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Ashmore

Signs of a modest cyclical upswing in EM

The past week produced solid evidence that a modest cyclical upswing is taking root in Emerging Markets. Q2 GDP growth rose in two thirds of the countries that released fresh macro data in the past week. However, country stories continue to play an important part in the broader picture. The non-Emerging Markets economic backdrop also brightened, but all eyes remain on the US treasury market.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	950		-0.79%
MSCI FM	561		0.30%
GBI-GD	6.67%		-2.05%
ELMI+	4.24%		-0.59%
EMBI GD	5.90%	303 bps	-1.07%
EMBI GD IG	5.03%	214 bps	-1.40%
EMBI GD HY	8.96%	631 bps	-0.37%
CEMBI BD	5.74%	335 bps	-0.51%
CEMBI BD HG	4.89%	248 bps	-0.55%
CEMBI BD HY	7.61%	524 bps	-0.23%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,656	-1.92%
VIX Index	14.37	12.18%
5 year UST	1.59%	20 bps
10 year UST	2.85%	23 bps
10 year Bund	1.90%	20 bps
EURUSD	1.3319	0.14%
USDJPY	97.72	0.84%
Brent	$109	0.00%
Copper	$340	1.21%
Gold	$1373	2.53%

Emerging Markets

The trough in the cycle in Emerging Markets has been particularly marked in the first half of this year, but fresh GDP data released over the past week suggest that a modest economic re-acceleration is now in swing in several countries. Eleven Emerging Markets countries released GDP figures for Q2 this week and on average growth rates increased from 2.15% yoy in Q1 to 3.2% yoy (growth accelerated in Czech Republic, Hungary, Poland, Slovakia, Singapore, Kazakhstan, Mongolia, and Hong Kong). Romania and Bulgaria and Peru saw their growth rates moderate an average of 0.5% relative to Q1, though in all three cases growth was positive. This data from Eastern Europe underlines that regional aggregation is unwise, let alone aggregation across the entire Emerging Markets universe – country differences are material.

We expect the upturn in Emerging Markets to gradually become more pronounced and widespread as the year wears on, albeit hand in hand with greater credit differentiation. Credit differentiation will gain importance going forward, because the global environment is changing and many Emerging Markets have reached the stage where they have to address bottlenecks that constrain their growth rates.[1]

The market's expectation of tighter global financial conditions is already leading to important differences in market and economic performance across Emerging Markets. Our pick of the most important country stories of the past week is the following:

1. **In Mexico, President Pena Nieto formally presented his PRI party's proposal for energy reform to parliament. PRI's proposal involves constitutional change to allow the oil and electricity sectors to be opened to private investment.** PRI's proposal is broadly similar to the opposition PAN party's proposal. We expect eventual passage of a joint PAN-PRI sponsored bill in what is likely to be one of the most significant economic reforms in Mexico for decades.
2. **A state of Emergency was declared in Egypt as the tensions between the government and supporters of ex-President Morsi escalated into serious violence.** Unlike the occasional outbreak of political unrest in other Emerging Market countries – and indeed in developed countries – the domestic political situation in Egypt does not merely reflect domestic interests. As a result, Egypt's crisis may prove far more entrenched and difficult to resolve than typical political upheavals.
3. **The Reserve Bank of India this week launched a number of measures to discourage capital flight by residents, including increases in reserve requirements for residents holding foreign currency denominated assets.** We believe these measures only to have a temporary effect, which in isolation will not prevent the need for more fundamental macroeconomic adjustment at a later stage. One possibility is that deeper adjustments take place after the arrival of Raghuram Rajan, a former IMF chief economist, at the helm at the RBI in a few weeks' time. The next window would be after next year's election.
4. **Indonesia is also facing short-term pressures on its currency.** In response, the central bank this week tightened reserve requirements. Reserves have declined to USD93bn while USDIDR has traded to 10350, the highest rate since 2009. India and Brazil and to a lesser extent Indonesia need to boost the supply-sides of their economies in order to preserve domestic and external equilibria, though longer-term structural fundamentals remain solid. As such, their situation is almost the reverse of that facing most developed economies (which desire greater current demand, but face major structural deleveraging challenges over the longer term).

[1] See Jan Dehn, *"Convergence, global imbalances, and the role of infrastructure in EM"*, The Emerging View, June 2013.

Continued overleaf

Global backdrop

Market sentiment was driven by US treasury volatility. The US treasury market responded strongly to the marginally better US data, pushing the 10yr yield to 2.82%. Having thus broken the June high of 2.74% the next material support level is now around the 3.0% level.

