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Ashmore

Flight from yield to search for yield

By Jan Dehn

EM's traditional appeal is higher yield. Provided EM fundamentals are ok, it makes more sense to own EM bonds than developed market bonds, because you get paid more. During the years of Quantitative Easing (QE), the appeal of EM yield faded due to the enormous capital gains generated in developed economies on the back of QE. However, capital gains gradually erode yield and are now largely gone, leaving very substantial yield differentials in favour of EM. With EM fundamentals also looking stronger compared to developed economies, the erstwhile flight from yield in EM during the QE years is now making way for a genuine search for yield in EM for the first time since the onset of QE.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.8	–	-0.67%
MSCI EM Small Cap	10.0	–	0.31%
MSCI Frontier	8.3	–	-1.93%
MSCI Asia	11.7	–	0.00%
Shanghai Composite	10.1	–	6.77%
Hong Kong Hang Seng	7.8	–	0.70%
MSCI EMEA	8.5	–	-1.19%
MSCI Latam	11.2	–	-4.26%
GBI-EM-GD	6.27%	–	-0.41%
ELMI+	5.41%	–	-0.11%
EM FX spot	–	–	-0.41%
EMBI GD	6.18%	341 bps	0.10%
EMBI GD IG	4.59%	179 bps	0.02%
EMBI GD HY	7.90%	515 bps	0.18%
CEMBI BD	5.89%	320 bps	0.18%
CEMBI BD IG	4.72%	204 bps	0.13%
CEMBI BD Non-IG	7.50%	480 bps	0.23%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.1	–	0.46%
1-3yr UST	2.55%	–	-0.09%
3-5yr UST	2.55%	–	-0.28%
7-10yr UST	2.74%	–	-0.68%
10yr+ UST	3.11%	–	-1.82%
10yr+ Germany	0.17%	–	-1.66%
10yr+ Japan	0.00%	–	-0.62%
US HY	6.55%	376 bps	0.49%
European HY	4.54%	460 bps	0.82%
Barclays Ag	1.99%	-75 bps	-0.35%
VIX Index*	13.69	–	-1.16%
DXY Index*	96.76	–	0.35%
EURUSD	1.1320	–	-0.33%
USDJPY	111.88	–	-0.73%
CRY Index*	182.05	–	0.30%
Brent	66.1	–	2.10%
Gold spot	1285	–	-3.18%

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

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Quantitative Easing (QE) introduced distortions of truly mind-boggling proportions in global bond markets, particularly between European fixed income and EM fixed income. Investors bought bonds in Europe in search of unprecedented capital gains and liquidated bonds in EM, where the yield, though higher than in developed countries, could simply not match the capital gains on offer in European bonds. Some numbers may help to illustrate this point. In 2010, the yield on a 30-year German bond yield was 4.5%, but by December 2015 when the Fed finally got around to hiking for the first time, the yield on the German bond had fallen to just 1.4%. Since the bond has a duration of 25 years, investors made 65% between 2010 and 2015, the most potent phase of QE. Over the same period, however, EM bond yields actually went up due to selling by foreign investors. The yield on EM sovereign Dollar-denominated bonds rose from a low of 5.25% in 2010 to 6.39% by the end of 2015, while the yield on EM local bonds increased from a low of 6.13% in 2010 to 7.25% by the time the Fed hiked in late 2015. In other words, investors in EM bonds made capital losses. There were also large distortions created between EM and US bonds although they never reached the same epic proportions as in Europe, mainly because investors traded QE in the US mainly by going long US stocks, not bonds. Indirectly, however, even the stock market rally in the US ended up hurting EM bonds, because the capital gains in the US stock market were so large that investors liquidated positions in EM in order to participate in the US stock market rally. The only way for foreigners to participate in the US stock market rally was to buy Dollars, so EM currencies fell by more than 40% between 2010 and 2015.

