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Ashmore

Lower US yields make EM spreads attractive

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A record of USD 16trn of developed market bonds – equivalent to 18% of total outstanding developed market fixed income – have now moved into negative yield territory, including USD 1trn of corporate bonds. The manufacturing recession is the cause of the US Treasury yield curve inversion as expectations of weaker growth drive interest rates to record lows. Value investors should move into bonds with better risk-reward metrics. The rally in Treasuries has so far not been matched by a rally in Emerging Markets (EM) dollar-denominated bonds. EM bonds trade with nearly 50bps wider spread than just a few weeks ago. In local markets, most EM central banks still have room to cut interest rates, which we think could be highly supportive of growth. If recession fears further adversely impact US equities, the Dollar will ultimately be the casualty, further enhancing the attractiveness of EM local bonds.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	-1.03%
MSCI EM Small Cap	9.7	–	-2.14%
MSCI Frontier	9.5	–	-0.36%
MSCI Asia	11.8	–	0.07%
Shanghai Composite	10.1	–	1.81%
Hong Kong Hang Seng	7.6	–	-0.30%
MSCI EMEA	8.3	–	-2.84%
MSCI Latam	11.4	–	-5.39%
GBI-EM-GD	5.30%	–	-0.48%
ELMI+	5.82%	–	-0.73%
EM FX spot	–	–	-0.79%
EMBI GD	5.34%	377 bps	-0.67%
EMBI GD IG	3.48%	188 bps	1.05%
EMBI GD HY	7.75%	621 bps	-2.53%
CEMBI BD	5.13%	363 bps	-0.28%
CEMBI BD IG	3.63%	213 bps	0.58%
CEMBI BD Non-IG	7.30%	580 bps	-1.48%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.8	–	-0.94%
1-3yr UST	1.50%	–	0.29%
3-5yr UST	1.44%	–	0.57%
7-10yr UST	1.57%	–	1.37%
10yr+ UST	2.06%	–	4.28%
10yr+ Germany	-0.68%	–	2.14%
10yr+ Japan	-0.23%	–	0.43%
US HY	6.14%	437 bps	-0.17%
European HY	4.06%	464 bps	-0.30%
Barclays Ag	1.21%	-36 bps	0.53%
VIX Index*	18.47	–	0.50%
DXY Index*	98.17	–	0.79%
EURUSD	1.1092	–	-1.09%
USDJPY	106.39	–	1.04%
CRY Index*	170.41	–	-1.69%
Brent	59.3	–	1.30%
Gold spot	1509	–	-0.18%

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

Emerging Markets

- **Argentina:** Last week, President Mauricio Macri responded to his primary election defeat by announcing a freeze of fuel prices for 90 days, a reduction in payroll taxes and an increase in the minimum salary. He also replaced the Finance Minister. It remains to be seen if these measures will have any impact on the outcome of the presidential election scheduled for 27th October. On current projections, Macri will lose to opposition candidate Alberto Fernandez. In interviews over the weekend, Fernandez pledged not to default on Argentina's sovereign debt, but requested a re-design of the IMF programme in order to help boost growth and ease the immediate repayment burden. The new Minister of Finance, Hernan Lucanza, was formerly at the central bank and has also been finance minister for the Province of Buenos Aires. He is closely associated with some Peronists, including Sergio Massa. His main task will now be to meet with the IMF, which is due to arrive in Buenos Aires in the coming week, unless the meeting is postponed due to the current political turmoil. Indeed, a number of economic advisers to Fernandez are already signalling the importance of restoring investor confidence, but asset prices in Argentina could remain volatile until the election is over and the new economic policies and policy makers are known. Two credit rating agencies, Fitch and Standard & Poor's, lowered Argentina's credit rating last week. Fitch cut its credit rating from B to CCC, while Standard & Poor's lowered the rating to B- from B. It is not uncommon for ratings agencies to be reactive, which is why investors should generally not act in accordance with their decisions.

