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WEEKLY INVESTOR RESEARCH

Ashmore

Another USD 535bn of potential for EM stock markets!

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Following on from last year's declaration of intent, the Saudi capital markets regulator has now formally announced that the USD 535bn Saudi Arabian stock market will open its doors to qualified foreign institutions in June. Saudi Arabia's stock market is larger than the stock markets in Mexico, Indonesia, Malaysia and Russia. Technicals are strong and valuations are likely to re-rate higher over several stages, particularly when the market is included in the main benchmark indices. Fundamentally, the market offers attractive exposure to petro-chemicals and consumer stocks with the latter strongly supported by counter-cyclical policies recently announced by the government. We also see further developments in China, encouraging signs of greater Indian bond market access, Russian economic resilience and continued pressure on the Turkish lira.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,034	–	-0.69%
MSCI EM Small Cap	1,097	–	-0.82%
MSCI FM	602	–	0.61%
GBI EM GD	6.32%	–	0.66%
EM FX spot	–	–	0.86%
ELMI+	4.31%	–	0.95%
EMBI GD	5.40%	352 bps	-0.14%
EMBI GD IG	4.13%	220 bps	-0.11%
EMBI GD HY	7.70%	596 bps	-0.18%
CEMBI BD	5.19%	352 bps	0.32%
CEMBI BD HG	4.07%	239 bps	0.32%
CEMBI BD HY	7.39%	575 bps	0.31%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2081	-0.53%
VIX Index	13.89	-0.36%
5 year UST	1.32%	-5 bps
7 year UST	1.64%	-6 bps
10 year UST	1.87%	-5 bps
US HY	6.41%	0.20%
European HY	4.49%	-0.34%
EURUSD	1.0735	1.43%
USDJPY	119.08	-0.97%
Brent	62.70	4.77%
Copper	274.55	2.65%
Gold	1199.13	-0.07%

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

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- **Saudi Arabia:** The capital markets regulator announced on 16 April that Saudi Arabia's USD 535bn stock market will be opened to qualified foreign institutions on 15 June 2015. Final regulations will be published on 4 May and enacted on 1 June. Draft regulations were released for consultation in August 2014; they suggest a 10% cap on aggregate foreign ownership and limits access to investors with at least USD 5bn in assets under management and a minimum of five years of investment experience.

Saudi Arabia is a very large, liquid market. It will potentially be the seventh largest Emerging Markets (EM) equity market by market capitalisation, which places it just behind South Africa (USD 543bn), but ahead of Russia, Malaysia, Mexico and Indonesia. The Saudi Tadawul Exchange trades on average USD 2.4bn per day across 162 listed companies and offers a rich selection of opportunities ranging from banks to consumer-driven businesses.

The opening of the Saudi market will widen the foreign investor base, which is currently less than 1% of total holdings. Given the size and depth of the market, we expect Saudi Arabia to be included in the main EM equity benchmark indices by mid-2017, though this requires the authorities to further lift restrictions on access to the market. Should this happen, billions of Dollars will flow into Saudi Arabia over the next few years, in our view. Judging by other precedents in the region, such as Morocco, Egypt, UAE and Qatar, Saudi Arabia's market is likely to re-rate when it becomes included in EM indices. Indeed, we see analogies to the opening of the Indian market for foreign equity investors and the on-going opening of the onshore Chinese stock markets.

Saudi Arabia's decision to open its markets now is highly intelligent – global financial conditions are bound to become tighter in the coming years and the winners among EM countries will be those that are able to maintain or increase their share of a shrinking global 'financial pie'.

From a fundamental perspective, the opportunity in Saudi Arabia is exciting. Contrary to popular perceptions, Saudi Arabia's stock market is not just about oil. In fact, not a single oil company is listed on the Tadawul Exchange. Petro-chemical businesses have some correlation with oil, but they are exceptionally profitable given their access to low feedstock costs and offer less volatile earnings streams than other chemical businesses in other markets. Banks are also attractive with the country's peg to the USD making them beneficiaries of rising rates. Large parts of the stock market consist of consumer businesses, whose earnings are determined by domestic conditions. The new Saudi King's affirmation of the country's commitment to domestic spending and

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development and job creation creates favourable tailwinds for consumer-focused sectors, aided by the announcement recently of two extra months of salaries and bonuses. We see opportunities for consumer stocks similar to those found in some African or Asian markets, but at much more attractive multiples, because of Saudi Arabia's very favourable demographics. The population distribution has a very low average age, which points to sustained consumer demand for years to come.

- China: Four important developments are worth highlighting. First, the economy expanded at a 7% yoy rate in Q1 2015. This was in line with expectations, but other higher frequency indicators pointed to softer economic momentum, including tax revenues, retail sales and industrial production as well as money and credit indicators. Inflation is also continuing to decline with the GDP deflator hitting a six-year low. Second, in recognition of the weaker data the PBOC cut reserve requirements by 100bps for China's banks plus introduced additional easing measures for banks lending to the SME and the agricultural sectors. So far, the PBOC has been reluctant to cut policy rates. Resisting rate cuts even as inflation declines is how China is gradually liberalising interest rates. The resulting rise in real rates is weighing on growth. Our expectation is that the PBOC will eventually feel that inflation has fallen enough to warrant some cuts in the policy rate. Thirdly, on Friday China's securities regulator warned markets against irrational exuberance by tightening rules on stock lending. Such measures are reassuring because they show that China's regulators are keen to avoid the kind of asset price bubbles that have literally come to underpin 'recoveries' in Western economies. Finally, China's foreign exchange reserves declined by USD 90bn in March to USD 3.73trn. The decline was almost entirely due to changes in the value of the EUR and JPY during March.

- India: Alpana Killawala, spokesperson for the Reserve Bank of India (RBI), told reporters that the RBI has approached both Euroclear and Clearstream to propose new models for settling trades in Indian government bonds. She also made clear that the proposals are under discussion and that no final decision has been taken. India is currently foregoing the opportunity to attract foreign capital to both its government bond markets and more importantly to its corporate issuers, partly due to a slow and cumbersome trade settlement system (the other reason being quotas). India's closed bond market sits oddly alongside a largely open equity market and flies in the face of the Modi administration's message that India is open for business. We believe the RBI favours opening the bond market, but that it is rightly concerned that the Indian economy not be destabilised. We think fears are overstated for two reasons: First, flows into India are unlikely ever to reach a size that could destabilise India's enormous onshore bond market. After all, the GBI EM GD, a widely used benchmark index for EM local currency debt, would limit India's index weight to 10%, which is a mere fraction of the onshore bond market. Second, institutional investors now make up more than 85% of total foreign holdings in EM local markets. Their investments tend to be stickier than those of hedge funds, investment bank proprietary desks and retail investors, which simply no longer dominate EM's local markets. We believe that the RBI's comments show that the government is actively looking at greater capital account liberalisation, albeit cautiously and slowly. In other news, wholesale prices were 2.3% lower in March than at the same time last year. The softening impulse from producer prices will have a benign impact on CPI inflation and justify further cuts in rates by the RBI, in our view. India is experiencing a 'Goldilocks' moment with strong growth and declining inflation rates.

- Russia: The supply-side of the Russian economy is proving far more resilient than many expected in the face of lower oil prices and sanctions from Europe and the US. Industrial production rose in March by a modest 0.4%, but this was still far stronger than the consensus expectation of a decline. Meanwhile, demand side indicators are going through the necessary adjustment with investment, real wages and retail sales softening materially in March. This is exactly what needs to happen in order for the Russian economy to adjust to the external shock of lower oil prices. In that context, the fact that weekly inflation is now showing clear signs of slowing is very positive, because it allows the central bank to enact material rate cuts over the course of 2015. Another positive sign is that retail deposits are now recovering, which suggests that Russians believe the RUB is now a good place to park savings again.

- Turkey: The Lira (TRY) came under considerable pressure in the past week. One reason is technical; long TRYRUB was a popular trade in H2 2014 as oil prices declined and Turkey being a large oil importer. As RUB has regained its poise, these positions are now being unwound. A higher oil price – Brent pushed through the USD 60 per barrel threshold last week as inventories finally began to come down – has also contributed to the rout in TRY. But there is also a home-grown reason: Turkey is heading for a general election on 7 June 2015 in which President Erdogan hopes to achieve a majority for the AK Party. In the past he has not shied away from reprimanding the central bank and the President appears to believe that higher interest rates cause inflation. The central bank, under the leadership of Erdem Basci, has attempted to accommodate the President's aversion to interest rate increases by targeting rate volatility through a series of complicated policy instruments. However, this policy is at best partially effective. As the election approaches, there will be those that see this as an opportunity to short TRY on the grounds that the central bank will not be able to respond. So far, this has proven correct. A similar dynamic occurred ahead of the local election in March 2014, where a sharp fall in TRY ultimately forced the central bank to hike rates by 400bps.

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- **Moldova:** Farmers took to the streets to protest their loss of access to the Russian market for fruit and vegetables. Moldova was banned from exporting these commodities to Russia as part of Russia's response to European sanctions. Moldova has signed an Association and Trade Agreement with Europe. Moldova is unable to redirect its agricultural products to Europe, because of non-tariff barriers designed to protect European farmers from competition. The situation in Moldova is worth monitoring: the country is split, with a pro-Russian enclave (Transnistria) divided from the rest of the country. Moldova also sits at the Western end of Ukraine's Black Sea coastline and at the other end lies Crimea.

Snippets:

- **Singapore:** Singapore's non-oil exports – a frequently cited gauge of high-end manufacturing trading activity in East Asia as a whole – rose a huge 18.5% yoy in March. Part of the rise was due to catch up from a Chinese New Year affected low reading in February, but even taking into account this effect the rise was strong and broad-based across all categories.
- **Pakistan:** The government has raised more than USD 1bn by selling its stake in a local bank, earning the country a positive comment from ratings agency Moody's as well as boosting reserves. China has indicated that Pakistan could become a major destination for Chinese investment in the coming years.
- **Poland:** Inflation rose a mere 0.2% in March, which means that prices are 1.5% lower than at the same time last year. The expectation in the market was that prices would only be 1.3% lower yoy.
- **South Africa:** Retail sales bounced back strongly in February, rising 1.9% mom, which means that sales are 4.2% higher than at the same time a year ago. There were also upward revisions to previous months. The likely reason for the pick-up in spending is that energy prices have fallen, freeing up disposable income for the weekly shopping spree. The vast majority of EM countries are oil importers.
- **Belarus:** Moody's downgraded Belarus's sovereign credit rating to Caa1 from B3.

Global backdrop

Global markets have become more unsettled as often happens when a big consensus trade – this time the USD rally – runs out of steam. Suddenly investors have to think for themselves without the lazy comfort of just doing what everyone else is doing. US data has continued to disappoint at the margin as the American economy is going through what is most likely a temporary cyclical slowdown set against an unchanged underlying trend of lacklustre real GDP growth of about 2%. Most of the data released in the past week disappointed, including retail sales, Philadelphia's Federal Reserve Bank, Empire manufacturing, industrial production, claims for unemployment benefit, housing starts and higher inventories (which does not bode so well for Q2 growth). Consumer confidence and core CPI were stronger than expected, however, which generated some market jitters towards the end of the week. The weakness of the US economy is coinciding with a cyclical pickup in Europe, which was reaffirmed by firm Euro area industrial production figures. Despite the better economic data, the market got spooked towards the end of the week by the tragedy that is Greece. Greece obviously has a completely unsustainable debt burden, but this fact seems to be the only thing that politicians are reluctant to face up to. Instead, they are engaging in a futile tug-of-war over the details of an economic adjustment program that is doomed to fail precisely because of the debt overhang. One yearns for Europe's leaders to show some courage – like the engineer in the Hollywood movie 'Titanic', who points to the blueprints for the doomed ship and explains plainly that it is designed to only withstand a breach of four compartments, not five. So, with five compartments breached, the ship's demise is a mathematical certainty. Greece needs to default again and only when its debt burden is back to a sustainable level can a genuine recovery take place. Facing up to this reality in Greece would enable Europe to quickly identify a sustainable solution and then to move on to better times. Sadly this is very unlikely in our view.