The flight from yield in EM slowly began to wane after the first Fed hike in December 2015. Since then, EM bonds have delivered both capital gains and high yield. Local currency government bonds are up about 23%

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since Q1 2016 compared to 4% for US 5-year bonds, while EM Dollar-denominated sovereign bonds are up 21% versus 5% for US 10-year bonds. EM high yield (HY) corporate bonds have also outperformed US HY 31% versus 28% (all returns in Dollars).

Yet, despite the strong recovery so far, there are still huge distortions between EM and developed market bonds, which suggests that the trade has further to run. To gauge the magnitude of the remaining distortions, consider Figure 1, which shows yield to maturity for key EM and developed bond markets as well as the terminal Fed funds rates currently priced into each market.

The table shows that the yields on EM bonds – sovereign, corporate and local – are currently consistent with a terminal Fed funds rates between 4.99% and 5.2%, assuming a stable relationship between the Fed funds rate and EM bond yields relative to previous hiking cycles.

It is clearly excessive for EM bonds to price in such high terminal Fed funds rates. After all, the Fed stopped hiking at 5.25% in the last hiking cycle and the Fed is currently signalling a pause with the Fed funds rate at only 2.5%. The US 10-year bond says that the Fed will eventually stop hiking just short of 3%, i.e. at 2.94%.

While EM bonds appear to price in far too high a terminal Fed funds rate, so the German 10-year bond is pricing in a terminal Fed funds rate of just 15bps, which seems far too low. The one thing that seems 100% certain is that the Fed will only stop at one particular rate and that rate is probably going to be close to 3% than either 5% or 0%. This is because US bonds are less distorted than either EM or German bonds, since the Fed has been normalising monetary policy for some time and investors' favourite QE trades in the US were stocks and the Dollar, not bonds. In short, the current yields on German and EM bonds are both very distorted and the total distortion between them adds up to a massive 479bps.[1]

Fig 1: **Yields to maturity and current implied terminal Fed funds rate**

Market	Current Yield to Maturity	Current implied terminal Fed funds rate
US 10yr bond	2.63	2.94
German 10yr bond	0.11	0.15
EM external debt	6.18	4.94
EM corporate HY bonds	7.38	5.23
EM local currency bonds	6.26	4.89

Source: Ashmore, Bloomberg, JP Morgan. Data as of 27 February 2019.

As these distortions are eroded away by flows and trading decisions, EM bonds should outperform both US and European bonds. Could the high yields in EM be due to factors other than misallocation of capital? For example, it is a possibility that EM bonds trade at high yields because of high levels of inflation in EM or because of widespread credit stresses.

However, this is not the case. As noted in a recent Weekly, inflationary pressures are low and waning in EM. Inflation in EM local bond markets, as weighted by the JP Morgan GBI EM GD index, is currently sitting at near all-time low of just 2.6%.[2]

Similarly, there is no evidence of broad-based credit stress. To illustrate this, consider Figure 2, which shows the default rate for EM high yield, bonds as of the end of January 2019. Junk bonds are a particularly good gauge of credit stress, because these bonds are issued by corporates in EM, which are the most indebted, least diversified and most likely companies to be cut off from financing. As Figure 2 shows, the EM HY corporate default rate currently sits at a multi-year low of just 0.87%, which compares very favourably to the default rate of 1.73% for US HY corporate bonds. It is particularly impressive that default rates are so low, because EM issuers have just recently been subject to major external stresses, including a massive Dollar rally, a halving of commodity prices, massive flight of capital from EM and having to price in a de facto full normalisation of US monetary policy.

[1] The distortion can be calculated very simply as the sum of the differences between the terminal Fed funds rate priced into the US 10-year bond on one hand and the terminal Fed funds rates priced into the German 10-year bonds and EM sovereign Dollar bonds on the other.

[2] See *'Declining inflation re-injects value into EM local bonds'*, Weekly investor research, 11 February 2019.

