds is the constant threat of US and European sanctions. Sadly, this threat does not appear to be abating anytime soon and may escalate further. This erodes liquidity in Russian assets as investment banks become reluctant to make markets.[1] However, sanctions are unlikely to have any material impact on Russia's ability and willingness to pay. As such, the main effect of sanctions is to rob savers of the opportunity to make lucrative investments in Russian assets with better risk-reward than most assets in developed countries.[2]
- **India:** The political season in India has kicked off in style. The ruling BJP party received a bloody nose in state elections and Urjit Patel, central bank governor, then resigned and was replaced by less confrontational official, Shaktikanta Das. Expectations of a fiscal stimulus program are growing, which could begin to weigh on markets. The silver lining is that the Indian economy is doing very well, currently experiencing a 'goldilocks period' with inflation of just 2.3% yoy and industrial production running at a yoy rate of 8.1% in October (versus 6.0% yoy). The Indian 10-year bond yields 7.4%. Such high real yields compensate investors well for the risks, in our view. Still, from now as election fever grips India, investors would be wise to pay close attention to each data release, each policy change.
- **China:** The latest economic data has been mixed. On the negative side, industrial production slowed to 5.4% yoy in November from 5.9% yoy in October, while retail sales also softened over the same period (8.1% yoy from 8.6% yoy). On the other hand, the jobless rate declined to 4.8% from 4.9% and fixed asset investment picked

[1] *"Morgan Stanley to close equities and FX desks in Moscow"*, FT.com, 14 December 2018.

[2] This critical nuance was sadly lost on the journalist, who recently penned an article that wrongly characterised our negative view of the impact of sanctions on trading as a negative view of the impact of sanctions on the Russian sovereign. We are negative about the impact of sanctions on the ability to trade Russian bonds, but not negative on sovereign risk in Russia. Here is the article in question: https://www.bloombergquint.com/onweb/sanctions-turn-a-big-emerging-market-bull-into-a-russia-bear#gs.1uqoTWc

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Emerging Markets

up to 5.9% yoy in November from 5.7% yoy in October. The pickup in investment offers a glimmer of hope for stronger growth in 2019, especially since total social financing is now also stronger than expected (CNY 1519bn versus CNY 1350bn in November), while NDRC eased guidelines for local currency corporate bond issuance. As we note below, China's economy is likely to begin to respond positively to fiscal stimulus in the first half of 2019 just as developed countries slow.

- Peru: Nearly 75% of Peruvians participated in a referendum on measures to reduce corruption in public life. In line with President Vizcarra's recommendations, Peruvians approved with a margin of 80% three counter-corruption measures and rejected a fourth with 90% (voters rejected the introduction of a bicameral system in the congress). Meanwhile, growth is strong as the monthly GDP proxy showed that real economic activity was up 4.2% yoy in October versus 3.1% yoy expected. The central bank left the policy rate unchanged at 2.75%.

- Sri Lanka: There are signs that the weeks' long political impasse may be easing after Prime Minister Rajapaksa resigned on Friday. Rajapaksa's resignation was followed by the re-appointment of Ranil Wickremesinghe as Prime Mininster. The re-appointment of Wickremesinghe puts President Maithripala Sirisena into an awkward position, having just sacked Wickremesinghe in October. As such, fresh elections cannot be ruled out. The political upheaval in Sri Lanka triggered ratings downgrades due to fears about the government's ability to pay. The new government, even if short-lived, should be able to approve the budget and thereby facilitate payment of the government's debt obligations, which fall due early in January.

- Mexico: The much-anticipated first budget of President Andres Manuel Lopez Obrador (AMLO) was orthodox. The medium-term program envisages a declining debt to GDP ratio, fiscal deficits not exceeding 2% of GDP and primary surpluses of 1% of GDP. All the macroeconomic assumptions are credible, e.g. 1.5%-2.5% real GDP growth, 3.4% inflation and USDMXN at 20. Attention will now shift to passage of the Budget by 31 December 2018 and then AMLO's commitment to remaining within the constraints of the Budget. In economic news, industrial production slowed to 0.1% yoy in October from 2.5% yoy in September.

- Index news: Investment bank JP Morgan published new updated weighting for five Middle-East countries, which are due to be included in the EMBI GD starting on 31 January 2019. Saudi Arabia, Qatar, UAE, Bahrain and Kuwait will be assigned index weights of 3.1%, 2.8%, 2.6%, 2.3% and 0.7%, respectively. The number of countries in the EMBI will rise to 73. The five countries will be phased into the index over 9 months and the index weights of largest incumbent index members will be impacted relatively more in making room for the incoming countries.