The ECB knows this, of course. Hence, in its regular scheduled press conference, ECB President Mario Draghi confirmed that ECB's QE program is a marathon, not a sprint, and that the race just begun. In practice this means that Central banks across the Eurozone will be buying EUR 60bn of bonds a month, which will drive bond yields for European sovereigns to zero and below. The ECB insists that it sees no sign of a bubble in European fixed income. Not only has QE created a huge bubble in developed market fixed income it is also slowly bringing about the destruction of pension savings and other large pools of capital, such as insurance company funds. Not only are future cash streams adversely affected by ever lower coupons, but lower term-yields also increase the present value of future liabilities. Regulated to the point where they have few means of diversifying into far safer and better paying alternatives in EM, these pools of capital increasingly have no alternative but to go down the credit spectrum, accept lower liquidity or – in particular – to extend duration. Not ideal at the end of a 30 year rally in fixed income and just ahead of Fed hikes. Bunt Ghosh, a pioneer of the EM business at a major investment bank, once said, "The big mystery is not why EM asset prices are volatile; the bigger mystery is why there is so little volatility in developed market asset prices". As developed economies

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move ever closer to robbing future generations of their savings by policies such as QE and financial repression, Bunt's observation only increases in relevance.

EM asset prices have benefitted from most of these developments, particularly the perception that the Fed is likely to delay its first rate hike and that the USD rally has taken a breather. Can the USD resume its rally, given its 30% gain versus EM currencies over the last three years is surely inflicting pain on America's low productivity economy? Probably. As yields are pushed ever lower more and more money will move into currency markets, where yields are also zero, but where at least liquidity is far greater and default risk non-existent. Currency trading has a far less immediate relationship with fundamentals and tends to move as much with technicals as anything else. Recall that since 2011 currency markets have inflicted huge macroeconomic volatility upon the world through two bouts of EUR weakness, two bouts of JPY weakness and two bouts of EM FX weakness. The key question at this juncture is therefore this: what will be the next big unifying 'herd trade' to engulf the global FX markets?

Market data	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	7.10%	9.48%	6.14%	3.62%	3.02%
MSCI EM Small Cap	7.94%	11.83%	7.47%	7.04%	3.92%
MSCI FM	3.31%	-0.36%	-5.86%	11.92%	5.05%
S&P 500	0.71%	1.67%	13.88%	16.84%	14.15%
GBI EM GD	1.94%	-2.10%	-10.15%	-3.21%	0.75%
ELMI+	2.15%	-0.31%	-8.04%	-2.50%	-0.88%
EM spot FX	1.49%	-4.93%	-17.41%	NA	NA
EMBI GD	1.58%	3.62%	6.28%	5.64%	7.14%
EMBI GD IG	0.81%	3.43%	8.46%	4.85%	6.61%
EMBI GD HY	2.72%	3.71%	2.19%	6.91%	7.94%
5 year UST	0.41%	2.29%	4.55%	1.60%	3.71%
7 year UST	0.58%	2.98%	7.40%	2.45%	5.53%
10 year UST	0.70%	3.53%	10.32%	4.18%	7.40%
CEMBI BD	1.57%	3.96%	5.51%	5.82%	6.28%
CEMBI BD HG	1.02%	3.42%	6.79%	5.82%	6.49%
CEMBI BD HY	2.61%	4.96%	2.72%	6.02%	5.96%
US HY	1.16%	3.61%	2.14%	7.88%	8.82%
European HY	0.45%	3.88%	5.43%	12.87%	11.09%
Barclays Agg	0.78%	-1.15%	-3.62%	-0.06%	2.33%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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