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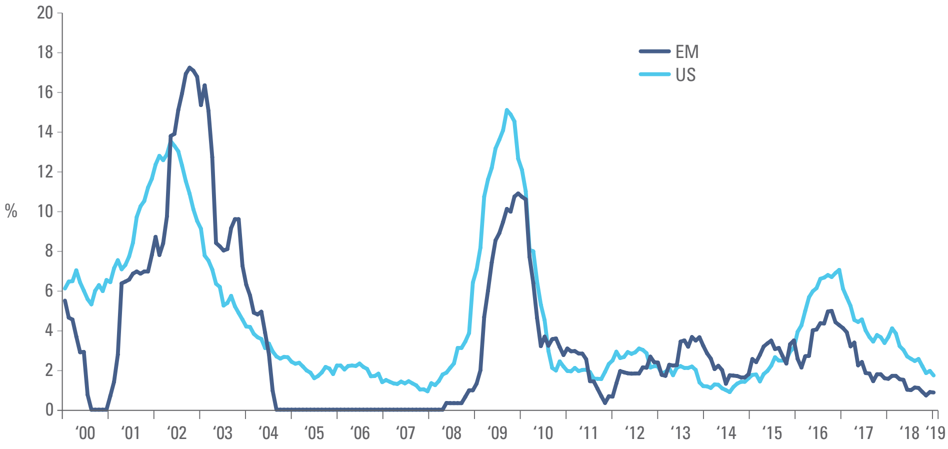
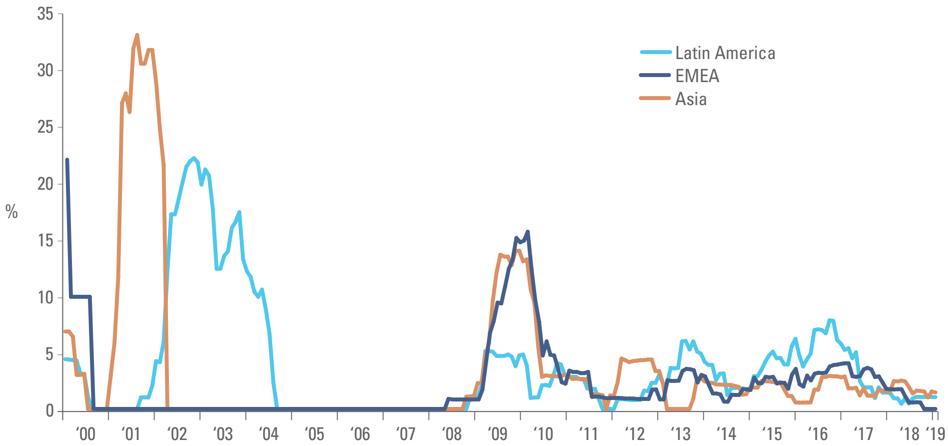
Fig 2: **EM versus US HY default rates**



Source: Ashmore, BAML. Data as at 31 January 2019.

What is even more impressive is the broad-based nature of EM credit resilience. Figure 3 shows the default rate for EM HY corporates by region. Default rates are lower in every region of EM than in the US. Specifically, Eastern European HY corporates have not had a default in four months, the Latin American default rate is stable at just over 1% and the default rate for Asian HY bonds is stable at roughly 1.5%. We note, in passing, that EM corporate net leverage at 1.8x EBITDA is also materially lower than in the US (2.6x) and has been falling since 2016. US HY net leverage has increased outright over the same period.

Fig 3: **EM corporate high yield default rates – by region**



Source: Ashmore, BAML. Data as at 31 January 2019.

In conclusion, the low default rates and low inflation rates in EM support the argument that the big yield differentials between EM and developed countries reflect a still material misallocation of capital. The establishment of such misallocations was obviously painful for EM, because it involved the liquidation of huge volumes of EM bonds. However, the unwinding of misallocations, which is now underway is an altogether more pleasant experience. It amounts to a genuine search for yield. EM's traditional appeal – to offer higher yields than developed markets – is now back in play, especially since EM fundamentals are okay too. This points to several more years of EM fixed income outperformance versus developed bonds before global bond markets are once again back in long-term balance.

