Issued: 20 May 2019

Volatile sentiment amidst solid credit fundamentals

By Jan Dehn

While markets fret over trade wars and other problems emanating from developed countries, EM is experiencing the strongest credit fundamentals in many years. In country specific news, Ukraine looks to settle local bonds in Clearstream, Venezuela's PDVSA pays the 2020 coupon, Brazil slows as the pension reform drags on, inflation moderates in Argentina as Cristina Kirchner announces her candidature for Vice President, exit polls points to a Modi victory in India, Ecuador's Moreno and Philippines' Duterte both emerged stronger from elections. Russian growth was weak in Q1 2019. Argentina and Saudi Arabia join the MSCI EM. The global backdrop remains negative as Trump's economic nationalism enters a new phase.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.6	–	-3.55%
MSCI EM Small Cap	9.6	–	-3.43%
MSCI Frontier	8.8	–	-1.56%
MSCI Asia	11.5	–	-3.43%
Shanghai Composite	9.9	–	-1.91%
Hong Kong Hang Seng	7.6	–	-1.41%
MSCI EMEA	8.4	–	-1.61%
MSCI Latam	10.7	–	-4.80%
GBI-EM-GD	6.23%	–	-0.60%
ELMI+	6.56%	–	-0.64%
EM FX spot	–	–	-0.74%
EMBI GD	6.05%	364 bps	0.05%
EMBI GD IG	4.27%	183 bps	0.24%
EMBI GD HY	8.05%	567 bps	-0.13%
CEMBI BD	5.63%	333 bps	0.06%
CEMBI BD IG	4.33%	203 bps	0.20%
CEMBI BD Non-IG	7.44%	513 bps	-0.13%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.4	–	-0.69%
1-3yr UST	2.21%	–	0.14%
3-5yr UST	2.19%	–	0.30%
7-10yr UST	2.40%	–	0.52%
10yr+ UST	2.83%	–	0.87%
10yr+ Germany	-0.10%	–	1.05%
10yr+ Japan	-0.05%	–	0.15%
US HY	6.39%	393 bps	-0.07%
European HY	4.25%	457 bps	0.00%
Barclays Ag	1.76%	-64 bps	-0.11%
VIX Index*	15.96	–	-0.08%
DXY Index*	98.02	–	0.70%
EURUSD	1.1151	–	-0.63%
USDJPY	110.12	–	0.75%
CRY Index*	180.99	–	2.04%
Brent	73.1	–	4.09%
Gold spot	1276	–	-1.84%

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

Emerging Markets

While returns in Emerging Markets (EM) have been strong for the year as a whole, they have also been volatile. The volatility is due to shifting sentiment originating from outside the asset class, notably from Trump's trade war, spectacular U-turns by the Fed, US stock market volatility, European economic woes and Brexit.

While some individual EM economies face serious challenges, some of which can be made worse by the global jitters, these countries are few and far between. Their problems are idiosyncratic. Even so, many investors still gauge the health of the asset class as a whole based on the performance of a few weak countries and short-term movements in asset prices.

That is not to say that volatility should be ignored. Only the most complacent investors, such as the passive type, ignore short-term price volatility. It is always advisable to re-examine EM credit fundamentals closely whenever price volatility spikes. There are two reasons for doing so. First, global factors do sometimes adversely affect EM fundamentals, thus potentially justifying adjustment of exposure. Second, bouts of global risk aversion often create opportunities. After all, if all EM asset prices drop in response to risk aversion, but without corresponding changes in credit fundamentals in most countries, it makes sense to consider nibbling.

The best way to obtain a quick overview of the state of EM credits is to focus on its weakest link, namely corporate high yield bonds. Junk bond issuers sit at the most vulnerable end of the EM credit spectrum and they are typically the first companies to be cut off from financing during bouts of risk aversion. As such, they are an excellent barometer of overall EM credit health.

