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WEEKLY INVESTOR RESEARCH

Ashmore

Big countries, big themes

By Jan Dehn

EM has delivered excellent beta since the Fed began to hike rates some three and a half years ago. However, there are also very interesting country-specific narratives playing out in many EM countries. This Weekly examines the key themes focusing the minds of investors on a selection of the larger EM countries at this time.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	0.76%
MSCI EM Small Cap	10.2	–	-0.10%
MSCI Frontier	11.1	–	-0.16%
MSCI Asia	12.4	–	0.99%
Shanghai Composite	10.1	–	-0.08%
Hong Kong Hang Seng	7.9	–	1.16%
MSCI EMEA	9.1	–	1.29%
MSCI Latam	12.0	–	-0.90%
GBI-EM-GD	5.51%	–	1.01%
ELMI+	4.90%	–	0.27%
EM FX spot	–	–	0.31%
EMBI GD	5.49%	342 bps	0.48%
EMBI GD IG	3.85%	174 bps	0.25%
EMBI GD HY	7.45%	540 bps	0.72%
CEMBI BD	5.22%	327 bps	0.07%
CEMBI BD IG	3.92%	197 bps	0.28%
CEMBI BD Non-IG	7.05%	509 bps	-0.21%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.2	–	-1.21%
1-3yr UST	1.84%	–	0.09%
3-5yr UST	1.83%	–	0.22%
7-10yr UST	2.06%	–	0.47%
10yr+ UST	2.58%	–	0.99%
10yr+ Germany	-0.32%	–	1.70%
10yr+ Japan	-0.13%	–	0.26%
US HY	5.96%	384 bps	-0.15%
European HY	3.98%	425 bps	-0.31%
Barclays Ag	1.47%	-59 bps	0.45%
VIX Index*	14.45	–	2.06%
DXY Index*	97.22	–	0.29%
EURUSD	1.1216	–	-0.37%
USDJPY	107.95	–	0.04%
CRY Index*	178.59	–	-5.78%
Brent	63.4	–	-4.62%
Gold spot	1426	–	0.82%

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

Emerging Markets

Objectively, the fact that Emerging Markets (EM) bonds pay far higher yields than developed market (DM) bonds is a bit of a miracle. After all, investors are literally being paid more for taking exposure to countries with: (a) faster growth rates, (b) lower debt burdens, and (c) greater proclivity to undertake structural reforms. The attraction of EM bonds today is further enhanced by the fact that EM inflation is very low by historical standards and default rates for EM credit are far below long-term average. One of the reasons for this very fortunate constellation of facts is that many investors were sucked into selling rather than buying EM during the Quantitative Easing (QE) frenzy of the last decade. Positioning is therefore still very heavily skewed towards DM bonds, which offer very little or even negative yield. In short, EM beta has been strong and, judging by valuations and technicals, is likely to continue to be strong for some time (Figure 1).

Fig 1: **EM bonds versus DM bonds since Q1 2016**

	2016-2018	2019 YTD	Annualised since Q1 2016
Government bonds			
EM local currency bonds	**18.80%**	**10.57%**	**8.35%**
3-5yr UST	*3.56%*	*3.95%*	*2.13%*
EM external debt (USD)	**16.20%**	**12.13%**	**8.05%**
7-10yr UST	*4.13%*	*6.67%*	*3.07%*
Corporate high yield			
EM HY (USD)	**23.74%**	**13.00%**	**10.44%**
US HY	*22.23%*	*10.00%*	*9.16%*
EU HY	*8.21%*	*7.64%*	*4.51%*

Source: Ashmore, JP Morgan, Bloomberg. Data as at 22 July 2019.

