Issued: 12 August 2019

WEEKLY INVESTOR RESEARCH

Ashmore

Volatility likely to remain high during the summer

By Gustavo Medeiros

US naming China a currency manipulator doesn't change anything, but is a symbol of the White House's political interference in key institutions. Venezuelan assets frozen while full-blown economic sanctions are announced. President Macri suffers heavy defeat in Argentinian primaries ahead of 27 October general election. Oil sell-off versus higher gold prices, point to further hedging against negative rates and recession. Volatility is likely to increase further as tensions between asset pricing and economic and monetary policy divergences abound.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.0	–	-2.20%
MSCI EM Small Cap	9.9	–	-1.31%
MSCI Frontier	11.5	–	-0.56%
MSCI Asia	11.7	–	-2.69%
Shanghai Composite	9.9	–	-3.22%
Hong Kong Hang Seng	7.5	–	-3.43%
MSCI EMEA	8.6	–	-2.79%
MSCI Latam	11.7	–	0.24%
GBI-EM-GD	5.34%	–	0.48%
ELMI+	5.71%	–	-0.38%
EM FX spot	–	–	-0.39%
EMBI GD	5.24%	347 bps	0.79%
EMBI GD IG	3.59%	179 bps	1.32%
EMBI GD HY	7.30%	557 bps	0.22%
CEMBI BD	5.11%	344 bps	0.15%
CEMBI BD IG	3.74%	208 bps	0.44%
CEMBI BD Non-IG	7.05%	537 bps	-0.25%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.0	–	-0.40%
1-3yr UST	1.61%	–	0.20%
3-5yr UST	1.53%	–	0.43%
7-10yr UST	1.70%	–	0.95%
10yr+ UST	2.21%	–	2.83%
10yr+ Germany	-0.59%	–	1.52%
10yr+ Japan	-0.22%	–	1.44%
US HY	6.07%	415 bps	-0.31%
European HY	3.97%	447 bps	-0.15%
Barclays Ag	1.31%	-39 bps	0.82%
VIX Index*	18.85	–	-5.74%
DXY Index*	97.71	–	0.18%
EURUSD	1.1170	–	-0.29%
USDJPY	105.29	–	0.63%
CRY Index*	172.09	–	-1.26%
Brent	58.1	–	-2.81%
Gold spot	1497	–	2.30%

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

Emerging Markets

The US Treasury named China a currency manipulator for the first time since 1994. That is a largely symbolic and politically motivated move as China doesn't even meet the US Treasury criteria for manipulation under the Trade and Facilitation and Trade Enforcement Act of 2015.

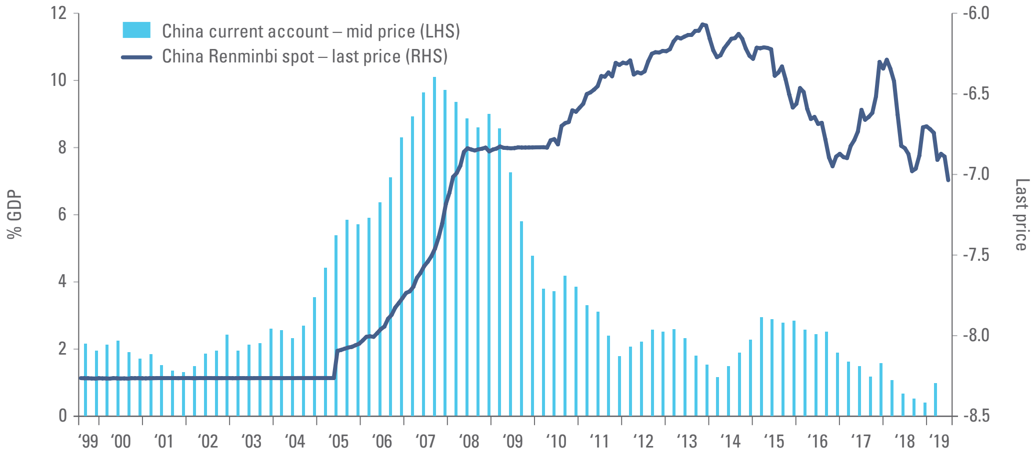
We don't believe it is in Beijing's interest to let their currency devalue significantly, unless a strong increase in international tariffs forces a natural macroeconomic adjustment. Instead, Beijing will seek to contain Yuan volatility. The country's long term strategy is clear. China is long behind the industrialisation phase that demanded a weaker currency to boost competitiveness in the 1990s. Instead, it is now focused on cutting edge technology and exporting its infrastructure machine via the Belt & Road initiative. Cutting edge technology requires abundant capital and highly skilled labour. Both forms of capital (financial and human) tend to sail in pursuit of stable harbours to lay anchor.

China has committed to a strong and stable RMB policy for over a decade. The PBoC allowed the RMB to strengthen from 7.50 to 6.05 between Sep-2007 and Jan-2014. At the same time, its Current Account surplus dwindled from a peak of 10.1% GDP to 1.1% GDP. Since then, the surplus has never exceeded 3.0% GDP. Last Tuesday the PBoC intervened to strengthen the RMB by fixing the Yuan below the psychological 7.00 mark and selling CNH 30bn (USD 4.2bn) of bills in Hong Kong in order to drain liquidity and increase the cost of shorting the Renminbi. Over the next days, the currency oscillated slightly above the 7 mark, showing that there is no line in the sand and that volatility is the primary source of concern, rather than a directional path.

On the other hand, the US leadership has been primarily engaged in the 2020 campaign. The different political time horizons these countries operate hands China an advantage on strategic matters.

Emerging Markets

Fig 1: **China current account balance & RMB**



Source: Bloomberg, Ashmore.

Snippets:

- Argentina: President Macri suffered a heavy defeat in the Obligatory Primaries (PASO). The Primaries are conducted across the nation to determine the candidate for each party, effectively becoming a universal poll across the country with no margin for error ahead of the national ballot on 27th October. With 80.4% of the votes counted, Alberto Fernandez had 47.4% against 32.3% for Mauricio Macri. Former Finance Minister Lavagna got 8.4% of the votes. Alberto Fernandes is running with Cristina Kirchner as his Vice President under a broad Peronist coalition. The president's 'Cambiemos' coalition suffered defeats in important provinces with the current governor of Buenos Aires Eugenia Vidal trailing Axel Kicillof, the former finance minister under Cristina Kirchner, by 17%. Any candidate who receives more than 40% of votes and keeps a larger than 10% margin against the runner-up, is declared winner in the first round.

- Brazil: The Brazilian senate has enough votes to approve the pension reform voted by the Congress. The lower house will focus its attention on tax reform – a difficult matter where the consensus is still to be formed. It will be a good test for Brazil's congress which has detached itself from executive political noises to approve the pension plan reform.

- Venezuela: Trump expanded US sanctions against Venezuela to include a total economic embargo and asset freeze, putting the country on a par with North Korea, Iran, Syria and Cuba. Such embargo failed to achieve regime change in all the countries above. The Financial Times reported Russian oil company Rostneft to be the single source of refined petroleum in the country.

- Mexico: inflation decelerated to 3.8% in July from 4.0% in June. Core inflation was unchanged at 3.8%. The Mexican economy underperformed its potential in H1-19, barely avoiding a recession, due to domestic factors, with poor confidence playing a large role. The Mexican central bank is to cut its policy rate from a very high 8.25% level as inflation expectations remain anchored below 4.0%.

- Peru: the central bank cut its policy rate by 25bps to 2.5%, surprising 2/3 of analysts according to Bloomberg surveys.

- Turkey: the brain purge at the Central Bank continues with nine high ranked officials, including chief economist Hakan Kara removed from their positions. The clean-up came one week after president Erdogan criticised the Central Bank for cutting interest rates by 'only' 4.25% to 19.75%. Inflation has been declining due to a stabilisation of the Lira, base effects and poor economic growth. Technical market positioning may keep the currency stable as local bonds will adjust for a deeper cut. However, the undermining of the central authority will prevent a much-needed convergence of inflation expectations at lower levels. The economic slowdown and currency depreciation pushed the country to record its first trade surplus since 2002.

- Egypt: received the latest USD 2bn tranche of its USD 12bn IMF loan. The programme has successfully rebalanced the country's core finance and external accounts by reducing subsidies on energy and fuel. Tight monetary policy was required to stabilise inflation, keeping borrowing costs on local markets high. The central bank of Egypt is likely to cut interest rates by as much as 300bps over the coming quarters, allowing borrowing costs to decline. The country's main challenge is to resist the temptation of going back to the 'easy' path of overspending. Maintaining a primary surplus of at least 2% GDP will allow the country's debt to decline towards more sustainable levels.

- China: Chinese trade surprised on the upside in July in spite of sluggish global growth. Exports increased by 3.3% across major destinations except the US. Imports also improved from previous months, led by iron-ore and coal. FX reserves rose by USD 11bn in July

Continued overleaf

Global backdrop

Asset price volatility has increased across asset classes and is likely to remain high. There is no shortage of concerning developments suggesting a volatile summer: Global economic data continues to deteriorate. Last week, industrial production in Germany declined by 5.2% YoY in June, in China, PPI declined to 0.3% deflation in July and UK GDP growth was negative on Q2-19, at -0.2% QoQ. Trade data across Asia suggests trade war supply shock disruptions are not behind us yet. Not only is the direct impact on tariffs being felt, but the confidence channel is also being hit by the uncertainty at play. This dynamic makes this process hard to reverse without a significant commitment and actions for a de-escalation of trade tensions. Global trade also faces the increased probability of a hard Brexit scenario on 31 October. International policy dysfunction is also a manifestation itself of increased Geopolitical risks. North Korea is again testing nuclear bombs, Iran seized a third oil tanker in the Persian Gulf, tensions are rising in Kashmir and the US decided to walk away from a historical non-proliferation of nuclear weapons deal with Russia.