Snippets:

- Argentina: Inflation continues to collapse in November, when prices rose 3.2% mom compared to 5.4% mom in October and 6.5% mom in September. President Mauricio Macri's approval rating increased to 39% in December from 32% in November, according to polls conducted by Poliarquia Consultores, a credible pollster.
- Brazil: Retail sales contracted 0.2% mom in October. The central bank left the policy rate unchanged at 6.5%.
- Colombia: S&P Ratings affirmed Colombia's BBB- investment grade rating with stable outlook.
- Ecuador: President Lenin Moreno obtained a USD 900m loan from China.
- Ghana: Inflation declined to 9.3% yoy in November from 9.5% yoy in October.
- Indonesia: The trade deficit widened to USD 2.05bn in November from USD 1.8bn in October. Imports rose sharply, while exports slowed.
- Malaysia: Industrial production expanded at a stronger than expected 4.2% yoy rate in October, up from 2.3% yoy in September.
- Philippines: The Central Bank left the policy rate unchanged at 4.75%. The trade deficit widened to USD 4.21bn in October from USD 3.73bn in September on the back of strong imports.
- Singapore: Retail sales expanded at a 0.1% yoy in October, down from 1.9% yoy in September. The trade surplus was USD 2.5bn in November, down from USD 4.0bn in October.
- South Africa: CPI inflation ticked higher to 5.2% yoy in November from 5.1% yoy in October.
- Thailand: The military government took a firm step towards an election in early 2019 by lifting a ban on public assembly and voter interactions.
- Turkey: The Central Bank of Turkey left the policy rate unchanged at 24%.
- Ukraine: The National Bank of Ukraine left the policy rate unchanged at 18%.

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Global backdrop

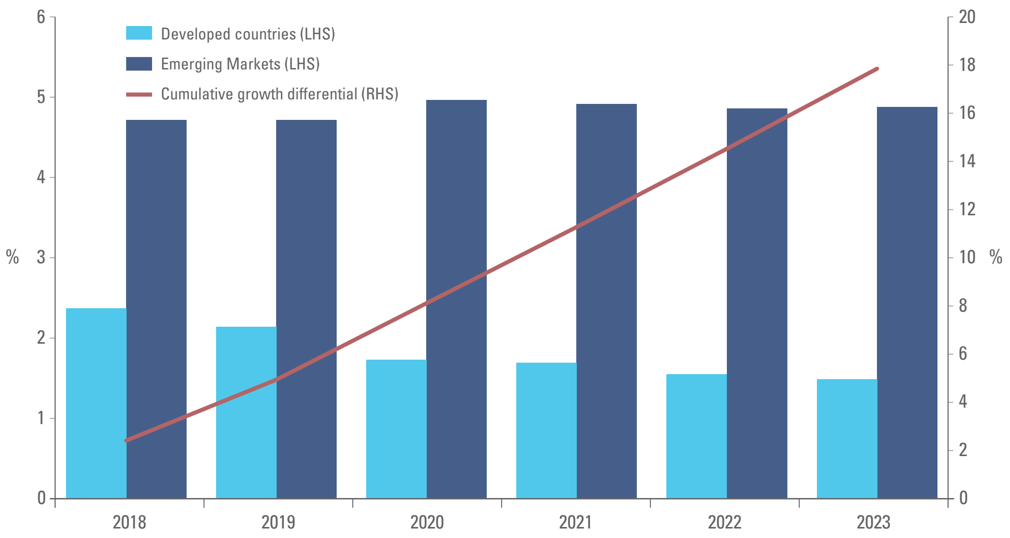
Investors with annual risk budgets have entered full position-squaring mode, triggering the usual seasonal slowdown in trading activity at year-end, aided by worries about slower US growth, Brexit, trade war, French politics and other troubles emanating from developed countries. Investors with time horizons extending beyond the Christmas period should use the seasonal December pullback to pick up paper ahead of 2019, which looks very promising from an EM perspective.

US mid-term elections out of the way, the political focus in the US has shifted to November 2020 with growing recognition of the importance of keeping the US economic expansion going for another two years. In recognition of already weakening data, the US government is already changing its tune on trade. China, whose economic data are also weakening, has naturally embraced the American trade détente with goodwill gestures, including more soybean purchases and a reduction in retaliatory auto tariffs. If peace erupts on the trade front, the main difference between China and US in 2019 could boil down to growth. Whereas China's economy should begin to respond positively to various stimuli in the first half of 2019, the US economy is likely to slow further on fading fiscal stimulus and more hikes from the Fed (the Fed is also likely to hike this week). It may pay off to place chips on Chinese growth versus US growth in 2019, especially given the +20% underperformance of Chinese stocks versus US stocks this year.

In Europe, the ECB formally announced the end of net asset purchases and reduced forecasts for Eurozone growth and inflation, albeit very marginally. Protests caused a large 5-points downdraft in the French PMI as President Macron rewarded 'yellow vest' protesters first by cancelling fuel price hikes and secondly by hiking the minimum wage and granting tax-free overtime and bonuses. Understandably, the protests continue. In the rest of Europe, the news was less alarming. The moderation in PMIs was modest (51.5 from 51.8) and the Italian government proposed a fiscal deficit of 2% of GDP for the 2019 Budget, down from 2.4% of GDP in an earlier draft.

Many of the political and economic problems facing developed countries can be traced back to slower growth. Growth is likely to slow further in the coming years as the gradual normalisation of monetary policies continues. EM looks very different in this respect. EM never got addicted to hyper-easy money and interest rates are already at normal levels. In fact, IMF expects stable real GDP growth just below 5% in EM over the next several years. Viewed against expected slower growth in developed countries, IMF is now forecasting cumulative EM growth to outperform developed market growth by nearly 18% by 2023 (Figure 1).

Fig 1: **EM vs DM growth 2018-2023**



Source: IMF, Ashmore.

The clear and present danger within the developed world currently resides in the UK. On the current trajectory, UK is heading for Hard Brexit by March 2019. Moreover, it may prove challenging to change course. UK Prime Minister Theresa May failed to win meaningful concessions from EU on her Brexit deal, which the UK parliament has already *de facto* rejected. Inability to resolve the Irish border issue could force the UK onto one of two paths, one being Hard Brexit, the other being one or a combination of: (a) a second referendum; (b) suspension or cancellation of the Article 50 process, in order gain time.

Currently, the Hard Brexit path looks more likely due to the intricacies of the political situation in the UK parliament. Last week's confidence vote against May illustrated unequivocally that more than one third of Tory MPs have no confidence in her Brexit deal. If these disaffected Tory MPs vote with Labour and DUP,

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Global backdrop

they command nearly 60% of the votes in the parliament. In other words, they can topple her government. This means that if May makes any move towards a second referendum or suspension of the Brexit process she could fall. The Labour Party, which wants a general election, would not shy away from toppling May.

If, say, in a bid to head off Hard Brexit, May's government falls, the Tories would elect a new leader, who would almost certainly be a hard Brexiteer. He or she would then take the Tories into the general election. Due to time restrictions, a general election would most likely take place after Brexit has already happened. The timing matters greatly for three reasons. First, after Brexit only the Hard Brexit Tories have policies, which are in tune with the 'facts on the ground'. Second, the Hard Brexit Tories would be able to blame the economic fallout from Brexit on time wasting and useless negotiations with the EU conducted by May and her soft Brexiteers. Thirdly, Labour would struggle to present a clear position in a post-Brexit reality due to internal divisions over Europe and Labour's official position of supporting membership of the EU Customs Union. Labour's wishy-washy, out of date, divided position in a post-Brexit reality would fare badly against the stoically resolute message of the Hard Brexit Tories that 'we were right all along, now let us get on with it'.

What about all the talk of letting parliament decide or giving the decision back to the people via a second referendum? Could an alliance of moderates from across the aisles possibly form a majority to head off a Hard Brexit? The problem with this emotionally appealing idea is that it is difficult to see how it comes about. The Conservatives would still be in power (under May or some other leader), so there is no reason why Labour should support such a course of action, which only keeps the Conservatives in power for longer. Besides, Labour would have to change its own policy on a second referendum and Jeremy Corbyn, the Labour leader, is himself an EU sceptic. Supporting a second referendum would also be a risky move for Labour, since there is no guarantee that it would deliver a different result than the June 2016 referendum. In short, at the moment, a cross-party alliance can only be formed against the official policy of Labour. It is not clear such a majority even exists nor that it would command any influence at constituency level, where UK politics remains firmly under the party control.

Faced with these realities, May's current policy is to persevere with her deal and each day brings Hard Brexit closer. May hopes that parliament 'chickens out' as Hard Brexit approaches, but it is quite possible that May blinks before parliament. After all, individual MPs can hide in the crowd of other MPs, while May would shoulder the full blame if things go wrong. May has one final – and radical – option for staying in power, namely to switch sides, i.e. joining the Hard Brexit camp. This will not be easy nor would it be the preferred option for the Hard Brexit camp, because it dilutes their claim of clear blue water between them and the soft Brexiteers. Still, the Hard Brexit Tories cannot unseat May due to the rule of no second intra-party confidence vote within 12 months.

If Brexit becomes a reality Ireland faces a serious problem. Ireland would have to choose between frictionless trade with UK or with the EU. If Ireland prioritises frictionless trade with EU, the border between UK and Ireland hardens, bringing back the old troubles in Northern Ireland. DUP would be happy and would support the Hard Brexit Tory government. If Ireland goes for a hard border with EU there would be wider economic and political ramifications.

In conclusion, Hard Brexit looks like a very serious risk at this point. It is not possible to rule out a Hard Brexit, an economic crisis, a general election and a new hardline Hard Brexit government in the UK over the next twelve months. It is not a certainty, however. It can still be headed off if: (a) EU offers a significant concession to May, which helps her pass her Brexit deal in the UK parliament; (b) Hard Brexiteers shy away an unholy alliance with Labour to topple the May government; or (c) Labour shift its stance on a second referendum.

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Ashmore

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.26%	-7.08%	-14.01%	-10.89%	11.00%	2.37%
MSCI EM Small Cap	-1.88%	-7.40%	-18.65%	-14.35%	5.75%	1.34%
MSCI Frontier	-0.47%	-1.90%	-14.29%	-12.79%	5.72%	1.46%
MSCI Asia	-2.02%	-8.01%	-13.63%	-11.40%	10.28%	4.68%
Shanghai Composite	0.22%	-8.04%	-19.65%	-19.29%	-7.70%	5.75%
Hong Kong Hang Seng	-2.47%	-5.96%	-7.91%	-6.49%	7.88%	2.65%
MSCI EMEA	-1.65%	-4.12%	-15.65%	-9.19%	10.00%	-2.22%
MSCI Latam	-1.80%	-0.62%	-7.25%	-2.63%	14.70%	-1.37%
GBI EM GD	-0.64%	0.15%	-8.01%	-5.85%	5.67%	-1.54%
ELMI+	-0.44%	0.08%	-4.41%	-3.27%	3.44%	-1.12%
EM FX Spot	-0.60%	-1.43%	-9.68%	-8.31%	-1.22%	-7.34%
EMBI GD	1.44%	-1.17%	-4.18%	-3.93%	5.39%	4.88%
EMBI GD IG	1.60%	-0.69%	-2.46%	-2.38%	4.59%	4.32%
EMBI GD HY	1.27%	-1.66%	-6.01%	-5.62%	6.24%	5.36%
CEMBI BD	0.57%	-0.18%	-1.78%	-1.68%	5.23%	4.37%
CEMBI BD IG	0.74%	-0.02%	-1.00%	-1.00%	3.65%	3.86%
CEMBI BD Non-IG	0.35%	-0.41%	-2.72%	-2.47%	7.87%	5.00%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-5.72%	-10.38%	-0.91%	-0.05%	10.98%	10.15%
1-3yr UST	0.27%	0.77%	1.02%	0.99%	0.75%	0.69%
3-5yr UST	0.56%	1.35%	0.43%	0.28%	0.80%	1.20%
7-10yr UST	1.07%	2.07%	-0.73%	-1.14%	0.78%	2.35%
10yr+ UST	3.04%	1.79%	-4.10%	-4.58%	1.38%	5.14%
10yr+ Germany	1.31%	3.24%	6.11%	4.30%	3.76%	7.28%
10yr+ Japan	0.56%	1.72%	1.02%	1.08%	3.50%	4.24%
US HY	-0.03%	-2.47%	0.03%	0.23%	8.49%	4.35%
European HY	-0.35%	-3.57%	-3.53%	-3.31%	3.92%	4.03%
Barclays Ag	0.55%	-0.26%	-2.62%	-2.22%	2.00%	0.72%
VIX Index*	19.70%	78.47%	95.92%	129.62%	14.20%	33.44%
DXY Index*	0.11%	2.36%	5.71%	3.67%	-1.90%	21.63%
CRY Index*	-0.78%	-7.61%	-6.99%	-2.28%	5.63%	-35.51%
EURUSD	-0.04%	-2.49%	-5.75%	-3.96%	4.52%	-17.82%
USDJPY	-0.11%	-0.25%	0.65%	0.78%	-7.46%	10.47%
Brent	2.67%	-27.13%	-9.85%	-4.67%	62.66%	-44.41%
Gold spot	1.31%	3.86%	-4.95%	-1.89%	17.82%	0.61%

*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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