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Emerging Markets

In addition to strong beta, EM also delights by offering great diversity. The main benchmark index for EM sovereign bonds now includes 73 countries and some of the most interesting macroeconomic stories are currently unfolding among EM's largest markets. Large EM issuers always exert a disproportionate influence on sentiment towards the asset class as a whole. While this focus on size is entirely irrational, it is undeniable that country-specific stories give rise to alpha opportunities, which, for the active manager, is an opportunity to deliver alpha over and above EM's already strong beta.[1] The following paragraphs summarise the main macroeconomic themes, which are currently focusing the minds of investors in EM's largest bond markets:

- Brazil: The approval of the pension reform is a key turning point in Brazil. Without the pension reform, Brazil's public finances would be moribund. With reform, a long and sustained cyclical upswing within a low-inflation context can commence, i.e. goldilocks. The years of weak demand mean that Brazil's currency is no longer overvalued, inflation is within the central bank's target range and there is money ready to be put to work. There is room for rates to come down and even space for some fiscal stimulus. The main risk in Brazil is political noise.

- Argentina: Remember this date: 27th October 2019. This is the day, when Argentina elects its next president. Rarely has so much been at stake. Argentina's electorate faces a stark choice between a better life in exchange for some upfront macroeconomic adjustment costs and the certainty of renewed crisis disguised within misleading populist rhetoric. If incumbent President Mauricio Macri is re-elected, the country may escape decades of absurd economic policies and finally begin to realise its enormous potential. On the other hand, if the populism associated with former President Cristina Kirchner and Peronism win Argentina will almost certainly face many more years of decline and crises. As Argentineans place their crosses on the ballot papers, investors must place their chips!

- India: For a recipe on how opportunities are created, look no further than Prime Minister Narendra Modi and India. Start by winning an election. Then, while your political capital is still intact, immediately do all the difficult stuff, such as fiscal retrenchment, restoration of central bank credibility, cutting red tape, tax reforms, and so on. Take the initial hit as the economy slows, but then enjoy a sustained recovery and cruise to a successful re-election with a full majority. Then repeat. This is where India is today. As the economy slows in the healthy post-election fiscal retrenchment, bond holders are rejoicing, but when the public finances and the economy are back to balance the opportunity will shift back to stocks and the private sector. India is showing everyone how it is done. By the way, as India prepares to become a large issuer of external debt, bond investors will now have a new way to express their views of the credit.

- China: The inclusion of Chinese bonds in the three main benchmark indices is the single most important change in the global financial landscape since the establishment of local bond markets in EM in the late 1990s and early 2000s. Over the next few years, index inclusion alone should drive some half a trillion Dollars of foreign capital into China's domestic bond market. Other factors will also support the Chinese bond market, including continuing attention to structural reforms (see Snippets section) and gradual appreciation of CNY as the Dollar loses strength after years of only getting stronger. By 2050, China will be two to three times larger than the US and China's markets will be, by far, the largest and most liquid in the world. This means, in our opinion that soon everyone will be benchmarking against CNY, Chinese government bonds and the Shanghai Composite.

- Russia: In Russia, bond investors face two massive cross-currents. On one hand, from a pure value perspective, Russian bonds are awesome. Investors are paid more than 7% yield for taking exposure to low inflation, a floating currency, no capital controls, low debt, solid external balances, a large stock of FX reserves, tight fiscal policies and a solid monetary policy framework overseen by the most capable central banker in the world, Elvira Nabiullina. What is not to like? On the other hand, President Putin appears to have something on President Trump, so the US Congress continues to ramp up sanctions against Russia, making Russian bonds ever more difficult to trade in size. What weight should you, the investor, assign to the declining liquidity versus the solid returns on offer in Russia?

- Turkey: Active managers require some bad credit stories or expensive markets to underweight if they wish to overweight EM's many good stories. The fact that Turkey is doing so badly is therefore not necessarily a bad thing, seen from the wider perspective. Economically illiterate, Turkey's government has been running terrible economic policies for years with excessive intervention in monetary policy a particular concern. The government has also neglected to develop the domestic market, so savings rates are low and the country relies far too much on fickle foreign capital. The non-stop emphasis on demand stimulus has created large macroeconomic imbalances, but the government only attacks the symptoms of imbalance, not the causes. Hence, as the economic outlook worsens investors and businesses are defending themselves by taking their wealth overseas, reducing investment and pursuing other hedging strategies. Now blaming investors for the economic slump, the government is clamping down on the private sector. Expect capital controls, nationalisations, forced conversion of contracts to lira from EUR, etc. Eventually the government will run out of financing, out of growth and out of future. The end game is a crisis. Turkey could U-turn at any time, but will President Erdogan change? U-turning has very big upfront political costs. The longer Erdogan delays, the bigger the cost. The contrast between Turkey and India could not be greater.

[1] In general, the key to successful investing is to identify markets, where prices have moved out of line with risks. This is unrelated to country size per se. Each EM market, regardless of size, can offer good or bad value. .

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Emerging Markets

- **Indonesia:** Joko Widodo (aka Jokowi) was recently re-elected as President of Indonesia, giving him a second term of five years. This is very good news. Like Modi in India, Jokowi is wasting no time. In a speech earlier this month, he pledged a return to economic reforms with promises of lower corporate taxes, an easing of stringent labour laws and lifting of curbs on foreign ownership. His reform package also includes measures to improve the skill base of the workforce, reducing red tape, broadening the revenue base and expanding infrastructure. Even if he is not able to deliver everything he promises, Jokowi has already proved that he can be trusted. He knows good policies from bad polices and there should be no doubt whatsoever about the broad direction of travel. As it happens, Indonesia also has some of the highest yields in the world. Not a bad combination.

- **South Africa:** Let there be no doubt. President Cyril Ramaphosa faces an uphill battle over the next few years. The ANC, his party, is deeply divided and corruption is widespread. The reform backlog after the years lost under Zuma's presidency is enormous. Slow growth and big quasi-fiscal challenges in ESKOM, the national energy company, weigh heavily on sentiment. As if that was not enough, South Africa continues to struggle with the legacy of Apartheid in almost all areas of society. Still, under Ramaphosa, South Africa has a better chance of moving forward than in many years – and is likely to do so, albeit slowly. With a solid economic team and strong key institutions, notably the Judiciary and the Central Bank, the likelihood of major downside surprises from a policy perspective is very low. The biggest risks, in our view, are political.

- **Saudi Arabia:** As the flows associated with Tadawul's inclusion into the main MSCI EM index slowly decelerate, the drivers of Saudi markets will shift from technicals to fundamentals. Relations with Qatar look set to improve as the World Cup draws nearer, the retail sector is being reformed along with other segments of Saudi society and a major pickup in public investment is about to spur forward the domestic economy. Saudi Arabia was able to dull the pain from lower oil prices by increasing borrowing from a low base, so bond markets already play a larger role than they have done for many years.

- **Mexico:** Mexico's biggest liability used to be its biggest asset: proximity to the United States. Under President Donald Trump, who has been labelled racist by Congress due to his frequent expressions of hostility towards people from Latin America, the United States has already inflicted two major macroeconomic shocks on Mexico in the shape of the dissolution of NAFTA and tariffs to discourage the flow of Central American migrants through Mexico to the United States.[2] Mexico's own president, Andres Manuel Lopez Obrador aka AMLO, has also struggled to establish trust with investors, partly due to his failure to place PEMEX, the heavily indebted state-owned oil company, on a sound financial footing. Investors have always loved to punish Mexico, because it is easy do to so. After all, Mexico's markets are super liquid and the country is strongly committed to open capital markets. In general, we think the risks associated with AMLO per se are overstated. On the other hand, the risks of rising corruption and gradually weaker governance are probably understated. The most under-appreciated risk of all is, even now, Mexico's close association with the US. Hence, the only thing we feel very strongly about when it comes to investing in Mexico at this time is that it will not be boring: active management can deliver rich pickings.

In other news:

Argentina: Disinflation has arrived. Headline inflation dropped to 2.7% mom in June, down from 3.1% mom in May, 3.4% mom in April and 4.7% mom in March. Core inflation also declined sharply from 3.2% mom in May to 2.7% mom in June. Confidence in the government increased for the third consecutive month, according to the Di Tella index.

China: The government announced further measures to open the economy to foreign investment. Among a broad range of new initiatives, foreign rating agencies will now be able to rate bonds in the Chinese interbank market, while foreign investors will be able to establish wealth management firms in China. Foreign asset managers are also given greater access to managing Chinese pensions and taking greater stakes in Chinese companies, especially in the insurance sector. Foreign companies will also be permitted to become lead underwriters.

Mexico: The government's commercial plan for PEMEX failed to convince anyone that the company's fortunes will improve. Basically, PEMEX will continue to be run as an inefficient job creation agency with a bit of oil business on the side. This has two costs: an indirect quasi-fiscal burden for the government and an opportunity cost in terms of inadequate oil sector development.

India: CPI inflation increased marginally to 3.2% yoy in June from 3.0% yoy in May. The Reserve Bank of India's target is 4%. Industrial Production growth slowed to 3.1% yoy in May versus a market consensus expectation of 3.2% yoy. The trade deficit was stable at USD 15.3bn in June.

South Africa: President Ramaphosa has called for a judicial review of charges that he misled parliament over campaign donations. The charges were brought by the anti-corruption ombudsman, who was appointed by former president Jacob Zuma, who is widely regarded as very corrupt. In other news, the central bank cut the policy rate by 25bps to 6.5% with a neutral accompanying statement.

South Korea: The Bank of Korea cut the policy rate by 25bps to 1.5%. Per day exports declined at a yoy rate of 15.6% in the first twenty days of July, which was slightly better than last month (-16.2% yoy). On a sequential basis, exports now appear to be stabilising.

[2] See: https://www.politico.com/story/2019/07/16/house-democrats-trump-resolution-1416782

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Snippets:

- **Chile:** The Central Bank left the policy rate unchanged at 2.5%, but signalled future cuts.
- **Croatia:** CPI inflation eased to 0.6% yoy in June from 0.9% yoy in May.
- **Ghana:** The central bank left the policy rate unchanged at 16%.
- **Hong Kong:** Protests continue.
- **Indonesia:** Bank Indonesia cut the policy rate by 25bps to 5.75%.
- **Pakistan:** The central bank hiked the policy rate by 1% to 13.25%.
- **Poland:** After very strong performance for some time, industrial production slumped at a rate of -2.7% yoy in June. This follows 7.7% yoy growth in May.
- **Russia:** Industrial production and retail sales both beat expectations in June by rising 3.3% yoy and 1.4% yoy. June CPI inflation declined to the middle of the central bank's target range (4.5% yoy).
- **Singapore:** Non-oil domestic exports plunged at a yoy rate of 17.3% yoy in June in response to a return to trade hostilities between the US and the rest of the world in May.
- **Slovenia:** Fitch upgraded Slovenia's credit rating from A- to A with stable outlook.
- **Thailand:** The trade surplus expanded to USD 3.2bn in June from USD 0.2bn in May. Imports declined more than exports to bring about the big surplus.
- **Turkey:** The Central Bank indicated that rate cuts are coming.
- **Ukraine:** President Volodomyr Zelensky won a large share of the seats in the Rada at the weekend. This puts Zelensky in a strong position to reform Ukraine's corrupt institutions. The National Bank of Ukraine cut the policy rate by 50bps to 17%.
- **Venezuela:** EU threatens further sanctions on the government in Caracas in a bid to encourage negotiations with the opposition.