Given the current volatility in EM markets, it is therefore interesting to observe that EM junk bond issuers are in rude health. To see this, consider Figure 1, which shows default rates for EM and US high yield corporate issuers up to and including 30 April 2019, i.e. very recent data. In fact, the default rate for EM corporate high yield bonds is currently just 0.51%, which is seven times lower than the long-term average default rate of 3.5% (based on data going back to December 1999). The current EM junk bond default rate is less than half the default rate for US junk bonds (1.3%).

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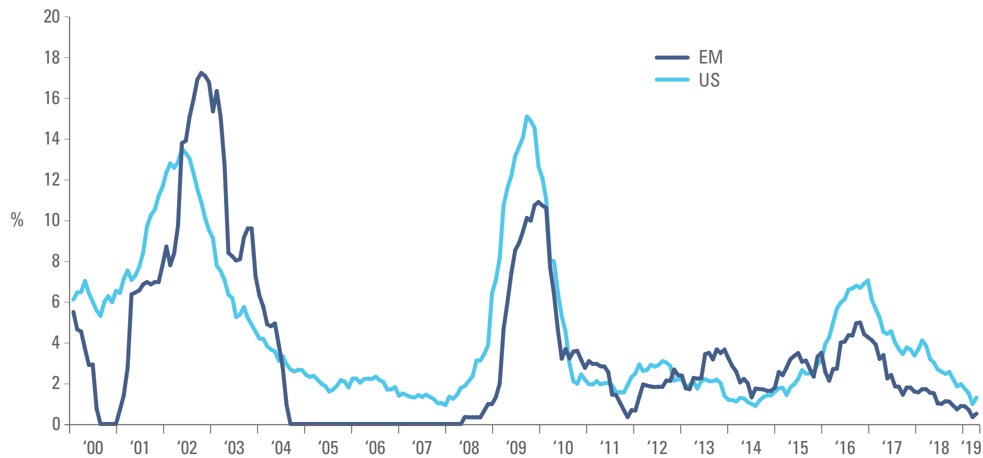
Emerging Markets

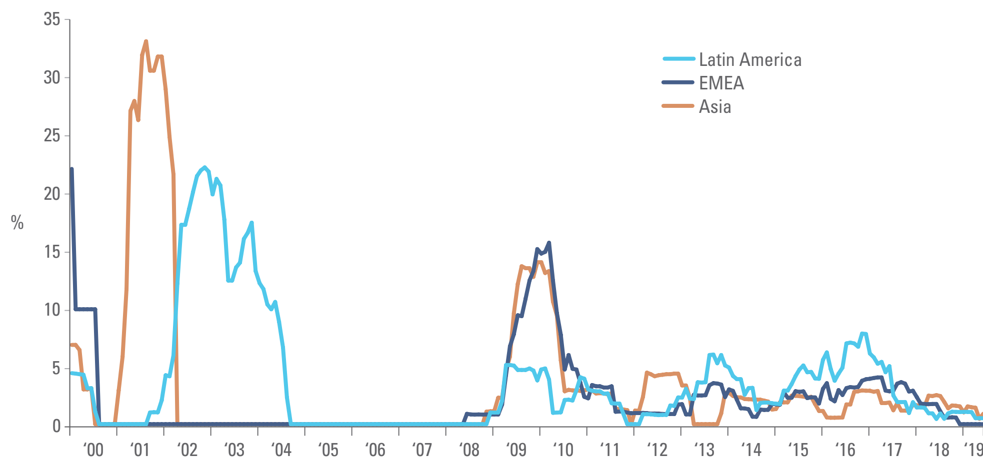
Fig 1: **EM versus US corporate high yield default rates**



Source: Ashmore, BAML, data as of 30 April 2019.

Credit strength in EM is broad-based. Figure 2 depicts EM corporate high yield default rates across the three major regions of EM, namely Latin America, Eastern Europe and Asia. Default rates in all three regions are running below default rates in the US high yield bond market. High yield corporates in Eastern Europe have not experienced a single default for the last six months.

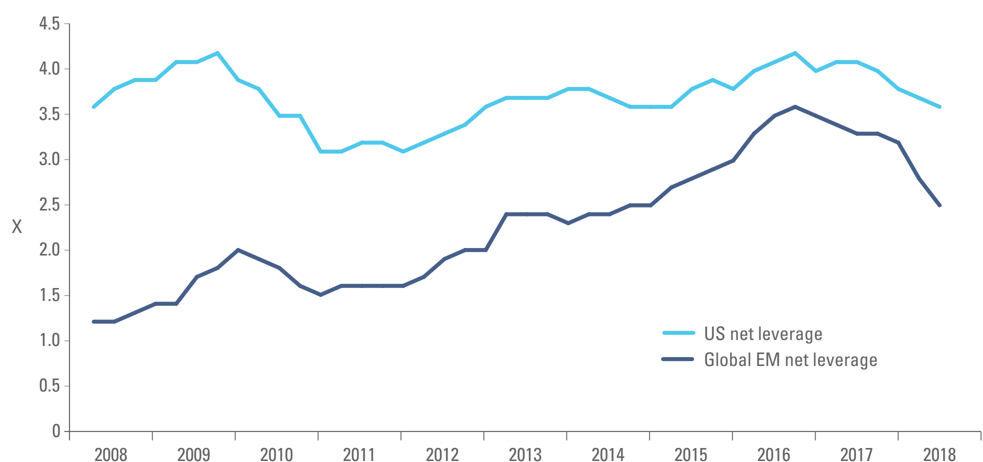
Fig 2: **EM corporate high yield default rates by region**



Source: Ashmore, BAML, data as of 30 April 2019.

Leverage ratios among EM corporates have also been declining (Figure 3). EM junk issuers' leverage is now just 2.5 times EBITDA, which is down 31% since the peak in 2016. By contrast, US high yield corporate leverage is higher (3.6 times EBITDA) and declining less quickly (13%).

Fig 3: **EM and US high yield corporate leverage (expressed in terms of EBITDA)**



Source: Ashmore, BAML, data as of 30 April 2019.

Emerging Markets

The strong EM credit metrics are particularly impressive given the serious headwinds faced by EM issuers in recent years, which include:

- A 50% rally in the Dollar;
- A halving of commodity prices;
- A third of foreign money invested in EM left between 2010 and 2015;
- Pricing in a full normalisation of US Fed policy;
- Two US-instigated trade wars with China.

If the most vulnerable part of the EM credit spectrum is showing such strength, it is reasonable to conclude that investment grade companies and sovereigns are even less encumbered. Investors should therefore consider putting money to work in the current period of price volatility. Developments in rich countries are clearly causing larger moves in EM asset prices than changes in EM fundamentals. Besides, yields for EM junk bonds are currently excessive. They are trading at levels, which have historically been associated with a terminal Fed funds rate of about 5.3%. The Fed is currently at 2.5% and few believe that the Fed will hike more than once or twice more in this hiking cycle.

- Ukraine: Local currency government bonds are due to start to settle via Clearstream on 27th May. The first government bond auction under the new settlement regime is due to take place on the following day. Local bonds have performed strongly in the past year, aided by a strong currency and very high yields. The latest Ukrainian inflation print was 8.8% yoy (April). At the most recent bond auction on 8th May this year, 3 month yields were 18.3% and the 6m yield was 18.4%. Yields at the five-year point of the curve are rough 16%. The currency has been broadly flat versus the Dollar over the past twelve months. Clearstream settlement should enable the government to approach JP Morgan with a proposal to include the bonds in the GBI EM GD, the main benchmark index for EM local currency government bonds. JP Morgan may or may not meet the request. JP Morgan only includes bonds if they meet the bank's subjective liquidity thresholds. In political news, a split in the Rada dealt a blow to newly elected President Volodymyr Zelensky, who may now find it hard to call an early parliamentary election to exploit his present popularity. Zelensky is due to be sworn in as President today.

- Venezuela: PDVSA, the Venezuelan national oil company, paid the coupon on the PDVSA 2020. This suggests that the company is concerned that failure to pay would have meant surrendering control of CITGO, a chain of petrol stations in the US, to bond holders. In other news, senior officials in the *de facto* government of Nicholas Maduro are meeting with the *de jure* government of Juan Guaido in Norway. Norway has frequently hosted negotiations to resolve intractable political conflicts.

- Brazil: Recent economic data has been extra-ordinarily weak, raising the prospect of a double-dip recession in Brazil this year. Consumers and investors appears to be putting spending decisions on hold pending approval of the pension reform. The timing could not be worse for President Jair Bolsonaro. Slower growth is likely to undermine the willingness of legislators to support the pension reform, which is certain to inflict pain on a significant and vocal segment of the labour force, namely public sector workers. Brazilians took to the streets last week in protest against spending cuts elsewhere in the public sector. The rising deficit in the pension system is to blame for spending cuts elsewhere, because a fiscal rule binds the government to operate within a set envelope of resources. It follows that the longer it takes the government to pass the pension reform the worse the economy gets. The main reason for slow progress on the pension reform is poor political coordination on the part of the far-right populist Bolsonaro Administration, which has been characterised by numerous flip-flops, attention to special interests and a general lack of focus. Still, we expect parliament to approve the pension bill in the third quarter of this year. The central bank left the policy rate unchanged at 6.5%.

- Argentina: Inflation is finally moderating. The yoy pace of inflation declined sharply to 3.4% mom in April from 4.7% mom in March. Core CPI inflation softened to 3.8% mom from 4.6% mom. The government recently intervened in the currency market, which informs most people's expectations of inflation. On the political front, former President Cristina Kirchner announced that she intends to run as vice-presidential candidate for Alberto Fernandez, a Peronist. The alliance is designed to broaden support within the Peronist Party. Alberto Fernandez is less populist than Cristina Kirchner, though far less attractive, from a market perspective, than the current Macri Administration. The election takes place on 27 October 2019. It is positive that Cristina will not be President. It is negative that the Peronists' chances of winning have now gone up.

- India: Exit polls indicate that Prime Minister Narendra Modi will emerge victorious in the Indian general election. Some polls even show that his majority may increase. If confirmed, this will be positive for three reasons. First, the Congress Party, which has campaigned on an extremely populist ticket, will not be in power. Second, the uncertainty surrounding the election will be over. Third, there is now a chance of renewed reform efforts, including capital market liberalisation and reform of public sector banks. In economic news, the trade deficit widened on strong imports in April, in addition to higher oil prices. Industrial production softened as did CPI inflation (2.9% yoy in April, below the expected inflation rate of 3.0% yoy). Core inflation hit 2.0% yoy, the lowest in the history of the series.

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Emerging Markets

- **Ecuador:** The government of President Lenin Moreno was able to maintain control of the National Assembly in legislative elections last week. This is very positive news, in our view. The government should now be able to forge ahead with more market-friendly reforms, including revenue-raising measures, which should enhance the government's ability to service debt.

- **Philippines:** Midterm elections can be a minefield for incumbents, but not in the Philippines. The Duterte Administration was strengthened in last week's election. Meanwhile, the central bank announced a reduction in the reserve ratio for banks of 200bps to 16% to be implemented in three stages between 31 May and 26 July this year.

- **Russia:** In a significant downside surprise relative to market expectations, Russian real GDP growth declined 0.5% on yoy basis in Q1 2019. High frequency indicators have been pointing to a significantly stronger number. For example, the fiscal surplus increased to 3.0% of GDP in April from 2.7% of GDP in March. Hence, revisions may be expected. The government will publish industrial output numbers this week, which may help throw some more light on the quality of the low GDP print.

- **Index news:** Saudi Arabian and Argentinian stocks will be included in the MSCI EM index from 28 May 2019, according to MSCI. The number of China A shares in the index will also go up.

Snippets:

- **China:** Property prices in China's 70 largest cities were up 10.4% yoy in April. The economy gave up some of the strong gains from last month as investment, retail sales and industrial production all came in softer than expected.
- **Colombia:** Construction took a hit in Q1 2019 to push the growth rate to 2.8% yoy, a bit below the consensus expectation of 3.0% yoy. However, other segments of domestic demand remained solid, including consumption (3.8% yoy). Imports were also strong.
- **Czech Republic:** Headline inflation declined to 2.8% yoy in April from 3.0% yoy in March.
- **Hungary:** Hungary's solid 5.3% yoy growth rate for Q1 2019, up from 5.1% yoy in Q4 2018 exemplified the general recent strength of economic data from Eastern Europe.
- **Indonesia:** Bank Indonesia left the policy rate on hold at 6.0%.
- **Israel:** Economic growth accelerated from 3.9% qoq annualised in Q1 2029 to 5.2% qoq annualised in Q2 2019.
- **Malaysia:** The economy racked up firm growth of 4.5% yoy in Q1 2019. This was ahead of expectations (4.3% yoy).
- **Mexico:** Banxico left the policy rate unchanged at 8.25% with a neutral bias. The government announced a USD 8bn syndicated loan to PEMEX, the national oil company.
- **Pakistan:** IMF officially announced a USD 6.0bn programme following lengthy discussions with the government. This is good news for bondholders, in our view.
- **Peru:** Growth rebounded in March. The real economy expanded at a yoy pace of 3.2%, well above February's pace (2.1% yoy).
- **Poland:** The central bank left the policy rate unchanged at 1.5%. Real GDP growth was strong in Q1 2019 (4.6%).
- **Romania:** The central bank left the policy rate unchanged at 2.5% in line with expectations. Industrial production was up 1.4% yoy in March. CPI inflation increased to 4.1% yoy in April from 4.0% yoy in March.
- **Singapore:** Non-oil domestic exports declined at a yoy pace of 10% in April, which was worse than expected (-4.6% yoy). However, exports were positive on a mom basis (4.0% mom), which could indicate that the hit from US President Donald Trump's trade war may be fading.
- **South Africa:** Retail sales disappointed in March, declining 0.7% mom.
- **South Korea:** The rate of unemployment was higher than expected in April (4.1%, sa).
- **Sri Lanka:** The IMF approved the fifth review of Sri Lanka's Extended Fund Facility.
- **Turkey:** The government imposed a tax on selected FX sales, which may indicate continuing pressure on the external balances. The strain on the balance of payments traces back to too-loose monetary policies. Industrial production rebounded. The current account deficit was USD 589m in March, which was lower than expected (USD 1.0bn).

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Ashmore

Global backdrop

The wave of US-instigated protectionism under US President Donald Trump moved to an entirely new phase last week, when Trump signed an executive order barring Huawei, a Chinese mobile phone and technology company, from selling products in the US and limiting access to certain parts from US suppliers. The executive order has implications, which extent far beyond Huawei itself. Huawei is an extremely successful company with a global footprint, including operations in Europe and in many EM economies. Hence, consumers in all countries, not just China and the US, will feel the consequences. While Huawei will obviously be hurt in the near-term, Trump's executive order will also have immediate negative implications for the many US companies, which currently supply nearly US 70bn of parts to the Chinese mobile phone giant. Finally, in the longer-term, US suppliers will lose influence overseas, because companies and governments in other countries will seek alternative providers in order to reduce their now evident excessive reliance on US suppliers.

This last point bears further elaboration: The Huawei case illustrates the danger posed when companies with near-global monopoly power, such as Google with its Android System, obey the edicts of an economic nationalist, such as Trump. The practice of using economic nationalism to champion large domestic companies at the expense of foreign companies formed the backbone of economic policy in Nazi Germany in the 1930s. It was also extremely widespread in Latin America in the 1950s and 1960s. In both cases, the policies failed, because they undermine competition, erode international trade and reduce consumer welfare. In general, it is not good economic policy to protect companies behind tariffs and non-tariff barriers. Rather than increase their fitness, it encourages said companies to spend resources on lobbying for continued protection instead of making productive investments. Protectionism thereby weakens companies and eventually countries. Recent European trade data shows that Europe is already benefitting significantly from diversion of Chinese trade from the US to Europe. European exports to China are up 11.1% yoy in April.