- Index news: MSCI, the dominant EM equity index provider, has announced that the inclusion factor for Chinese A-shares in the main MSCI EM index will rise from 5% to 20% between May and November 2019. This decision reflects China's consistent efforts to improve market accessibility and reduce trading suspensions. China A-shares will become 3.3% of the MSCI EM index by November. The combined weight of Chinese A and Chinese non-A shares in the MSCI will reach 33.34% over the same period. MSCI also agreed to add Saudi Arabian stocks, whose share in the index will rise from 0% today to 2.59% by November 2019. The inclusion of both these markets will obviously make the MSCI EM index more representative of the EM equity universe as well as increase diversity and the size of the opportunity set for investors in EM equities.

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- **India-Pakistan:** India and Pakistan were again in conflict with Pakistan shooting down two military jets after Indian bombed its neighbouring country. This is a regular occurrence due to an ongoing dispute over the territory of Kashmir. Our view is that this is a skirmish, which is unlikely to break into a full-fledged, sustained war. Still, this particular episode has potential to be a bit more fruity than others due to the proximity of the Indian election. Indian Prime Minister Narendra Modi is a nationalist who will be expected to show strength or risk losing votes.

- **China:** The Caixin manufacturing PMI bounced back strongly from 48.3 in January to 49.9 in February. New orders also bounced back to 50.6 in January from 49.6 in the December release of the official manufacturing PMI. It is clear that the government's efforts to stabilise growth are now beginning to work.

- **Argentina:** The central bank announced that it will 'over-comply' with tight monetary targets until May. This is when recent increases in administrative prices due to a hike in VAT will temporarily push the headline inflation rate higher. This is necessary because the central bank has almost no credibility, though the current team in charge of monetary policy is far stronger than past teams and may eventually succeed in establishing some inflation fighting credibility. The central bank also indicated that FX purchases will be scaled back, which is disinflationary. In our view, these measures reflect a bias towards monetary orthodoxy. The decline in economic activity is still serious, but moderated slightly in December (-7.0% yoy from -7.5% yoy in November).

- **Brazil:** The Senate confirmed the appointment of Roberto Campos Neto to the position of President of the Brazilian central bank. We expect continuity in policy. Campos Neto and his predecessor, Ilan Goldfajn, are serious and competent professionals. In other news, the fiscal balance swung into a larger than expected surplus of BRL 46.9bn in January, but economic growth moderated to 0.13% qoq sa in Q4 2018 from 0.53% qoq sa in Q3 2018. The trade balance was in surplus to the tune of USD 1.6bn in January, which is a smaller surplus than in the same month of 2018 (USD 2.4bn).

- **Mexico:** Private sector credit increased at a yoy rate of 5.5% in January, driven mainly by strong growth in corporate credit, while the rate of unemployment was 3.6% in January in line with expectations. However, retail sales surprised sharply to the downside in December, down 1.3% yoy versus an expected increase of 2.7% yoy. Real GDP growth was 1.7% yoy in Q4 2018.

Snippets:

