Ashmore

The Emerging View
Prejudice, Value and Opportunity

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Reality has Changed...

The end of the Cold War was a pivotal moment for Emerging Markets, affecting more than a hundred countries in Latin America, Eastern Europe, Asia, and Africa. By the late 1990s the 'lost decade' had given way to leaner, stronger, and more democratic governments right across the emerging universe. Still unrecognized by many, the transitions to sound economics and representative government was arguably the most significant event for the largest number of people in the 20th Century.

Profound economic and political changes post-1989 explain the resilience of Emerging Market economies in the face of the massive upheavals experienced by developed economies following the collapse of the US housing market in 2007. Voters in poor countries have strong preferences for growth and stability, and will, now that their voices have meaning, punish governments which fail to deliver. It is highly unlikely that emerging economies will not continue to pursue the sound macroeconomic policies. There continue to be broadly supported by electorates.

…But Prejudice Lives

Emerging Markets are of course not immune to the global business cycle. In each of the past three years, the global economy has experienced major upheavals. The 2008/2009 Lehman collapse triggered the largest sell-off in Emerging Market assets in years, briefly pushing spreads on JP Morgan's EMBI GD index to some 900bps over US Treasuries. In 2010, the market first discovered that there was something rotten in the state of Greece. And 2011 witnessed a protracted bear-market, which began in July with the downgrade of US sovereign debt by the S&P ratings agency, but then quickly morphed into a broad-based and deeply entrenched sovereign debt crisis in Europe. In each of these episodes, longer-term trends of spread compression and currency appreciation in Emerging Markets were interrupted as investors lost sight of the distinction between risk and volatility, reverting to habits originating as far back as the Cold War to sell EM. And in each case these sell-offs constituted excellent entry points for value investors, because the sell-off in asset prices far exceeded the minimal erosion in fundamentals.

Why do Emerging Market asset prices over-react to events in Developed Markets? In part because investors have not updated their understanding of Emerging Markets. A significant problem is that the universe of Emerging Market assets is still a relatively small part of the portfolios of institutional investors in the West and central banks within Emerging Markets. Due to agency problems and herd mentality, large pools of capital, particularly cross-over investors, only reluctantly and slowly rotate into Emerging Markets. Prejudice means that many investors still do not know that the last 20 years not only ushered in better macroeconomic policies and more stable governments, but also saw emerging economies put in place major defences against volatility and external shocks. The average level of public debt to GDP in Emerging Markets by the end of 2012 is likely to be around 40% versus 90% in the US and Europe and 240% in Japan. Pension funds and other local institutional investors in Emerging Markets now hold the majority of total local currency debt issued in Emerging Markets. Emerging Market central banks today control two thirds of global reserves (IMF).

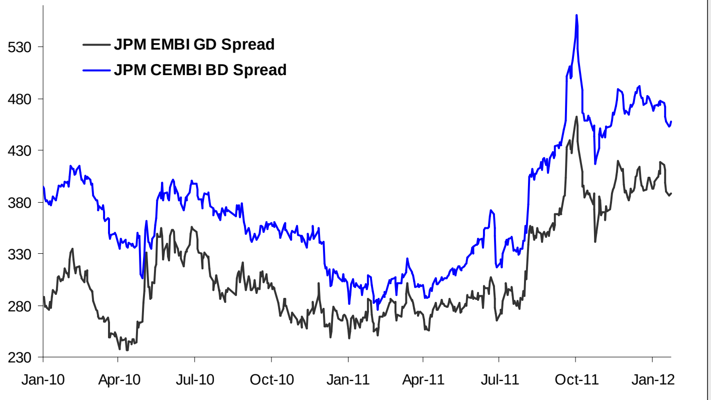
The pattern of Emerging Markets price action, however, is slowly changing as institutional investors learn the true nature of risks in Emerging Markets, and as the investor base becomes more diverse and sophisticated. Increasingly, investors are becoming aware that they are leaving money on the table whenever they sell EM assets in response to pessimism about events in Developed Markets. But prejudice takes years to erode, leading to opportunity.

The Pattern of Value

It is the nature of balance sheet recessions that they take many years to resolve themselves. The experiences of Japan over the past 20 years and Scandinavia in the early 1990s show clearly that the combination of high debt levels and banking sector crises produces long-lasting drags on growth. Thus, it is unlikely that 2012 is going to be very different from 2011. Developed Market economies will continue to experience sub-trend growth, while pursuing easy monetary policies in the absence of fiscal room due to excessive public debt levels. Emerging Market economies without the drags from vulnerable banks and excessive debt loads will grow near trend, with departures from trend growth mainly accounted for by shorter-term inventory cycles and occasional policy mistakes. Fundamentals, in other words, are really not very different from last year. Asset prices, however, are very different this year from where they were at the same time last year. Then there was a broadly shared consensus – to which Ashmore did not subscribe – that the US would grow by a very strong 4% in real terms for 2012. There was talk of 'exit velocity'. US stock markets were on a roll and 10 yr US treasury yields briefly topped 3.7% during the first quarter of 2011. This year, the market started on a very different footing. The Dollar began from a position of relative strength, while US treasury yields hovered near or below the 2.0% level. Bank analysts were focussed on 'the ugly contest': that is EURUSD weakness. The profound bearishness over Europe also depressed stock prices and widened spreads on bonds in Emerging Markets, especially corporate bonds.

On 29th September 2011, very near the lows of the market in 2011, we published a recommendation to our investors to 'fire a bullet', that is, to put money to work. We felt that clear value had been created in the market. And we felt that a solution to gradually remove the worst tail risks over Europe was evidently in the making. This view has proven to be correct. Europe is moving towards its 'fiscal compact', and the European Central Bank is backstopping the financial system through a combination of EUR1.04trn of de facto QE and importantly sizeable 3 year long-term repo operations. The result has been a robust start to markets in 2012. And as we move through 2012 we will undoubtedly get more volatility and more opportunities to add further to Emerging Markets longs at distressed prices (but not distressed assets).

