A strong start to EM

By Jan Dehn

Update on the reasons for positive EM sentiment in the first couple of weeks of 2019. Argentina's two main challenges and why they are likely to be overcome. The alleged illegitimacy of Nicholas Maduro's presidency in the eyes of many weakens him. India will be larger than the US in just eleven years' time on a PPP-adjusted GBP basis. Peru's Attorney General is ousted. Falling inflation increases room for monetary stimulus in China, but will more monetary easing even be necessary? Egypt reforms energy prices. The World Bank presidency changes; will the World Bank now become more of a US policy instrument? In the global backdrop, Britain braces for Brexit, China and US talk trade and Powell urges patience and flexibility.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.0	–	3.77%
MSCI EM Small Cap	9.2	–	2.38%
MSCI Frontier	8.1	–	2.10%
MSCI Asia	10.5	–	4.09%
Shanghai Composite	8.3	–	1.55%
Hong Kong Hang Seng	6.9	–	4.24%
MSCI EMEA	8.5	–	3.18%
MSCI Latam	11.1	–	2.94%
GBI-EM-GD	6.42%	–	0.75%
ELMI+	5.18%	–	0.74%
EM FX spot	–	–	0.74%
EMBI GD	6.64%	392 bps	0.73%
EMBI GD IG	4.88%	214 bps	0.41%
EMBI GD HY	8.70%	601 bps	1.07%
CEMBI BD	6.15%	352 bps	0.76%
CEMBI BD IG	4.93%	231 bps	0.40%
CEMBI BD Non-IG	7.84%	521 bps	1.25%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	13.8	–	2.58%
1-3yr UST	2.52%	–	-0.04%
3-5yr UST	2.50%	–	-0.12%
7-10yr UST	2.68%	–	-0.25%
10yr+ UST	3.02%	–	-0.98%
10yr+ Germany	0.21%	–	0.44%
10yr+ Japan	0.02%	–	-0.45%
US HY	7.20%	444 bps	1.89%
European HY	4.76%	552 bps	1.63%
Barclays Ag	2.03%	-65 bps	0.17%
VIX Index*	19.88	–	-1.52%
DXY Index*	95.63	–	-0.04%
EURUSD	1.1458	–	-0.14%
USDJPY	108.13	–	-0.54%
CRY Index*	178.02	–	3.39%
Brent	60.1	–	4.78%
Gold spot	1294	–	0.38%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

Sentiment towards Emerging Markets (EM) is off to a good start in 2019. This follows good performance in aggregate over the last three years (2016-2018), when, in Dollar terms, local bonds returned 18.80% and EM stocks delivered 34.02% return and EH high yield corporate debt returned 23.74%, beating US equivalent markets in all three themes.

There are two main reasons for the positive start to 2019.

First, the pullback in 2018 created value and investors seem to be recognising this and are reducing their extremely large under-allocations to EM accordingly. For example, EM sovereign bond spreads blew out to 420bps last year, which is 70bps wider than the long-term average. This is plain silly, in our opinion, given that the asset class is investment grade on average and far more diversified than in the past (the index will comprise no less than 72 individual countries at the end of January). Similar cheapness can be demonstrated for other segments of fixed income as well as equities. Aside from chasing 'extra cheapness', investors are also responding to the fact that the 2018 pullback was clearly temporary in nature. The pullback was due to a Dollar rally in response to stronger growth in H1 2018, the April 2018 hawkishness from the Fed, President Trump's instigation of the China trade war in May as well as general profit-taking in non-Dollar currencies after serious Dollar weakness in 2017. All four drivers of the Dollar in 2018 are now moving into reverse.

In fact, investors should only view two developments of 2018 as having any semi-permanent implications. One is the fact that the US government became a de facto lame duck in legislative terms as control of the House of Representatives changed to the Democrats. The other is that in the Q3 2018 earnings release it was clear that for the first time since 2008/2009 costs are now eating into US company earnings. Cost are up due to the strong Dollar, Fed hikes, rising wages and tariffs. None of these cost pressures will dissipate soon. This means that US equities will put in a distinctly more lacklustre performance going forward relative to the last

Continued overleaf

Emerging Markets

few years. Or to put it slightly differently, yet another one of the big four QE trades – long US equities – is coming to an end. Two other QE trades – long Dollars and shorting everything in EM - already gone into reverse at the start of 2016 and the final QE trade – long European fixed income - will turn once European growth picks up at some point.