- **Chile:** Manufacturing was 2.7% higher on a yoy basis in January, but mining declined at a yoy rate of 4.8%.
- **Colombia:** Real GDP growth was 2.8% yoy in Q4 2018, which was slightly stronger than in Q3 2018 (2.7% yoy). This means that growth for 2018 as a whole was 2.7% compared to 1.4% yoy in 2017.
- **Czech Republic:** Real GDP growth accelerated in Q4 2018 to 0.9% qoq from 0.7% qoq in Q3 2018.
- **Hong Kong:** Q4 2018 GDP growth was 1.3% yoy, down from 2.9% yoy in Q3 2018.
- **Hungary:** The rate of real GDP growth in Q4 2018 was revised marginally higher to 5.1% yoy relative to the flash estimate.
- **India:** The PMI rose further to 54.3 in February from 53.9 in January. Real GDP growth in Q4 2018 slowed to 6.6% yoy from 7.0% you in Q3 2018.
- **Indonesia:** Headline CPI inflation declined to a near-decade low yoy rate of 2.6% in February.
- **Israel:** The Attorney General announced that Prime Minister Benjamin Netanyahu will be indicted on three charges of bribery, fraud and breach of trust.
- **Nigeria:** Incumbent President Buhari was re-elected in Nigeria. Bond yields declined due to the resulting reduction in uncertainty.
- **Peru:** CPI inflation surprised to the downside in February (0.13% mom versus 0.23% mom expected). Inflation on a yoy basis dropped to 2.0%.
- **Poland:** The government is unleashing an election-motivated fiscal stimulus of 1.3% of GDP upon the Polish economy. The government debt to GDP ratio is stable at just over 50%.
- **Saudi Arabia:** Reserves declined USD 6.6bn in January to USD 490bn. Saudi Arabia accounts for roughly 5% of global FX reserves and EM accounts for about 75% of global FX reserves.
- **Slovenia:** Real GDP growth was 4.1% yoy in Q4 2018, which was slightly higher than expected, took the rate of real GDP growth for the year to 4.5%.
- **Singapore:** Industrial production was up 0.9% in January, driven by higher output on pharmaceuticals.
- **South Korea:** Exports weakened further in February, down at a yoy rate of 11.1%, which was worse than expected (-9.5% yoy). The primary driver of weak exports is lower prices for electronics. In fact, industrial production in January beat expectations by rising 0.5% in the month, seasonally adjusted. The Bank of Korea kept the policy rate unchanged at 1.75%.

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- **Sri Lanka:** The IMF is re-engaging with Sri Lanka as political stability returns following the political turmoil in late 2018. IMF is considering extending a loan of USD 1.5bn to the government. IMF money is cheap, but comes with policy conditionality. IMF programs are therefore usually welcomed by bond investors.
- **Thailand:** The yoy rate of core inflation declined to 0.6% in February from 0.7% in January.
- **Venezuela:** The United Nations Security Council failed to pass a resolution to enforce new elections in Venezuela, while a 15-member group of countries seeking a democratic solution to the political conflict stated its opposition to a military solution. We expect financial and diplomatic pressure eventually to undermine the military's support for President Nicholas Maduro, but for now the political situation is in a stalemate.

Global backdrop

German retail sales staged a very strong rebound of 3.3% mom in January, suggesting that the doom and gloom surrounding German growth may be a bit overdone. Despite the stronger consumer story in Germany, European core CPI inflation remained extremely low at just 1.0% yoy in February compared to 1.1% yoy in January. Europe-wide PMI declined to 49.3 in February from 50.5 in January. In Japan, industrial production dropped very sharply in January (-3.7% mom). This is the second consecutive month with negative growth in industrial production.

The US economy grew 3.1% in real terms in 2018, but with a clear slowdown in the second half of the year, while 2019 is starting on a particularly soft note. Growth peaked at 4.2% qoq annualised in Q2 2018 and has since been slowing steadily. Growth in Q4 2018 was just 2.6% qoq annualised. It is remarkable that growth is already slowing, because Congress approved a fiscal stimulus, which, in its full glory, will be 7% of GDP. In our opinion, the Trump tax cut was one of the least effective fiscal stimuli in living memory. This is probably because the tax cut was extremely badly timed (coinciding with the attainment of full employment) as well as inefficient in the sense that it only granted minimal relief for low income earners with high spending propensities and mainly fuelled stock buybacks rather than new investment.

The growth outlook for 2019 is not off to a great start, currently tracking less than 1% for Q1 2019. ISM manufacturing slumped in January, single family housing starts were poor, claims for unemployment benefit went up 8K to 225K, consumer sentiment softened and real personal expenditure practically collapsed in December (-0.6% mom). Inventories also increased in December, which, in the context of weakening spending could signal that an imminent retrenchment in production is about to happen.

It is therefore disconcerting that the US trade deficit is still widening, hitting a whopping USD 79.5bn in December. Granted, chronic low productivity growth and a massively overvalued Dollar makes it challenging to export. However, tariffs are also to blame. It is deeply ignorant to try to address trade deficits using tariffs. In fact, trade deficits are caused by excess demand, while tariffs worsen trade balances marginally by increasing the cost of imported intermediate goods for exporters. It is all basic macroeconomics.

