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WEEKLY INVESTOR RESEARCH

Ashmore

Big elections coming up in Brazil and Ukraine

By Jan Dehn

Elections in Brazil and Ukraine are now less than a week away. The stark differences in the quality of policy-making across Emerging Markets (EM) is on sharp display as India exploits a fall in global oil prices to eradicate price controls, while Turkey embarks on second-stage heterodoxy with its 'food committee'. Falling inflation in China allows the authorities to 'liberalise' interest rates without actually raising nominal rates. More talking heads join the cacophony of default predictors in Venezuela – the country's economic conditions are challenging, but so would be the default option and we expect Venezuela to pay. Jokowi embarks upon his first day as president of Indonesia. Turning to the global backdrop, any fears of imminent rate hikes have receded somewhat, not that they were a material threat to EM in the first place.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	987	–	-0.44%
MSCI EM Small Cap	1,028	–	-0.54%
MSCI FM	666	–	-2.14%
GBI EM GD	6.50%	–	0.08%
ELMI+	3.23%	–	-0.09%
EMBI GD	5.31%	308 bps	0.36%
EMBI GD IG	4.33%	206 bps	0.85%
EMBI GD HY	7.58%	555 bps	-0.55%
CEMBI BD	5.22%	327 bps	0.04%
CEMBI BD HG	4.29%	231 bps	0.19%
CEMBI BD HY	7.30%	539 bps	-0.28%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1887	0.66%
VIX Index	21.99	3.53%
5 year UST	1.41%	-12 bps
10 year UST	2.19%	-9 bps
US HY	6.48%	0.27%
European HY	5.49%	-0.80%
EURUSD	1.2760	0.74%
USDJPY	107.08	-0.35%
Brent	84.85	-3.47%
Copper	307.39	-0.98%
Gold	1241.14	1.02%

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

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- Brazil: Polls seeking to predict the outcome of the second round of the Brazilian election on 26 October are fluctuating wildly. One poll, by Sensus, puts opposition candidate Aecio Neves ahead of President Dilma Rousseff by 13%. But a Datafolha poll placed Neves ahead by just 2%. We think Brazil will have a fiscal adjustment and major changes in the economic team regardless of who wins, though the market reaction will be stronger if Neves wins. We doubt that either candidate would tackle deeper reforms in Brazil, but the low hanging fruit – simply restoring policy credibility after the disastrous management under Guido Mantega – will nonetheless have a profoundly positive effect on the economy.
- Ukraine: The conflict with Russia is de-escalating slowly, in little bite-sized chunks. First, few people ever talk about Crimea anymore. Realistically, Crimea remains an unrecognised federal subject of Russia from now on, and it seems that everyone has resigned to simply ignore the question of Crimea. By raising it, Western powers merely highlight their own impotence. Second, Ukraine and Russia are inching towards an agreement on Russian gas supplies to Ukraine this winter, though a final deal has yet to be inked. Thirdly, there has been some progress in monitoring and shoring up the fragile ceasefire between the Ukrainian armed forces and separatist rebels in Eastern Ukraine under the auspices of the OSCE. Three important issues now remain: Ukraine has yet to define its own relationship with the EU and, more importantly, NATO. Another unresolved issue is the precise nature of a solution in Eastern Ukraine, including potentially a new constitutional status for the areas in question. On both these points, there is likely to be scope for progress after the Ukrainian election on 26 October. Finally, Europe needs to be brought into the gas deal in order to secure its supplies ahead of winter and the IMF has to review the financing program in November. In many ways, the three toughest diplomatic hurdles still have to be overcome. Economic stabilisation in Ukraine and dismantling of sanctions against Russia will hinge on the EU and Russia's ability to make progress in these areas.
- India: The government has cleverly exploited a recent fall in global energy prices to remove controls on diesel prices. Diesel accounts for more than half of India's fuel demand. The measure not only saves the government money, but also lowers prices and increases economic efficiency. The announcement that diesel prices are to be liberalised follows benign consumer price inflation in September, which saw inflation drop to 6.46% yoy from 7.73% in August. The fall in consumer prices was matched by a similar-sized fall in wholesale prices. Inflation could decline further going forward as lower oil prices feed into lower pump prices. Delhi pump prices

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Emerging Markets

are now Rs 66.65 per litre compared to Rs 76 per litre at the same time last year, testifying to the positive effects of lower oil prices for consumption in India.