- **China:** In a sign that China is not letting short-term challenges to the growth and trade fronts get in the way of its long-term objectives, the People's Bank of China (PBOC) announced an important step forward in the reform program pertaining to interest rates. The Loan Prime Rate, which is the weighted average rate of interest charged on loans by major banks to their strongest clients, will now be based on the PBOC's open

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Emerging Markets

market operations rates instead of the PBOC's policy rate. Since the former trades about 1% lower than the latter, it follows that corporates in China can now expect lower interest rates, which should boost economic activity. Interest rate liberalisation is a critical element in China's reform process, because interest rates will increasingly be used to control consumption as China moves towards more domestic demand-led growth. In other news, US President Donald Trump announced a delay on new higher tariffs on approximately USD 155bn of consumer goods imported from China until 15th December as well as removal of some products from the list of goods targeted for new tariffs. Trump's change of heart likely reflects the fact that tariffs are hurting US growth. Tariffs are trade taxes paid by Americans, thus undermine US real income and economic activity. In China, the economic data continues to be weak. Retail sales expanded only at a yoy rate of 7.6%, while industrial production slowed to a yoy rate of 4.8% from 6.6% in June. China is likely to ease monetary policy further in order to contain the impact of US trade aggression. Meanwhile, protests in Hong Kong persisted as expected and USDCNY oscillated around 7.00.

- **Ukraine:** Ukraine's economy expanded at a yoy rate of 4.6% in Q2 2019, up from 2.5% yoy in Q1 2019 and higher than the consensus expectation of 2.7% yoy. The Ukrainian economy is benefiting from positive sentiment following President Volodymyr Zelensky's recent landslide election victory and his pledge to reform the political system and the public finances.

- **Egypt:** Rosneft reported that production of gas in the Zohr gas field has more than tripled from 3.1bn cubic meters in H1 2018 to 11.3bn cubic meters in H1 2019. The increase in gas production has helped to balance Egypt's external accounts. The rate of unemployment declined to 7.5% in Q2 2019 from 8.1% in Q1 2019. Inflation also declined to 8.7% in July, a four year low.

- **Guatemala:** Conservative Alejandro Giammattei was elected President, defeating leftist candidate Sandra Torres. Giammattai announced austere fiscal policies and his intention to renegotiate an agreement with the US, which would turn Guatemala into a buffer zone for migrants heading to the US from Central America.

Snippets:

- **Brazil:** The central bank announced that it will sell some Dollars from its very substantial stock of FX reserves to moderate volatility in the currency. Brazil has about USD 389bn of FX reserves.
- **Colombia:** Q2 2019 real GDP growth accelerated to a rate of 3.0% yoy in Q2 2019 from 2.8% yoy in Q1 2019, thereby also beating expectations (2.9% yoy). The stronger than expected growth rate was due to strong domestic demand and investment.
- **Hungary:** Real GDP growth slowed moderately to 4.9% yoy in Q2 2019 from 5.3% yoy in Q1 2019.
- **Poland:** Real GDP slowed marginally to 4.4% yoy in Q2 2019 from 4.7% yoy in Q1 2019. Eastern European countries continue to grow much faster than Western European economies.
- **Russia:** GDP expanded at a yoy rate of 0.9% in Q2 2019, which is better than 0.5% in Q1 2019. The improvement in growth was led by a pickup in mining and manufacturing activity. The government reported a fiscal surplus of RUB 2trn in June due to an increase in non-oil revenues.
- **South Korea:** The rate of unemployment was unchanged at 4.0% in June, in line with expectations. This means that the South Korean service sector is successfully absorbing the labour being shed in the manufacturing sector.
- **Thailand:** The pace of real GDP growth was 2.3% yoy in Q2 2019, in line with expectations. Domestic demand was strong, while exports detracted from growth.

Global backdrop

The immediate cause of the decline in US bond yields is the manufacturing recession caused by US President Donald Trump's trade war. The deeper causes include slowing productivity growth, rising debt levels and the gradual erosion of fiscal and monetary fire power by governments. The decline in market interest rates has now pushed a record USD 16trn of developed market bonds into negative territory, including some USD 1trn of corporate assets. This is equivalent to roughly 18% of all outstanding fixed income in developed countries.

Value investors should exploit the dramatic decline in developed market bond yields to move into bonds with better risk-reward metrics in EM. The rally in Treasuries has so far not been matched by an equivalent rally in EM dollar-denominated bonds. Spreads are now nearly 50bps wider than just a few weeks ago. In local markets, most EM central banks still have room to cut interest rates, which in our view would be highly supportive of growth. If recession fears further adversely impact US equities, the Dollar will ultimately be the casualty, further enhancing the attractiveness of EM local bonds.