The second reason for the strong start for EM in 2019 is that other forces begin to weigh on markets as the temporary Dollar drivers of 2018 subside. The most important of these less spectacular but far more persistent forces is relative value. Despite the good aggregate performance over the last three years, EM assets remain very cheap in both absolute terms and relative terms. For example, most EM bonds currently pricing in some 200bps more hikes than the Fed is likely to deliver, while EM currencies have about 20% upside versus the Dollar. The cheapness in both bonds and FX was not created due to major problems in EM. Rather, it originates from the enormous misalignment of capital (out of EM and into developed economies in search of capital gains), which can be traced to Quantitative Easing (QE) policies. Specifically, for several years developed markets delivered such enormous capital gains that EM's traditional appeal, higher yield, simply fell on deaf ears. However, as monetary policies began to tighten in developed countries the phase of extraordinary capital gains ended and EM's higher yield now suddenly offer an attractive proposition.

Hence, while the 'search for yield' did not favour EM during the QE period on account of the large capital gains on offer in developed markets, yield differentials clearly favour EM now. Yields in developed markets are low and developed markets offer a serious risk of capital losses as monetary policies normalise. Such normalisation is already more than priced into EM. 'Search for yield' could therefore lead to flows into EM for many years to come, at least until the distortions in relative value in global markets rooted in QE policies have been eroded away by market forces.

This environment, while strongly favouring EM over developed markets well into the medium term, is clearly not without risks. EM markets are known for occasional spectacular sell-offs, usually in response to some debacle or other in a developed country. However, EM markets can also stage truly vicious rallies, which can carry markets too far too fast. It is so easy to miss such rallies. It is inefficient that markets fall so far and rally so hard, but this is due to investor behaviour, because EM fundamentals are actually quite stable. While irritating, such inefficiencies do not undermine the case for investing, but they do call for tactical adjustment in exposures. If investors need to reduce their underweights in EM then temporary pullbacks are the best possible time to do so.

A more serious risk is that bad performance in developed markets freaks out investors and policy makers in developed markets. First there is denial, then anger. Eventually, acceptance sets in. But until then, policy makers will respond, which can lead to serious policy mistakes. Trump's tax cut at full employment, the Fed's hawkishness in April 2018 and the Trade War are excellent cases in point. However, in the same way that the waters, which wash ashore during a Tsunami always return to the sea due to the force of gravity, so relative value always eventually restores fair value to financial markets. This is why EM has upside and developed markets downside.

- **Argentina:** Investors have two concerns when it comes to Argentina. One concern is that President Mauricio Macri faces a challenging election later this year amidst a serious downturn in the economy. The worry is that he loses to former President Cristina Kirchner, whose hopeless economic policies are ultimately to blame for the current economic weakness. There is no way to tell the election outcome with certainty, but Macri's approval ratings remain healthy and Kirchner is under pressure due to justified corruption allegations and deep splits within the opposition. Hence, our base case is that Macri is re-elected, aided in part by support from a strong ally in the Governor of Buenos Aires, Maria Eugenia Vidal, a non-Peronist. The other concern about Argentina is that the government faces a very steep rise in repayments to the IMF in 2021. However, this is only a concern if one expects Argentina to pursue an early exit from IMF support. In our view, the current economic team in Argentina fully recognises that the country needs long-term therapy in order to overcome decades of addiction to bad macroeconomic policies. Remember that inflation is not even back to anywhere near normal levels and much work needs to be done to revise Argentina's policy framework as well to ensure that improvements are sustained. If Macri wins, he will continue with the IMF for much longer than many think and the upcoming repayments to the Fund are therefore likely to be rolled over.

- **Venezuela:** President Nicholas Maduro was sworn in as president last week. Most countries and the entire political opposition in Venezuela believe that Maduro committed election fraud in order to 'win'. He is therefore an illegitimate leader in the eyes of many, rendering him weak. Venezuela is in default except on the PDVSA 2020 bonds and sovereign debt is trading in the 20s. The bonds have significant option value, which will be realised in the event of regime change. Regime change can happen at any time or not at all. Meanwhile, the US imposed further sanctions on officials based on allegation of corruption.

Continued overleaf

Emerging Markets

- **India:** The Trump Administration's paranoia about China's rise is now being stoked from a new direction as another EM giant rises. A report by Standard Chartered Bank last week pointed out that the Indian economy is now on track to overtake the US economy in size within the next eleven years to become the second largest economy in the world after China.

- **Peru:** The Attorney General (AG) resigned following a failed attempt to derail anti-corruption investigations. President Vizcarra strongly supported the removal of the AG. Since the fall of Peru's previous president due to corruption and the imprisonment of the main leader of the opposition, Keiko Fujimori also for corruption, the current government has ruthlessly pursued an anti-corruption agenda with strong popular backing. May other countries take note and follow suit.

