Three stories from around the world

By Jan Dehn

This week we will present three stories from around the world: we start in Argentina, where markets have reacted to the Argentinian government's debt re-profiling proposals with conventional scepticism; we think bonds already offer value. Next, we take a trip back in time to 1919, when Irish poet W. B Yeats penned 'The Second Coming'. As global politics deteriorates, investors face the same conflict between the heart and the mind as Yeats did a hundred years ago. Finally, we ask how EM might react to a US recession. The question is gaining importance as the US yield curve inverts…

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.3	–	1.16%
MSCI EM Small Cap	10.5	–	0.70%
MSCI Frontier	9.4	–	-0.96%
MSCI Asia	12.1	–	0.62%
Shanghai Composite	10.3	–	-0.37%
Hong Kong Hang Seng	7.6	–	-0.89%
MSCI EMEA	9.1	–	0.52%
MSCI Latam	11.4	–	2.78%
GBI-EM-GD	5.26%	–	-0.70%
ELMI+	5.98%	–	-0.64%
EM FX spot	–	–	-0.88%
EMBI GD	5.16%	363 bps	0.51%
EMBI GD IG	3.35%	179 bps	1.16%
EMBI GD HY	7.57%	607 bps	-0.22%
CEMBI BD	5.14%	367 bps	-0.06%
CEMBI BD IG	3.56%	209 bps	0.40%
CEMBI BD Non-IG	7.44%	597 bps	-0.72%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.1	–	2.84%
1-3yr UST	1.51%	–	0.02%
3-5yr UST	1.39%	–	0.09%
7-10yr UST	1.50%	–	0.16%
10yr+ UST	1.96%	–	0.79%
10yr+ Germany	-0.69%	–	1.44%
10yr+ Japan	-0.26%	–	0.96%
US HY	5.73%	394 bps	0.49%
European HY	3.78%	421 bps	0.39%
Barclays Ag	1.18%	-32 bps	0.06%
VIX Index*	18.98	–	-0.89%
DXY Index*	98.87	–	0.79%
EURUSD	1.0984	–	-1.05%
USDJPY	106.26	–	0.12%
CRY Index*	170.36	–	1.75%
Brent	59.2	–	0.83%
Gold spot	1521	–	-0.38%

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

Opportunity re-emerges in Argentina

Over the course of the last five days, the Macri Administration announced a series of measures designed to alleviate pressing Dollar shortages. The centre-piece of the new measures was a maturity extension on t-bills and short-term Dollar-denominated local law debt. The securities will not suffer haircuts, so all payments and all principal will be paid eventually. Together with the disbursement by the IMF of the next USD 5.4bn tranche in mid-September, the new measures should enable the government to meet all its financing requirements for 2019. As such, they sharply reduce the risk that Argentina's ongoing liquidity crisis morphing into a genuine solvency crisis. Over the weekend, the odds that Argentina runs out of foreign currency reserves declined further as the government imposed a number of controls on the FX market, including accelerated sales of export proceeds, restrictions on access to Dollars, stricter scrutiny over the use of foreign exchange, etc. The IMF has issued public support for the capital controls. In addition, last week the Standard & Poor's rating agency downgraded the sovereign credit rating from B- to selective default in response to the maturity extension of t-bills, then immediately upgraded the rating to CCC-. The two other main ratings agencies did not react.

In addition to the immediate maturity extension of very short-dated debt, the government also announced a debt re-profiling of 1-3 year local law debt, which will require parliamentary approval. To this end, we expect a bill to be presented to parliament and approved prior to 27 October. Given that approval would require Peronist support, we think passage would be a strong and clear signal that the Fernandez team agrees with the measures, which have also been vetted by the IMF.

The government announced an invitation for voluntary maturity extension for global bonds (foreign law Dollar bonds) maturing over 2021-2023. There would be no haircut. The bonds have collective action clauses (CACs) in the bond indentures, which reduces the risk of holdouts and hence makes a quick deal possible. The appetite for extending maturity all boils down to the price of the bonds. At the current depressed prices (last Friday the

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2021 bond closed at a price of 42.5), markets clearly price in a very high perceived risk of imminent default. In this context, even a modest maturity extension could reduce the perceived default risk sharply, which would push up prices significantly. This upside has to be set against increased risks associated with a longer duration. However, at the current wide spreads for Argentinian debt, the relatively small moves in the US Treasury market should not be a major concern. In short, investors could have strong incentives to participate in a voluntary maturity extension at these prices, though perversely investors could also sell now to drive prices even lower in the hope of an even better entry point.

The government says it wants to convert the IMF Standby Agreement into an Extended Fund Facility (EFF). Alberto Fernandez has also said he wants to implement the same measures if he becomes president. Under an EFF, the main elements of the current IMF reform program could be maintained, but with more lenient repayment terms, enabling Argentina, which has already undergone significant adjustment under the Standby Agreement, to stage a genuine economic recovery within a relative short period after Fernandez takes office. The prospect of realising significant economic upside during the second half of his term in office (leading up to the next election in 2023) provides Fernandez with a powerful incentive to stick to the basic IMF program parameters. The analogy here is former Brazilian President Lula, who was able to enjoy the fruits of the reforms undertaken by his predecessor, Fernando Henrique Cardoso. We expect the IMF to issue a positive assessment of the economic performance in Q2 2019, which should pave the way for a disbursement of the USD 5.4bn tranche around 10 September.