India is in the middle of a moderate economic upswing, which is likely to find grounding within the reform efforts of Prime Minister Modi's administration. As such, the fact that inflation rates are declining makes the Indian bond market an attractive destination. The main challenge remains access;encouragingly, Central Bank governor Rajan recently stated the government's objective of opening the market further to foreign investors.

In other Indian news, the trade balance widened by USD 3.4bn in September to USD 14.2bn. More than half of the widening of the trade balance was attributable to a seasonal rise in imports of gold (festive season). We expect the trade balance to normalise in future data releases. Modi's BJP party made sweeping gains in elections in the Haryana and Maharashstra states. This means that the BJP now controls 8 states. BJP is now also in a strong position to make further gains in the Upper House, where 1/3 of legislators are due to retire by 2016. Modi's government has focused on cutting red tape and riding a cyclical upswing in the economy in order to build sufficient political capital to tackle tougher reforms down the line. This strategy appears to be bearing fruit.

- Turkey: In stark contrast with the intelligent approach adopted by the Indian government, the Turkish government has opted to establish a 'food committee' with members from the Central Bank, the Ministry of Finance, Foreign Trade and the Ministry of Economy in a bid to reduce food inflation. The idea is to actively manage food prices from the supply side. As we noted last week, Turkey's medium term program envisages a heroic decline in inflation for next year. It now seems that the "food committee" is how this moderation in inflation is to be delivered. This looks to us like classic second-stage heterodoxy. In the first stage, the central bank adopted an innovative but flawed instrument (funding volatility) to control demand in a thinly disguised bid to avoid raising interest rates. The government, it seems, is now going to intervene directly in prices of individual goods, thus taking the country even further into the realm of heterodox macroeconomic policy. Meanwhile, the August current account deficit in Turkey was lower than expected (USD -2.77bn versus USD -3.05bn expected), but marginally wider than the deficit in July (USD -2.65bn). The improvement relative to expectations was due to the so-called "errors and omissions" line, which recorded a USD 817m inflow. This is the line that local institutions use when they want to tap Dollar liquidity kept in branches of banks and corporates off-shore. The Turkish current account deficit may be wide, but Turkish institutions familiar with the country's history of macroeconomic volatility have accumulated substantial stocks of Dollar liquidity off-shore. This liquidity becomes an important source of inflows when portfolio investors feel faint. The greater economic challenge facing Turkey, in our view, is the domestic credit expansion, which has already been allowed to extend substantially beyond its sell-by date.

- China: The rate of inflation declined to 1.6% yoy in September from 2.0% yoy in August on lower food prices, while producer price inflation rates were -1.8% versus -1.2% in August. The decline in inflation rates is useful, because it allows the authorities to raise real rates without actually raising nominal rates (part of the process of interest rates liberalisation). The strong downwards pressure on prices in China is in large due to China's huge reform drive from export to domestic demand-led growth, which frees up resources in one part of the economy before they can be utilised in the other parts of the economy. The result is slower growth and declining inflation, but the phenomenon is temporary – although it could last a few years. However, as a result of these reforms, China will be able to embark on a second phase of sustained growth. China's large banks have also begun to beef up their capital by issuing offshore preference shares. This measure is part of China's preparation for further liberalisation of interest rates, which is bound to reveal more weak credits. We expect that corporate default rates in China should eventually converge to corporate default rates in the rest of the world – i.e. 2%-5% for high yield. Recovery values should converge towards the Asian average, which is roughly identical to recovery rates in developed economies. The local government bond market is an excellent way to take advantage of slower growth, falling inflation, and likely very gradual easing by the PBOC. Besides, this is a market in excess of USD 4trn in size, which currently has almost no foreign participation, but which is now being opened up to foreign investors.[1]

In other Chinese news, Bank of China Ltd. raised USD 6.5bn in fresh capital as part of a broader capital raising exercise required by the authorities in order to protect the financial system as interest rates are liberalised. NPLs are rising but remain low at about 1%. The capital was raised in the form of off-shore notes that qualify as Tier 1 capital. The sale was the largest on record, beating the previous two largest capital-raising exercises ever (two USD 6bn capital raisings by Citigroup and Bank of America Merrill Lynch in 2008).

- Venezuela: There is no dispute that President Nicholas Maduro of Venezuela was left a poisoned chalice by his popular predecessor, the late Hugo Chavez. The extent of institutional destruction and economic mismanagement under Chavez is difficult to exaggerate. Maduro is now paying the price. A new poll shows that 70% of Venezuelans have no confidence in his ability to solve problems and he would lose both the majority of parliament and the presidency if any such election took place today. Yet, things are likely to get tougher from here. Lower oil prices will require further adjustment of the Venezuelan currency, which will

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[1] See *'Probably the best bond market in the world'*, Ashmore Emerging View, September 2014.

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increase inflationary pressures and therefore erode living standards further. Still, such adjustments are likely to be implemented ahead of non-payment of debt on account of the central importance of access to dollar working capital for PDVSA, the state oil company. The chorus of academics calling for default in Venezuela has now been joined by Kenneth Rogoff, former chief economist at the IMF, who said that the odds of a Venezuelan default is close to 100%. He did not say when the default would take place, however making his comments largely meaningless, in our view. Moody's, the ratings agency, said on Friday that it saw no impending credit event in the country. Neither do we. Indeed, Venezuela has just paid in full the final amortisation of its 2014 bonds, while PDVSA announced that it has bought back 60% of its bonds due this year.

- Indonesia: Joko Widodo, aka Jokowi, President-elect of Indonesia, will be sworn in today. His main opponent Prabowo Subianto last week extended an olive branch to Jokowi and offered his party's support, though we think this support is extremely unreliable. It remains to be seen if Jokowi can command a working majority in parliament; the upcoming announcement of cabinet positions may provide much of the answer. Meanwhile, Jokowi has plenty of means to govern even without passing laws. The single most important issue in Indonesia is infrastructure spending, which Jokowi can beef up entirely without parliamentary approval simply by cutting fuel subsidies and re-allocating the funds towards infrastructure spending. Jokowi has already stated that he intends to cut subsidies.

A few other snippets:

- Colombia: Retail sales grew an impressive 7.5% yoy in August compared to 5.6% yoy expected. Planned shutdowns of Ecopetrol's two refineries accounted for a decline in industrial production of 3.0% mom. We expect this to be reversed once maintenance operations have been completed.
- Poland: Industrial production surged 4.2% yoy in September compared to 2.7% yoy expected, while construction spending rose 5.6% yoy versus 0.5% expected.
- Chile: The Central Bank cut rates by 25bps to 3.0% with a dovish bias.
- South Korea: Bank of Korea cut interest rates by 25bps to 2.0%.
- Uruguay: Uruguayans head to the polls on the 26 October. All the main contenders are sensible policy makers.

Global backdrop

Fed rate hikes that were priced as early as Q1 2015 have now been pushed back significantly. Why? If one looked solely at earnings and the economic data releases from the United States in the past week one could be forgiven for being puzzled. After all, the data is not showing major departures from recent trends. The intra-week price action in the US markets bordered on shocking. Within one spellbinding, two-hour interval 10yr US treasury yields dropped about 35bps, thus cementing that market's status as one of the most unstable bond markets in the world. There was also a brief moment last week, when it looked as if the Eurozone debt crisis had re-appeared, when Greek bond yields blew out over fears that Syriza, a left-wing party, could get to power as early as H1 2015. This fear has since receded, but the market seized on the periphery trade again, because of a disagreement between Berlin and the ECB over the use of conventional QE. If such a disagreement exists, it could take months of wrangling to reach consensus during which time the world's speculators and investment banks could surely whip up an almighty anti-Eurozone panic in order to get weaker-minded investors sucked into trading their portfolios entirely needlessly.