- **China:** Slowing inflation has increased the room for the central bank to cut interest rates, if required. CPI inflation declined to 1.9% yoy in December from 2.2% yoy in November. PPI inflation dropped even more sharply from 2.7% yoy to 0.9% yoy over the same period. However, the government may not need to exploit all the room to cut rates, because plans are already afoot to further expand the fiscal deficit and to implement additional off-budget fiscal stimulus this year. These and previously announced measures are likely to stabilise growth in 2019, in our view.

- **Egypt:** The government is directly linking energy prices with global crude prices. This is a major efficiency enhancing policy change, which should pave the way for disbursement of IMF support. Energy subsidies are the most common way to provide 'welfare' in many EM countries without conventional welfare state provisions.

- **World Bank**: Jim Yong Kim has resigned as President of the World Bank to join a private equity fund. The World Bank is major lender to the poorest segments of EM countries. In accordance with a long-standing neo-Colonial tradition, the US appoints the leader of the World Bank (and Europe appoints the leader of the IMF). Hence, there is now a risk that President Donald Trump appoints a partisan official to run the World Bank, raising the possibility that the World Bank starts to extend US policies, which include protectionism, bad environmental policies, gender bias and anti-China policies. If so, one would love to be a fly on the wall at senior policy meetings in the Bank, because 99% of World Bank employees, which are experts in economic development, firmly believe that such policies directly undermine rather than enhance efforts to promote economic development.

Snippets:

- **Brazil:** The central bank comfortably beat its own inflation target in 2018. Inflation on yoy basis ended the year at 3.75% compared to the target of 4.5%. This is the second year in a row that Brazil beats the inflation target, thereby depreciating the real effective exchange rate and enhancing competitiveness. Industrial production (IP) increased at a modest 0.1% mom pace in November.
- **Chile:** Headline inflation declined to 2.6% yoy in December from 2.8% yoy in November. The midpoint of the central bank's target range is 3.0%. Real GDP growth was 3.1% yoy in November, according to the monthly IMACEC index.
- **Colombia:** Inflation ended at 3.18% yoy in 2018, close to the central bank's target and the lowest level since 2013.
- **Czech Republic:** CPI inflation was unchanged at 2.0% yoy in December, which is well below the inflation target of 2.5% yoy.
- **Democratic Republic of Congo:** Opposition leader Felix Tshisekedi won the presidential election, defeating incumbent president Kabila's protege. If the result stands, it will be the first transfer of power to the opposition via an election since Independence.
- **Ecuador:** The fiscal deficit ended at 3.0% of GDP in 2018, beating the government's own target and halving the deficit relative to 2017.
- **Ghana:** Real GDP growth was 7.4 yoy in Q3 2018, up from 5.4% yoy in Q2 2018.
- **India:** The yoy pace of industrial production (IP) dropped sharply in November due to base effects following a very strong October. IP growth was 0.5% yoy, down from 8.4% yoy in October.
- **Lebanon:** The government is preparing to deal with the country's large debt stock, according to the ministry of finance. It remains to be seen what the government has in mind.
- **Mexico:** Industrial production (IP) contracted 1.3% on a yoy basis in November due to construction and especially weakness in oil and gas production, but manufacturing had positive growth. Consumer confidence rose sharply in December (+6.3% mom sa). Inflation in December was 3.92% yoy, while core inflation closed the year at 3.68% yoy.
- **Pakistan:** Talks with the IMF have resumed after the holiday break. The government has submitted for the IMF's perusal a formal plan to reform the economy.
- **Philippines:** The trade deficit narrowed to USD 3.9bn in November from USD 4.08bn in October.
- **Poland:** The central bank left the policy rate unchanged at 1.5%.

Continued overleaf

Emerging Markets

- **Russia:** Food prices pushed the year-end inflation reading to 4.3% yoy. VAT hikes may push prices higher yet in the next few months, but inflation will then come down, in our view.
- **Taiwan:** Exports rose 1.7% mom in December, more than reversing a decline of 1.0% mom in November.
- **Turkey:** The current account surplus was USD 1.0bn in November following a USD 2.7bn surplus in October. In a sign of improving sentiment, Turkey was able to place at 10-year USD-denominated sovereign bond in the global market at a yield of 7.875%. Six months ago, no one would touch Turkish markets with a barge pole.

Global backdrop

It is an important week for the UK as the parliament prepares to vote on Prime Minister Theresa May's deal for exiting the European Union. The vote is due to take place tomorrow. Between the pro-hard Brexit rebels within her own ranks and the opposition Labour Party, some 60% of British members of parliament (MPs) oppose her plan, albeit for different reasons. The pro-hard Brexit crowd wants Brexit for ideological reasons, while Labour wants to topple May come what may in the hope of taking power after a general election. Exiting the European Union without a deal will prove a disaster for the UK, in our view. A last minute solution may still emerge, but it would seem only to be possible if either the European Union or large numbers of MPs within Labour and/or the hard Brexit mob shift their positions meaningfully.