On the geopolitical front, US President Donald Trump and the North Korean leader Kim Jong-un failed to discover a way to normalise relations between the two countries. The summit, held in Vietnam, was meant be the crowning achievement after months of careful negotiations among lower level officials, a celebration of hugs, handshakes and photo shoots to enable the two men to bask in glory. The Summit failure suggests that someone failed to do their homework. Trump's Nobel Peace Prize now appears to be slipping from his grip.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	0.06%	8.88%	8.88%	-11.80%	11.78%	1.70%
MSCI EM Small Cap	0.21%	6.97%	6.97%	-13.90%	8.88%	2.26%
MSCI Frontier	-0.17%	5.42%	5.42%	-14.96%	7.36%	0.87%
MSCI Asia	0.45%	10.03%	10.03%	-7.57%	15.20%	6.68%
Shanghai Composite	1.80%	20.05%	20.05%	-6.31%	5.34%	10.27%
Hong Kong Hang Seng	1.23%	13.65%	13.65%	-3.63%	17.21%	7.13%
MSCI EMEA	-0.76%	6.19%	6.19%	-12.99%	10.79%	-0.52%
MSCI Latam	-1.58%	8.96%	8.96%	-6.20%	18.01%	1.90%
GBI EM GD	-0.48%	3.80%	3.80%	-5.55%	6.37%	-0.04%
ELMI+	-0.21%	2.00%	2.00%	-2.95%	4.49%	-0.28%
EM FX Spot	-0.40%	1.81%	1.81%	-9.00%	-0.48%	-6.42%
EMBI GD	-0.24%	5.20%	5.20%	2.89%	6.22%	5.37%
EMBI GD IG	-0.17%	3.29%	3.29%	3.58%	4.59%	4.42%
EMBI GD HY	-0.31%	7.15%	7.15%	2.10%	8.02%	6.28%
CEMBI BD	-0.06%	3.76%	3.76%	2.94%	6.20%	4.69%
CEMBI BD IG	-0.06%	2.89%	2.89%	3.49%	4.43%	4.03%
CEMBI BD Non-IG	-0.07%	4.93%	4.93%	2.30%	9.10%	5.55%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	0.69%	12.26%	12.26%	6.81%	14.63%	10.80%
1-3yr UST	-0.08%	0.28%	0.28%	2.10%	0.83%	0.81%
3-5yr UST	-0.17%	0.16%	0.16%	2.63%	0.70%	1.32%
7-10yr UST	-0.33%	0.02%	0.02%	3.58%	0.18%	2.25%
10yr+ UST	-0.67%	-1.22%	-1.22%	2.52%	0.00%	4.27%
10yr+ Germany	-0.23%	1.14%	1.14%	8.85%	1.69%	6.75%
10yr+ Japan	-0.26%	1.40%	1.40%	2.80%	1.37%	4.33%
US HY	0.04%	6.30%	6.30%	4.54%	9.50%	4.54%
European HY	0.10%	4.62%	4.62%	0.86%	5.68%	4.21%
Barclays Ag	-0.25%	0.69%	0.69%	-0.84%	1.98%	0.72%
VIX Index*	-7.37%	-46.14%	-46.14%	-30.12%	-18.80%	-2.91%
DXY Index*	0.63%	0.61%	0.61%	7.59%	-0.59%	20.70%
CRY Index*	-0.38%	7.21%	7.21%	-6.22%	8.01%	-40.56%
EURUSD	-0.45%	-1.28%	-1.28%	-8.24%	2.86%	-17.63%
USDJPY	-0.44%	-1.96%	-1.96%	-5.08%	1.66%	-8.64%
Brent	0.14%	22.90%	22.90%	2.72%	70.76%	-39.51%
Gold spot	-2.13%	0.22%	0.22%	-2.64%	2.09%	-3.68%

*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.

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Ashmore

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
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