Over the Atlantic, one notable highlight from last week was a comment from James Bullard, the usually hawkish president of the St. Louis Fed, who argued that the Fed should delay the end of bond purchases on account of the data. He referred in particular to a recent sharp drop in inflation expectations (which are currently far below the Fed's target).

The intervention from Bullard raises an interesting question: When the Fed says it is data dependent what exactly does it mean? What type of data, exactly? Inflation expectations are a basic fundamental economic variable, in fact probably the single most important determinant of core inflation there is. Clearly, therefore, inflation expectations qualify as data. Yet, inflation expectations change with market sentiment. And as we have seen over the past few months, inflation expectations can drop even when the economy is doing OK. So should the Fed respond to such data? If it does, there is clearly a risk that the 'lunatics have taken over the asylum'. It would be nice to get some clarity about what data dependence means. After all, this is just the latest in a serious of contradictory and confusing positions adopted by the Fed (the previous notable one being the discrepancy between the latest dovish minutes and the hawkish 'dots').

Anyway, as the dust settled, treasury yields ended only modestly lower, while US stocks were broadly flat on the week. But inflation expectations have remained significantly lower, which means that what was a gulf between the Fed's 'dots' (FOMC members' projections for when rates go up) and the market's expectations of rate hikes has now turned into a chasm. This tug-of-war between a Fed that wishes to move beyond tapering by landing a toe-hold on the path to interest rate normalisation, and a market perfectly prepared to take on the Fed by trashing inflation expectations will likely be repeated over and over in the coming years. Expect more volatility.

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Global backdrop

As for the 'other' type of US data, the picture remains mixed to moderately positive. Consumer confidence and industrial production were strong. But Empire Manufacturing and retail sales were disappointing (-0.2% mom versus +0.4% mom expected for the core/control category). Housing starts also rose significantly, thought this was mainly driven by multi-family dwellings. This component has the same effect as, say, aircraft orders in capex numbers, i.e. a few large orders can distort the broader picture. Indeed, single-family home starts were in line with the trend of the past few years, that is, improving, but not spectacularly, while housing permits -viewed by some as a leading indicator of starts – actually softened for the third time in a row. In other words, the US economy trundles along more or less at its post-Greenspan Bubble, mediocre pace. We note in passing that the disproportionate attention we pay to US data in the global backdrop section over, say, European and Japanese data, is entirely due to the completely dominant role of the Dollar as the world's main reserve currency. So many of EM's reserves are held in Dollar assets that what happens to both rates and the US dollar are of direct relevance to EM.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.8%	-0.3%	-2.9%	4.2%	3.0%
MSCI EM Small Cap	-3.2%	3.2%	1.3%	6.2%	4.9%
MSCI FM	-4.9%	16.3%	22.4%	15.5%	6.9%
S&P 500	-4.25%	3.73%	11.10%	18.77%	14.00%
GBI EM GD	1.65%	1.64%	-3.51%	1.48%	4.12%
ELMI+	0.13%	-1.58%	-3.48%	0.13%	0.60%
EM spot FX	0.13%	-5.45%	-9.37%	NA	NA
EMBI GD	0.91%	9.01%	8.35%	7.37%	7.90%
EMBI GD IG	1.96%	10.12%	8.67%	6.02%	6.88%
EMBI GD HY	-1.06%	6.97%	7.94%	9.57%	9.43%
5 year UST	1.74%	3.81%	2.38%	1.60%	3.68%
7 year UST	2.34%	6.91%	4.48%	2.52%	5.21%
10 year UST	2.86%	11.15%	7.93%	3.59%	6.28%
CEMBI BD	0.43%	6.70%	7.37%	7.34%	7.27%
CEMBI BD HG	0.88%	7.74%	8.02%	6.76%	6.98%
CEMBI BD HY	-0.52%	4.51%	6.00%	8.95%	8.24%
US HY	-0.02%	3.73%	6.06%	10.72%	10.83%
European HY	-1.09%	3.75%	6.74%	15.17%	12.54%
Barclays Agg	1.50%	3.16%	1.96%	1.44%	2.91%

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

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