Meanwhile, US data continues to be mixed. Housing starts and housing sentiment rebounded, while initial claims for unemployment were lower than expected. The Philly Fed index improved. On the other hand, the two heavy weight indicators of last week, industrial production and retail sales, both fell well short of expectations, while factory orders softened.

The latest inflation print in the Eurozone provided further evidence of a mild economic upswing. CPI inflation in the Euro-area was 0.36% mom in April with core rising 0.4% mom. This translates into yoy inflation of roughly 1.7%. Euro-area GDP growth was also stronger than expected at 1.6% qoq (saar) due to strong domestic demand in Germany. Employment improved.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-7.58%	-5.61%	3.77%	-10.44%	10.50%	2.04%
MSCI EM Small Cap	-6.65%	-6.44%	0.82%	-15.97%	4.71%	0.34%
MSCI Frontier	0.17%	0.13%	7.04%	-7.38%	5.56%	-0.82%
MSCI Asia	-7.53%	-5.77%	5.01%	-10.62%	11.60%	4.67%
Shanghai Composite	-6.31%	-6.66%	15.69%	-6.38%	2.65%	9.76%
Hong Kong Hang Seng	-7.37%	-6.03%	5.62%	-9.54%	12.74%	5.42%
MSCI EMEA	-4.97%	-0.01%	5.58%	-5.47%	7.53%	-1.76%
MSCI Latam	-7.81%	-7.39%	-0.05%	-4.93%	8.94%	-2.89%
GBI EM GD	-0.80%	-0.97%	1.92%	-1.38%	3.31%	-1.52%
ELMI+	-1.02%	-0.94%	0.52%	-1.39%	2.45%	-1.08%
EM FX Spot	-1.06%	-1.27%	-1.02%	-6.57%	-2.57%	-7.40%
EMBI GD	0.03%	0.28%	7.25%	7.66%	5.13%	4.85%
EMBI GD IG	0.34%	0.92%	6.95%	9.49%	4.35%	4.30%
EMBI GD HY	-0.27%	-0.35%	7.63%	5.85%	6.03%	5.28%
CEMBI BD	0.28%	1.06%	6.27%	7.47%	5.26%	4.64%
CEMBI BD IG	0.49%	1.21%	6.04%	8.53%	4.21%	4.13%
CEMBI BD Non-IG	0.01%	0.86%	6.56%	6.15%	6.99%	5.30%

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Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-2.76%	1.17%	14.98%	7.24%	14.06%	11.01%
1-3yr UST	0.23%	0.43%	1.43%	3.42%	1.13%	1.01%
3-5yr UST	0.46%	0.55%	2.15%	5.51%	1.18%	1.67%
7-10yr UST	0.98%	0.55%	3.43%	8.98%	1.00%	2.65%
10yr+ UST	2.13%	0.30%	4.99%	11.42%	1.31%	4.59%
10yr+ Germany	1.94%	0.59%	6.05%	14.05%	2.86%	6.88%
10yr+ Japan	0.45%	-0.20%	3.10%	4.40%	0.37%	4.64%
US HY	-0.56%	0.85%	8.17%	6.08%	7.54%	4.60%
European HY	-0.93%	0.42%	6.07%	1.87%	4.63%	3.94%
Barclays Ag	0.37%	0.07%	2.27%	3.01%	1.23%	0.72%
VIX Index*	21.65%	16.41%	-37.21%	18.93%	5.00%	23.15%
DXY Index*	0.55%	0.75%	1.92%	4.68%	2.81%	22.46%
CRY Index*	-1.77%	-1.50%	6.59%	-11.14%	-1.75%	-41.03%
EURUSD	-0.58%	-0.59%	-2.77%	-5.43%	-0.65%	-18.61%
USDJPY	-1.17%	-0.66%	0.38%	-0.84%	-0.03%	8.67%
Brent	0.41%	6.89%	35.87%	-6.89%	50.04%	-33.36%
Gold spot	-0.59%	-1.26%	-0.50%	-1.29%	1.90%	-1.42%

*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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