China and United States held official talks over trade. China never wanted a trade war. The US is now backtracking on the trade war it instigated, because the mid-term election is over and American business is hurting from tariffs. In our view, the whole trade war was an election gimmick, which inflicted significant costs on many economies and businesses in the US and abroad, in order to serve Trump's narrow, short-term political objectives.

Fed Chairman Jay Powell called for patience and flexibility in the operation of US monetary policy. His current message is very different from the message of hawkishness he delivered in Q2 2018, when the Fed pointed to four rate hikes in 2019. We may yet get a couple of hikes this year. Meanwhile, the US government remains shut and government employees go without pay, because Trump wants Congress to fund his Mexican wall, but Democrats, who now control the House of Representatives, do not want to pay for any wall. They also played music on the deck of the Titanic as the great ship went down.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	3.70%	3.70%	3.70%	-14.20%	14.42%	3.38%
MSCI EM Small Cap	2.39%	2.39%	2.39%	-19.07%	7.22%	1.65%
MSCI Frontier	3.01%	3.01%	3.01%	-17.25%	6.79%	0.94%
MSCI Asia	2.60%	2.60%	2.60%	-14.96%	12.92%	5.38%
Shanghai Composite	2.40%	2.40%	2.40%	-23.61%	-3.33%	7.27%
Hong Kong Hang Seng	3.26%	3.26%	3.26%	-11.49%	11.54%	4.52%
MSCI EMEA	5.45%	5.45%	5.45%	-12.57%	14.36%	-1.08%
MSCI Latam	9.87%	9.87%	9.87%	-1.66%	22.72%	1.08%
GBI EM GD	2.44%	2.44%	2.44%	-5.63%	7.65%	-0.44%
ELMI+	1.46%	1.46%	1.46%	-2.77%	4.98%	-0.51%
EM FX Spot	2.01%	2.01%	2.01%	-8.48%	0.40%	-6.56%
EMBI GD	1.70%	1.70%	1.70%	-2.61%	5.90%	5.05%
EMBI GD IG	1.37%	1.37%	1.37%	-0.67%	4.96%	4.53%
EMBI GD HY	2.04%	2.04%	2.04%	-4.62%	6.93%	5.39%
CEMBI BD	1.16%	1.16%	1.16%	-0.59%	5.62%	4.50%
CEMBI BD IG	0.79%	0.79%	0.79%	0.33%	4.03%	4.02%
CEMBI BD Non-IG	1.65%	1.65%	1.65%	-1.71%	8.27%	5.08%

Continued overleaf

Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	3.63%	3.63%	3.63%	-4.35%	12.78%	9.31%
1-3yr UST	-0.01%	-0.01%	-0.01%	1.66%	0.88%	0.80%
3-5yr UST	-0.02%	-0.02%	-0.02%	1.77%	1.02%	1.43%
7-10yr UST	0.06%	0.06%	0.06%	1.81%	1.13%	2.66%
10yr+ UST	-0.16%	-0.16%	-0.16%	-0.03%	2.13%	5.32%
10yr+ Germany	0.78%	0.78%	0.78%	8.54%	4.09%	7.58%
10yr+ Japan	0.38%	0.38%	0.38%	2.83%	3.25%	4.41%
US HY	3.13%	3.13%	3.13%	0.30%	8.53%	4.33%
European HY	1.09%	1.09%	1.09%	-3.23%	4.29%	3.84%
Barclays Ag	0.59%	0.59%	0.59%	-0.52%	2.70%	1.11%
VIX Index*	-21.79%	-21.79%	-21.79%	95.67%	-16.99%	61.89%
DXY Index*	-0.57%	-0.57%	-0.57%	5.11%	-3.49%	18.55%
CRY Index*	4.84%	4.84%	4.84%	-9.20%	9.14%	-35.68%
EURUSD	-0.08%	-0.08%	-0.08%	-6.57%	5.46%	-16.24%
USDJPY	-1.42%	-1.42%	-1.42%	-2.18%	-8.41%	3.75%
Brent	11.65%	11.65%	11.65%	-14.03%	93.59%	-43.54%
Gold spot	0.90%	0.90%	0.90%	-3.43%	20.00%	3.92%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.
Data as at 21 December 2018.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Other locations
Lima
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2019.

Important information: This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised and regulated by the Financial Conduct Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. Past performance is not a reliable indicator of future results. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment.