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WEEKLY INVESTOR RESEARCH

Ashmore

All change in India

By Jan Dehn

India voted for change and the ball is now in Narendra Modi's court to deliver. Eastern Europe enjoys 'Poldilocks'. The Ukraine situation receded somewhat from the headlines as Europe and Russia engaged in gas talks. Officials in Colombia, which has one of the strongest lobbies in favour of a cheap currency, began to verbally intervene following strong appreciation recently. Growth was sluggish in Brazil, again. China launched a broad-based financial reform agenda. The IMF wagged its finger at Ghana. Turkey's external balances improved again. And Russian growth was less bad than expected while Venezuela tapped markets for a hefty USD 5bn.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,035	–	1.94%
MSCI EM Small Cap	1,055	–	0.80%
MSCI FM	662	–	-0.43%
GBI EM GD	6.66%	–	0.56%
ELMI+	3.47%	–	0.27%
EMBI GD	5.24%	270 bps	0.48%
EMBI GD IG	4.43%	183 bps	0.61%
EMBI GD HY	7.24%	499 bps	0.22%
CEMBI BD	5.21%	305 bps	0.53%
CEMBI BD HG	4.30%	214 bps	0.53%
CEMBI BD HY	7.03%	487 bps	0.52%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1878	-0.92%
VIX Index	12.44	1.72%
5 year UST	1.55%	-12 bps
10 year UST	2.51%	-15 bps
US HY	5.29%	0.15%
European HY	4.37%	0.06%
EURUSD	1.3708	-0.36%
USDJPY	101.37	-0.74%
Brent	111.41	2.97%
Copper	323.16	0.28%
Gold	1299.95	0.19%

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

Emerging Markets

- India: The BJP won a landslide in the Indian parliamentary election. The party now has an absolute majority and therefore the power to make material structural changes. The BJP will ultimately be judged on its success in eradicating India's growth challenges. These are both structural and cyclical. On the cyclical side, India's fiscal deficits are still too big, which pushes inflation too high, and then puts pressure on the central bank to keep rates too low to maintain growth. This only leads to more inflation, current account problems, and loss of business confidence.

  Without business confidence investment then lags behind, which in turn puts even more pressure on fiscal policy and the central bank, and so it goes on. This cycle can be broken with better fiscal policy. We think Goods and Sales Tax reform is key. On the supply-side, infrastructure investment will be central to raising growth rates. India needs so much infrastructure investment that it is unlikely to fund it all from domestic sources. For this reason, we think the government will open India's USD 800bn domestic bond market to foreign investors and pursue inclusion in the main local currency benchmark indices. In the near-term, however, the focus will be on who Modi will appoint to his economic team, the budget, and news about the order of detailed policy priorities. Meanwhile, India's trade deficit was better than expected following a healthy rise in exports (5.3% yoy) and a fall in imports (-15% yoy).

- Romania, Hungary, Czech Republic, and Poland recorded stronger than expected growth in Q1 as their economies collectively accelerated from 2.8% yoy in Q4 2013 to 3.3% yoy in Q1 2014. At the same time, Poland, Czech Republic, and Hungary recorded lower than expected inflation rates. Czech inflation was just 0.1% yoy in April, half of the yoy rate of March, while Hungarian yoy core inflation dropped to 2.4% from 2.7%. Poland's inflation also fell to 0.3% yoy from 0.7% in March. The combination of low inflation and high growth – already dubbed 'Poldilocks' – has triggered a strong rally in local bond markets. Last week we noted better inflation elsewhere in EM. This week Slovak prices also fell in April for the third consecutive time, while Israeli inflation slowed sharply to 1.0% yoy in April from 1.3% in March. Both inflation and the variation in inflation numbers across the EM universe has collapsed over the past decade and a half. This shows just how institutionalised prudent macroeconomic management has become across the EM universe. Those familiar with EM are aware that this shift in inflation is due to political changes in the aftermath of the Cold War. Due to the substantial fiscal dominance in EM, low inflation is also indicative of better fiscal policies. Going forward, we think we will see an uptick in the variation in inflation across EM countries. As global financial conditions tighten some countries will face slower growth and a temptation to stimulate – a few will give in.