The initial reaction to surprise moves in the US treasury market are predictable. Positions in stock markets and in Emerging Markets are typically reduced. But once the initial panic subsides, attention turns to which countries are actually at risk. We have reviewed data on foreign holdings of local currency bonds in Emerging Markets and in the US treasury market. The data shows that foreigners in June held a total of USD610bn of Emerging Markets local currency government bonds. This is equivalent to 9% of the total universe of Emerging Markets local currency government bonds. Thus, if, in an irrational panic, foreigners sold all their positions (extremely unlikely) there would certainly be a temporary dislocation in the market, but Emerging Markets Governments would be able to continue to finance normally, because 91% of their funding sources are domestic (and hence intact).

By contrast, the latest data from the US treasury shows 51% of US treasury debt (USD5.6bn) is currently held by foreigners. In fact, the US treasury market is extremely sensitive to foreign selling as TIC data for June released this week showed. The data revealed that June's violent sell-off in the US treasury market was caused by the heaviest selling of long-dated treasury securities by foreigners since 2007. Of course, the risk is not confined to the selling of bonds. In the event of a major reduction in foreign holdings of Emerging Market local bonds Emerging Market central banks sell reserves to stabilise their currencies as foreign investors unload. Emerging Market central banks control 80% of the world's FX reserves, or some $8.7trn, many of which are invested in US treasuries. Their selling would result in additional pressure on the US treasuries, which are increasingly owned by central banks.

A rise in rates in developed economies would ultimately be far more dangerous than a spike in Emerging Market government bond yields. Higher real rates, even for a relatively brief period, would pose a major threat to the recovery in developed economies. The US stock market responded strongly this week to higher yields, aware that the economy cannot handle higher real rates. The problem that dare not speak its name is of course debt. US total debt is 405% of GDP.

And herein lays the main challenge facing the Fed as it prepares to phase out Quantitative Easing ('QE') starting next month: How will the Fed control long-dated interest rates? QE is certainly not fit for purpose (because it addicts the stock market to QE sugar highs), but without QE the belly and long end of the curve can rise sharply, potentially killing off the recovery. One way to control the long end could be to engage in further so-called 'Twist' operations, where the Fed swaps its treasury holdings into longer maturities. However, the Fed is already heavily positioned in long-dated securities. Some 54% of the Fed's holdings are invested in treasuries and mortgage backed securities with maturities ten years or longer and 82% of securities have maturities greater than five years. Bear steepening can therefore inflict major quasi-fiscal losses onto the Fed.

We think the long end of the US treasury market is fundamentally vulnerable for another important reason. The Fed's (positive) medium term growth projections and its (dovish) Fed funds rate targets are completely out of line. This implies negative real rates, which makes sense because the US debt stock ultimately has to be reduced in size before rates can be raised materially. But since a reduction in the debt stock can almost certainly only happen through a combination of financial repression, inflation, and currency weakness the term structure of the US treasury curve has to be much steeper, in our view.

The task of dealing with the term structure of interest rates will of course land on the desk of the next Fed Chairperson. A growing focus in the market is whether Janet Yellen or Larry Summers will take over as the next Fed Chairperson. Our view is that names matter less than policies: the next Fed Chairperson will have to be a dove. Abstracting from the fireworks in the US treasury market, the global economic backdrop improved over the past week. First, Europe moved out of recession. German growth rose from -0.3% yoy in Q1 to 0.5% yoy in Q2 and French GDP growth rose from -0.5% yoy to +0.3% yoy. However, we think the return to positive growth in Europe is unlikely to give way to a strong, sustained recovery: Europe will struggle for years with excessive debt, structural reforms, and insolvent banks.

Second, retail sales and claims for unemployment both improved in the United States, though industrial production, capacity utilisation, Philly Fed Manufacturing, Empire Manufacturing, producer prices and mortgage applications softened. The US is currently tracking an unexciting 2% real GDP growth in Q3, which also happens to be the average real GDP growth rate over the period from 2010 to today.

Japan provided the fly in the ointment. The big question in Japan is whether the government will do anything to address the country's deep fiscal and structural problems. The handling of an upcoming hike in sales taxes will be a good indicator, in our view, bearing in mind that past tax hikes have snuffed out recoveries in Japan. Over the past week both machinery orders and Japanese Q2 GDP growth disappointed (2.6% qoq versus 3.6% qoq expected).

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