Global backdrop

Strong retail sales suggest that the US is not in recession, but this could easily change. The next US recession is likely to start with a whimper rather than a bang. Here is how it might unfold. After raising rates for three and half years, the Fed is now widely expected to start the cutting cycle later this month. As the Fed cuts rates into slower growth and the yield curve flattens, net interest margins for US banks will decline. As banks become less profitable, they restrict lending to US companies. At the margin, this reduces investment and restricts refinancing for the most vulnerable companies. Default rates then slowly start to rise, which may easily prompt investors in the popular leveraged loan market and high yield investors to become more worried about risk-adjusted returns. Some may even take profits, starting to offload securities. In the illiquid loans market, selling can easily produce ugly price action. As prices gap lower, more selling ensues, which in turn feeds back to banks, which further restrict lending. In aggregate, this creates a slump in investment, which then begins to show up in labour markets and undermines consumption. In our view, the next recession is likely to evolve along the lines of a conventional recession rather than some extravagant variety of the Sub-prime Crisis. The real difference from previous recessions, however, is that policy-makers are now very poorly equipped to counter the recession. The Fed can only cut 250bps, the fiscal powder has already been expended in an inefficient tax cut for the rich and QE will not have the same effect at the start of a recession and at the current valuations for US stocks. These discussions about a lower Dollar are not merely the children of an idle brain…

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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	0.69%	0.69%	11.46%	2.57%	9.71%	2.67%
MSCI EM Small Cap	0.70%	0.70%	7.53%	-3.15%	4.95%	0.69%
MSCI Frontier	2.31%	2.31%	14.38%	4.87%	8.77%	-0.78%
MSCI Asia	0.55%	0.55%	11.36%	1.31%	10.44%	4.95%
Shanghai Composite	-1.07%	-1.07%	19.67%	8.05%	1.00%	9.56%
Hong Kong Hang Seng	0.97%	0.97%	11.13%	7.51%	10.74%	4.71%
MSCI EMEA	1.27%	1.27%	14.83%	8.81%	7.95%	-0.56%
MSCI Latam	2.59%	2.59%	15.76%	16.83%	10.29%	-0.75%
GBI EM GD	1.70%	1.70%	10.57%	10.52%	4.83%	-0.18%
ELMI+	0.29%	0.29%	3.87%	4.28%	3.07%	-0.45%
EM FX Spot	0.41%	0.41%	2.14%	-0.76%	-1.93%	-6.69%
EMBI GD	0.73%	0.73%	12.13%	10.99%	5.07%	5.35%
EMBI GD IG	0.37%	0.37%	11.39%	11.16%	4.36%	4.93%
EMBI GD HY	1.11%	1.11%	13.00%	10.90%	5.87%	5.47%
CEMBI BD	0.47%	0.47%	9.35%	9.80%	5.26%	4.90%
CEMBI BD IG	0.55%	0.55%	9.25%	10.16%	4.40%	4.49%
CEMBI BD Non-IG	0.37%	0.37%	9.45%	9.34%	6.68%	5.37%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	1.29%	1.29%	20.06%	8.30%	13.47%	10.75%
1-3yr UST	-0.03%	-0.03%	2.44%	3.95%	1.33%	1.22%
3-5yr UST	-0.14%	-0.14%	3.95%	6.22%	1.46%	2.06%
7-10yr UST	-0.25%	-0.25%	6.67%	9.60%	1.35%	3.16%
10yr+ UST	-0.73%	-0.73%	10.18%	11.01%	0.98%	5.33%
10yr+ Germany	-0.02%	-0.02%	10.67%	12.93%	2.67%	7.13%
10yr+ Japan	-0.07%	-0.07%	5.36%	5.36%	0.33%	4.87%
US HY	0.06%	0.06%	10.00%	6.91%	6.54%	4.84%
European HY	0.05%	0.05%	7.64%	3.58%	4.45%	4.10%
Barclays Ag	-0.18%	-0.18%	5.37%	5.90%	1.83%	1.20%
VIX Index*	-4.18%	-4.18%	-43.15%	12.36%	20.22%	18.06%
DXY Index*	1.14%	1.14%	1.09%	2.91%	-0.25%	20.35%
CRY Index*	-1.35%	-1.35%	5.17%	-7.29%	-2.36%	-39.94%
EURUSD	-1.34%	-1.34%	-2.21%	-4.07%	2.18%	-16.71%
USDJPY	0.06%	0.06%	-1.60%	-3.04%	1.85%	6.40%
Brent	-4.72%	-4.72%	17.86%	-13.22%	38.78%	-40.92%
Gold spot	1.15%	1.15%	11.17%	16.43%	7.81%	9.13%

*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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