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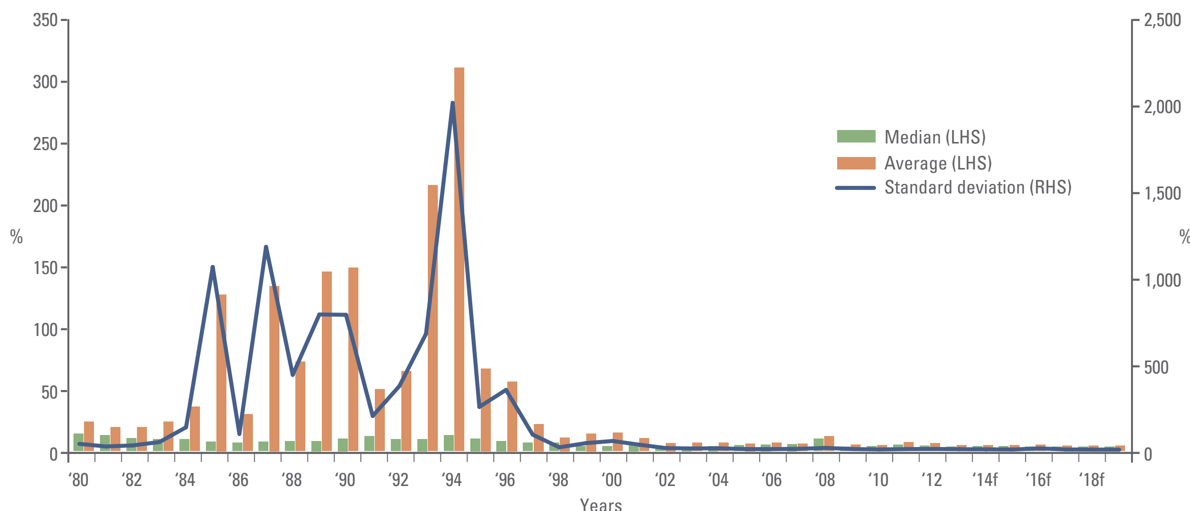
Emerging Markets

Fig 1: **Inflation in EM (% per year, 121 countries)**



Source: IMF World Economic Outlook, April 2014 (forecasts are the IMF's forecasts).

- **Ukraine:** In Ukraine, the Donetsk and Luhansk regions held referenda in favour of independence, but the referenda were highly dubious and did not receive very strong endorsement from Russia. Instead, the focus has shifted firmly to the 25 May election where a poll showed front runner Petro Poroshenko, a business man and long-term survivor of Ukrainian politics, leading with 47% of voting intentions. Meanwhile, the West and Russia are now deeply engaged in negotiating a new agreement on gas supplies. Some of Russia's gas supplies from Russia to Western Europe pass through Ukraine. We think Europe will ultimately seek to diversify its energy dependence away from Russia, but in the near-term there are no real alternatives. Russia will also pursue other markets for its gas, mainly in Asia. We note in passing that the German foreign minister, Frank-Walter Steinmeier, last week launched an initiative to bridge the gap between the interim government in Kiev and the pro-Russia separatists, while Ukraine issued a 5 year bond with a US credit guarantee (another indication of the very strong political support for Kiev from the West).

- **Colombia:** Colombia's government returned to verbal intervention in a bid to discourage excessive appreciation of the currency. According to Finance Minister, Mauricio Cardenas, the Treasury will buy Dollars as necessary in addition to central bank intervention. In the past Treasury intervention has been relatively small (USD 1.2bn in 2012 and USD 1.1bn in 2013). The financing plan for 2014 released in December indicates that the government would need to buy USD 763m this year. Any plan to buy more than that in the fx market would imply additional domestic financing requirements (TES issuance) to soak up the liquidity created to buy Dollars. We think investors should not be worried about capital controls. Instead, further currency strength could prompt more fx intervention, then agreements with Colombian petroleum giant, Ecopetrol, to delay inflows, then possibly pension reform to relax the foreign investment limits. Plans to further reduce or eliminate the current 14% tax on local TES could also be further delayed. Both retail sales and manufacturing output rose strongly in March. Colombia is benefitting from strong growth due to deep reforms undertaken in the last few years.

- **Brazil:** Growth continues to be very sluggish in Brazil, another country in need of some supply-side attention. The monthly real GDP indicator for March declined slightly, which means that the economy grew about 1.5% in the first couple of months of 2014. The current government inherited a very strong economy from its predecessors, but business confidence quickly declined once the government took economic policy away into the realm of heterodoxy. The government has since harvested an increasingly bitter economic and political crop, although we do not think investors should worry. After all, Brazil has primary surplus, sustainable debt, very high reserves, and a strong commitment to low inflation. Even so, the challenges are clear: Brazil needs to restore (a) business confidence and (b) resurrect supply-side reforms to raise the country's trend growth rate. The first of these could be restored with a change in the economic team, but the latter would require a deeper shift in the government (and possibly the population's) perception of the role of the state in Brazilian society. In our view this is unlikely to happen quickly.

- **China:** China this week launched a broad range of reforms of the financial sector, covering all markets including bonds, stocks, futures, cross-border flows, and market making. The reform framework is part of a shift from export to domestic demand led growth, which will also shift the main instrument of macroeconomic control away from the exchange rate towards bond markets. Hence, the need to have an efficient financial market. Meanwhile, China continues to experience marginally weaker than expected data not, we think, due to

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Emerging Markets

past mistakes, but as a consequence of its preparations for the world of tomorrow in which it needs to boost domestic consumption. Fixed asset investment rates came at 17.3% versus 17.7% expected, while retail sales and industrial production also missed estimates marginally (11.9% versus 12.2% expected, and 8.7% yoy versus 8.9%yoy expected, respectively).

- Ghana: The IMF cut its sharp message into convenient bite-sized chunks to ease digestion when it briefed markets about what Ghana needs to do in order to get its house in order. It is a bitter pill for Ghanaian policymakers. Following the conclusion of its recent mission, the IMF called for additional short-term measures to be taken, including a lower wage bill, restructuring of statutory commitments and further revenue mobilisation. Ghana has the most violent political business cycle in the world, and the amplitude has steadily increased after the country discovered oil.

- Turkey: Turkey's current account deficit continued to narrow in March. The deficit was USD 3.2bn, almost half of the deficit in the same month in 2013, underlining the fact that Turkey's problem last year was a standard cyclical adjustment challenge, not the structural problem assumed by the Fragile Five chorus.

The presidents of Rwanda, Kenya, and Uganda and Chinese Premier, Li Keqiang, signed an agreement to start the first phase of the Northern Corridor railway, which links Mombasa with Nairobi and with connections to South Sudan, Rwanda, Burundi, and Uganda. Construction may begin as early as October.

In other developments:

- Malaya: Malaysian growth surprised to the upside in Q1 at 6.2% yoy versus 5.7% expected. The current account also surprised positively. The surplus for Q1 was 7.7% of GDP compared to an expectation of 6.5% and grew from 5.6% in Q4 2013.

- Bolivia: Bolivia's sovereign debt rating was increased from BB- to BB by Standard & Poor's.

- Romania: Romania's sovereign debt rating was increased to investment grade on strong economic performance and fiscal discipline.

- Kenya and Tanzania: Officials in Kenya and Tanzania both indicated their intentions to issue sovereign bonds.

- Russia: Russia's Q1 growth rate proved more resilient than expected. Growth in Q1 2014 came at 0.9%, down from 2.0% in Q4 2013.

- Venezuela: Venezuela issued USD 5bn of external debt with repayment in 2022, 2023, and 2024.

Global backdrop

US data was very mixed and in several instances outright contradictory. Retail sales, housing sentiment, consumer confidence, and industrial production softened, but housing starts and permits as well as manufacturing surveys came out strong. Initial claims for unemployment also declined. The US treasury market rallied sharply, taking the 10 year yield to 2.51% from 2.62% as US Q1 growth was revised even lower (to -0.9%) on the back of disappointing factory orders data. Meanwhile, a second consecutive increase in inflation made little impression (core inflation is still running at a low 1.8% yoy).

Bundesbank President, Jens Weidmann, said that the Bundesbank would support a rate cut at the ECB if needed. The announcement gave some relief for the EUR, which has faced relentless appreciation pressure (and therefore deflationary impulses into the European economy – see our discussion about Europe's yearning for inflation in last week's research). EURUSD moved from 1.3930 to 1.3720. We think any moves by the ECB in June are likely to be very marginal; we think the ECB is likely to keep its powder dry for the future, when appreciation pressures in Europe are likely to increase due to the Dollar's eventual devaluation.

Japan's growth rate surprised to the upside in Q1 at 5.9% versus 4.2% expected. We think much of this 'beat' was due to front-running of consumption ahead of a material rise in corporate taxes.

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.1%	3.6%	1.3%	-0.4%	10.8%
MSCI EM Small Cap	1.5%	5.0%	-1.2%	-0.9%	13.3%
MSCI FM	0.5%	15.0%	25.6%	9.9%	12.0%
S&P 500	-0.15%	2.40%	16.17%	14.67%	18.76%
GBI EM GD	2.00%	4.86%	-6.82%	1.44%	8.15%
ELMI+	1.02%	1.78%	-0.82%	-0.77%	3.28%
EMBI GD	1.82%	6.93%	1.26%	7.26%	10.61%
EMBI GD IG	2.04%	7.13%	-0.27%	6.01%	8.55%
EMBI GD HY	1.39%	6.57%	4.25%	9.48%	13.54%
5 year UST	0.67%	2.07%	-0.93%	2.68%	3.31%
7 year UST	0.92%	3.94%	-2.05%	4.09%	4.50%
10 year UST	1.24%	6.77%	-1.62%	6.22%	5.15%
CEMBI BD	1.18%	4.82%	2.07%	5.85%	10.43%
CEMBI BD HG	1.19%	5.14%	2.19%	6.23%	9.23%
CEMBI BD HY	1.16%	4.14%	1.82%	5.43%	14.45%
US HY	0.55%	4.52%	7.22%	9.53%	15.97%
European HY	0.64%	5.10%	11.73%	12.99%	19.11%
Barclays Ag	0.51%	4.09%	4.39%	2.55%	4.82%

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