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Global backdrop

Talking about US recession, last week's inversion of the US Treasury yield curve, which saw the 3-month Treasury bill trade at 2.15% versus the 10-year Treasury bond yield of 1.55%, represents a clear warning about recession. Granted, the US economy is still not in recession, because consumption remains healthy, but it is clear that the policies of the current US government are harming the economy at a very late stage in the business cycle. The main concern arising from recession is deflation. Deflation would increase the real value of the debt stock, which already exceeds 105% of GDP. Fortunately, US inflation is still positive. CPI inflation was running at a yoy rate of 1.8% in July, while core CPI inflation was running at 2.2% yoy. Hence, there is still some way until deflation sets in.

Germany's real GDP growth was negative in Q2 2019 due to weak manufacturing activity, which in turn is due mainly to US trade policies. The trade war is exposing serious weaknesses in developed economies which cannot be fixed by monetary policies. Fiscal policy will therefore become even more important going forward, but debt levels in many developed countries are already far too high. Fortunately, Germany represents an important exception. Germany has plenty of room to increase fiscal spending. It is therefore encouraging that German Finance Minister Olaf Scholz signalled last week that a fiscal expansion is now possible as part of a wider program to fight climate change. Sensibly, Germany usually ties boosts in fiscal spending to specific structural reform objectives.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-6.29%	-7.38%	2.57%	-2.19%	4.77%	0.73%
MSCI EM Small Cap	-5.97%	-7.30%	-1.01%	-8.78%	0.45%	-1.04%
MSCI Frontier	-0.99%	1.52%	13.50%	6.42%	8.41%	-0.68%
MSCI Asia	-5.60%	-7.22%	2.81%	-3.61%	5.76%	2.72%
Shanghai Composite	-3.63%	-4.26%	15.81%	7.01%	-0.94%	7.10%
Hong Kong Hang Seng	-6.66%	-7.78%	1.51%	-1.44%	4.72%	1.57%
MSCI EMEA	-9.05%	-9.50%	2.61%	3.72%	2.06%	-2.48%
MSCI Latam	-7.89%	-7.77%	4.07%	6.66%	4.53%	-2.66%
GBI EM GD	-1.59%	-0.68%	7.99%	11.97%	2.74%	-0.42%
ELMI+	-2.39%	-2.38%	1.11%	2.98%	1.40%	-0.91%
EM FX Spot	-2.82%	-3.26%	-1.59%	-1.82%	-3.95%	-7.19%
EMBI GD	0.06%	1.28%	12.74%	13.00%	4.65%	5.46%
EMBI GD IG	2.92%	3.83%	15.23%	15.50%	4.97%	5.51%
EMBI GD HY	-2.97%	-1.45%	10.13%	10.39%	4.31%	5.14%
CEMBI BD	-0.02%	0.88%	9.79%	10.95%	4.90%	4.98%
CEMBI BD IG	1.37%	2.24%	11.10%	11.79%	4.57%	4.74%
CEMBI BD Non-IG	-1.91%	-0.99%	7.98%	9.68%	5.54%	5.28%

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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	-2.92%	-1.52%	16.73%	3.77%	12.10%	10.35%
1-3yr UST	0.83%	0.71%	3.20%	4.55%	1.59%	1.33%
3-5yr UST	1.69%	1.41%	5.56%	7.67%	2.00%	2.25%
7-10yr UST	3.70%	3.60%	10.78%	13.74%	2.69%	3.68%
10yr+ UST	9.99%	10.17%	22.26%	24.20%	4.71%	6.96%
10yr+ Germany	5.21%	7.67%	19.18%	20.94%	5.11%	7.94%
10yr+ Japan	2.29%	2.69%	8.26%	10.55%	1.98%	5.34%
US HY	-0.81%	-0.25%	9.67%	5.78%	5.93%	4.71%
European HY	-0.61%	0.01%	7.59%	3.24%	3.82%	4.13%
Barclays Ag	1.96%	1.67%	7.34%	8.42%	1.82%	1.54%
VIX Index*	14.58%	22.48%	-27.34%	46.12%	62.87%	51.27%
DXY Index*	-0.35%	2.12%	2.07%	2.15%	3.87%	19.89%
CRY Index*	-4.55%	-5.87%	0.36%	-9.71%	-9.73%	-40.63%
EURUSD	0.15%	-2.43%	-3.29%	-3.40%	-2.07%	-16.73%
USDJPY	-2.19%	-1.39%	-3.02%	-3.34%	6.17%	3.37%
Brent	-8.96%	-10.85%	10.28%	-17.40%	16.61%	-41.58%
Gold spot	6.69%	7.03%	17.63%	26.71%	12.47%	16.43%

*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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