Index spreads: much more value than 12 months ago



Source: Bloomberg

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EM Assets are Cheap

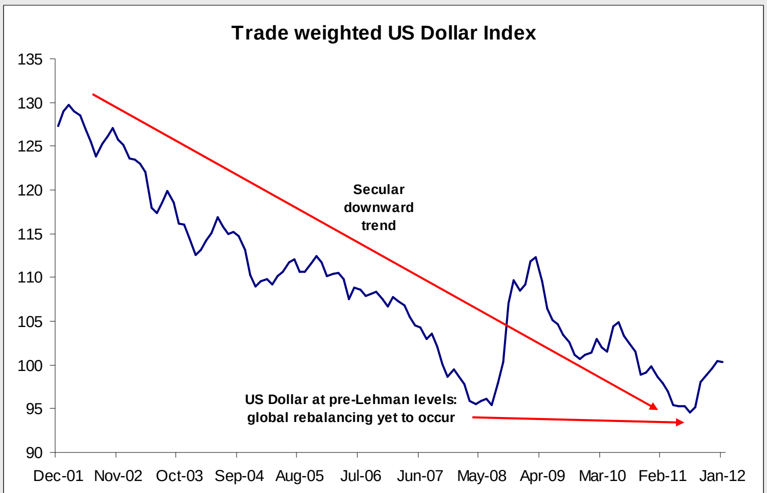
We are now once again in the midst of the third of these Developed Markets-related buying opportunities. We have entered 2012 near the peak of Europe-induced bearishness. Emerging Markets assets are cheap. Emerging Markets currencies began the year some 5% below fair value, and in our view there is no reason to believe that the case for gradual longer-term Dollar weakness versus Emerging Markets currencies has changed. This should add another 5% to currency returns in 2012. Add some 5% in carry and you are looking at 15% returns to local currency positions in Emerging Markets in 2012, plus alpha. Similarly, Emerging Markets external debt looks very attractive here with spreads just below 400bps versus pre-crisis lows near 165bps and post 2008/2009 lows of 220bps. If spreads recover to 250bps over US treasuries, and if the US Federal Reserve continues to pursue easy monetary policy in 2012 – our base case – then we would expect returns on Emerging Markets external debt, which is now an investment grade asset class to reach some 14% in 2012. But perhaps the biggest value in EM today is in corporate high yield, where we expect 19% return, based on a view that spreads will narrow to 600bps from highs of 900bps.

Challenges from Global Rebalancing

In the midst of all this focus on Developed Markets, it is worthwhile to take a step back in order to gain a broader perspective of the market since the peak of the crisis in 2008/2009. When one does so, it becomes clear very quickly that the main drivers of returns in Emerging Markets asset classes have been and sadly continue to be events in Developed Markets. Specifically, each of the three big buying opportunities in the past three years has been entirely Developed Markets driven.

For how long will Emerging Markets returns continue to be dictated by events in Developed Markets? The answer will depend in part on investor behaviour. There is no doubt that the global market place is becoming more aware of the distinction between risk and volatility. Developed Markets economies are evidently not risk-free. Sell-offs in Emerging Markets assets evidently do not signal deteriorating fundamentals. The process of diversification out of traditional Developed Markets asset classes in favour of broader global allocations which include substantial allocations to Emerging Markets is evidently underway. But it is also clear that these fundamental shifts will take time.

We do not rule out further rounds of Developed Markets-related risk aversion over the next few years. There are important negative tail risk scenarios which may yet play out, both in Europe and in the US. But it is our base case that the Developed Markets debt crisis will find resolution without a descent into depression and chaos. If we are right, then investors must already now begin to anticipate an important shift in market dynamics over the next few years. Investors must increasingly focus on the unwind of the global imbalances, which, in our view, will involve gradual currency strength in EM, which in turn shifts market attention away from global risk drivers to credit specific events in individual Emerging Markets economies. Currency strength and the gradual reserve depletion which accompanies currency strength will trigger a broader shift from export-led growth to domestic led growth across Emerging Markets. With the adoption of its latest 5 yr plan at the start of 2011, China has already embarked on this important shift, but other Emerging Markets economies will follow suit over the coming years.



Source: Bloomberg

The shift to domestic led growth is challenging. Perhaps the biggest challenge is overcoming the temptation to use short-term fiscal and monetary stimulus to beef up domestic demand. Such policies would quickly prove inflationary, requiring subsequent tougher medicine, which would interrupt the growth process. Our view is that some Emerging Markets economies are likely to be tempted into pursuing such policies, but that the majority will not. The reason why most EM countries will continue to stick to prudent policies is political. As long as Emerging Markets populations are poor and uninsured there will be little tolerance among voters for any policies which sacrifice stability for unsustainable short term policies to boost growth. Most Emerging Markets policy makers understand that the only way to ensure sustainable domestic led growth is to focus heavily on the supply side constraints to growth. These constraints fall into three categories, namely infrastructure bottlenecks, structural constraints to do with public goods delivery and imperfect competition in the private sector, and limitation in the access to capital in the private sector. We think we are likely to see a large number of Emerging Markets countries becoming far more focussed on these constraints over the next decade.

Price action in Emerging Markets assets continues to be dominated by Developed Markets developments, but as developed economies slowly de-lever and eventually recover from their deep crisis we are likely to see returns of emerging market investors becoming less dependent on global risk sentiment and more a function of credit specific stories. As this transition gradually gets underway in the next few years the implication is clear: one needs a specialist to navigate Emerging Markets credits.

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