Against this background, central banks from India, New Zealand and Thailand surprised on the dovish side, cutting interest rates by a larger degree than expected. That contrasts with US Federal Reserve Governor Jay Powell guiding the market for a shallower easing cycle than priced, (inter-cycle correction rather than the beginning of an easing cycle). So far, the market has ignored its guidance and moved to price in five 25bps cuts over the next 12 months. It is the expectation of further easing which keeps market prices at highs while the global economy's motors sputter. Oil prices declined by 2.1% while gold prices rose by 3.9%, as investors seek protection against a recessionary period bringing interest rates even lower. This tension between US policy maker guidance and market pricing is likely to keep volatility high during the summer.

Investors should consider higher volatility as an opportunity to allocate capital to Emerging Markets assets at compelling valuations. External Debt high yield assets trade at attractive 553 basis points spread over US Treasuries and any further sell-off would bring them to value territory.[1] Local bonds and equities are already in value territory, given the strong US Dollar and have larger upside potential.[2]

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-5.32%	-6.41%	3.64%	-6.37%	5.76%	1.51%
MSCI EM Small Cap	-3.91%	-5.28%	1.15%	-10.88%	1.57%	-0.19%
MSCI Frontier	-0.63%	1.89%	13.91%	4.17%	8.74%	-0.87%
MSCI Asia	-5.67%	-7.28%	2.74%	-8.28%	6.34%	3.24%
Shanghai Composite	-5.34%	-5.96%	13.75%	1.78%	-0.61%	7.03%
Hong Kong Hang Seng	-6.38%	-7.51%	1.81%	-5.99%	6.33%	2.13%
MSCI EMEA	-6.40%	-6.86%	5.61%	-1.18%	3.43%	-1.41%
MSCI Latam	-2.65%	-2.52%	9.99%	7.86%	7.08%	-1.00%
GBI EM GD	-1.12%	-0.20%	8.50%	8.81%	3.33%	-0.12%
ELMI+	-1.67%	-1.66%	1.85%	2.03%	1.97%	-0.64%
EM FX Spot	-2.04%	-2.49%	-0.81%	-3.29%	-3.41%	-6.95%
EMBI GD	0.74%	1.96%	13.49%	12.83%	5.17%	5.84%
EMBI GD IG	1.85%	2.75%	14.03%	14.29%	4.90%	5.56%
EMBI GD HY	-0.45%	1.11%	12.99%	11.37%	5.50%	5.87%
CEMBI BD	0.27%	1.16%	10.10%	10.57%	5.21%	5.20%
CEMBI BD IG	0.79%	1.65%	10.45%	11.08%	4.56%	4.75%
CEMBI BD Non-IG	-0.44%	0.50%	9.59%	9.86%	6.30%	5.80%

[1] See *'The case for EM external debt'*, The Emerging View, 23 May 2019.
[2] See *'The case for EM local currency debt'*, The Emerging View, 23 July 2019.

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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	-2.00%	-0.59%	17.84%	4.37%	12.42%	10.84%
1-3yr UST	0.53%	0.42%	2.90%	4.36%	1.48%	1.29%
3-5yr UST	1.12%	0.84%	4.97%	7.35%	1.76%	2.20%
7-10yr UST	2.30%	2.19%	9.28%	12.83%	2.14%	3.55%
10yr+ UST	5.48%	5.65%	17.25%	20.26%	3.01%	6.42%
10yr+ Germany	3.01%	5.41%	16.68%	19.68%	4.10%	7.78%
10yr+ Japan	1.85%	2.24%	7.80%	10.23%	2.11%	5.25%
US HY	-0.64%	-0.08%	9.86%	5.81%	6.20%	4.97%
European HY	-0.31%	0.31%	7.92%	3.30%	4.09%	4.39%
Barclays Ag	1.43%	1.14%	6.78%	7.49%	1.85%	1.50%
VIX Index*	16.94%	25.00%	-25.85%	43.24%	63.20%	33.40%
DXY Index*	-0.82%	1.64%	1.59%	1.40%	2.07%	19.88%
CRY Index*	-3.60%	-4.94%	1.35%	-10.23%	-5.80%	-41.02%
EURUSD	0.85%	-1.78%	-2.59%	-2.10%	0.07%	-16.45%
USDJPY	3.31%	2.43%	4.18%	5.14%	-3.79%	-2.88%
Brent	-10.80%	-12.65%	8.05%	-20.16%	23.76%	-43.57%
Gold spot	5.92%	6.23%	16.76%	25.46%	12.08%	14.35%

*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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