Two other risks remain. The market still does not know the policy preferences of a future Alberto Fernandez Administration. Also, it is not yet clear if the IMF will demand a haircut from bond holders if Argentina restructures its obligations to the IMF, and, if so, whether such a haircut would be greater than what has already been announced. We expect the Fernandez team to refrain from commenting extensively in public as the presidential election campaign enters the final intense stages, so investors should continue to expect significant volatility in the run up to 27 October. For more details, please see our *'Argentina Q&A'* and '*The path to averting a default in Argentina'*.

- Bottom-line: Policies, fundamentals and especially asset prices have moved significantly in the last few weeks. Investors should focus on the core investment case. We view the maturity extension and capital controls announced by Macri as positive for the government's ability to service debt and we believe that the current much lower prices for bonds make for an attractive investment case, including much higher yields and potential for capital gains. Argentina is not insolvent, rather the country faces a severe liquidity shortage. Liquidity shortages could still push the country into insolvency, especially since Argentina does not have a large, well-functioning domestic bond market, but this risk is now significantly reduced, in our view.

Developed market politics: tension between heart and mind

In 1919, the Irish poet William Butler Yeats wrote *'The Second Coming'*.
The famous poem opens with the following lines:

Turning and turning in the widening gyre
The falcon cannot hear the falconer;
Things fall apart; the centre cannot hold;
Mere anarchy is loosed upon the world,
The blood-dimmed tide is loosed, and everywhere
The ceremony of innocence is drowned;
The best lack all conviction, while the worst
Are full of passionate intensity.

Written in the interlude between the disaster of World War I and the trauma of the Irish War of Independence, Yeats' poem expresses fear of an increasingly unhinged world. The poem was visionary; the subsequent years from 1919 to the mid-1930s witnessed the rise of Nationalism, which eventually led to the displacement of democratic governments in favour of dictatorships in large parts of the developed world, which in turn ushered in the Second World War and then, for decades afterwards, the Cold War.

The rise of Nationalism was a disaster for the global economy and for peace. The founding principle of Nationalism, whether right-leaning or left-leaning, is that the political process is a zero-sum game. This places

[1] See: *'Argentina Q&A'*, The Emerging View, 23 August 2019 and *'The path to averting a default in Argentina'*, Market Commentary, 14 August 2019.

Nationalist ideology in direct contradiction to the ideologies behind both Democracy and free market capitalism, which rest on the idea that conflicts can be resolved by freely entered-into compromises.

Nationalists' zero-sum perspective of politics leads them to reject notions of mutually advantageous cooperation in favour of confrontation. The more extreme the Nationalism, the more confrontational the politics. The hyper-Nationalist governments of the mid-1930s – Italian Fascism, German Nazism, Russian Communism among others – extended the principle of confrontation into all spheres of life ranging from domestic politics, through economic policies to international relations. These regimes sought the total destruction of their enemies. Literally.

There are worrying parallels between the rise of Nationalism in the first half of the 20th Century and what is happening today, almost exactly one hundred years later. Post-Cold War consensus-seeking politics has already given way to a new political dynamic, whereby confrontation, scape-goating and identity-shaming has displaced reason, substance and the search for consensus across competing interests.

The early victims of this transformation of politics include international agreements, free trade and respect for institutions, which used to form the bedrock upon which rested the peace and prosperity of the last three decades. Today, many politicians appear to perceive greater benefit from sowing division among and fear within others by dismantling institutions than by seeking to build for the future. The new politics is therefore, almost by definition, populist and profoundly myopic.

The deterioration in global politics would be less worrisome if the economic backdrop was strong and improving. However, it is worsening, especially in developed economies. Despite the easiest fiscal and monetary policies in modern times, developed economies are stagnating. Policy-makers have few, if any, tools to arrest and reverse the decline. Almost all the problems are structural in nature. Populist and myopic politicians are unlikely to re-engage in proper economic reform, however, so there are no strong grounds for optimism about growth. Making matters worse, financial markets in developed economies are also precariously over-priced after years of highly distortionary monetary policies and regulatory excess.

The cocktail of rising nationalism, weakening fundamentals and overpriced financial markets is potentially explosive. A simple spark could trigger a chain reaction, which could place the world onto a dramatically worse trajectory, perhaps not unlike what happened in the 1930s, when the best lacked all conviction and the worst were full of passionate intensity. The most likely trigger would be a major stock market crash in the US, triggered by a US recession.

Granted, the US is not the weakest economy in the developed world, but risk is measured as the probability of outcomes times the associated cost. So even if a US downturn is less probable than, say, a downturn in a European country, the US, when it goes down, will inflict far greater pain because of the enormous exposure to the US, both institutional and financial. Over the past seventy years, the US has sponsored global institutions, but the Trump Administration are now busy tearing those down. Investors the world over are extremely heavily committed due to the enormous rallies in US stocks and the Dollar in recent years on the back of Quantitative Easing and massive fiscal largesse. When the US economy finally does nose dive, which it will at some point, the impact on markets and sentiment will be profound.

The big unknown is how America's political leaders and leaders in other countries will react to a big stock market crash and the protracted recession. If current politics is anything to go by, we are heading for very dark place. It is therefore prudent for investors to not ignore political risk in developed economies. Which takes us back to Yeats. In 1919, Yeats was deeply torn. In his heart, as reflected in *'The Second Coming'*, one clearly discerns Yeats' sense of foreboding that things are about to fall apart. Yet, we also know that Yeats was a fervent authoritarian Nationalist, who developed strong sympathies for Italian dictator Benito Mussolini, so, intellectually, he may have welcomed the rise of Nationalism. Yeats never lived to experience the final bitter harvest of Nationalism. He died in January 1939. He did not see the utter calamity of World War II. He never witnessed the decades of wasteful Cold War conflict. Yeats' heart was sending all the right signals, while his brain was all wrong. He did not have the benefit of hindsight. We have no such excuse.

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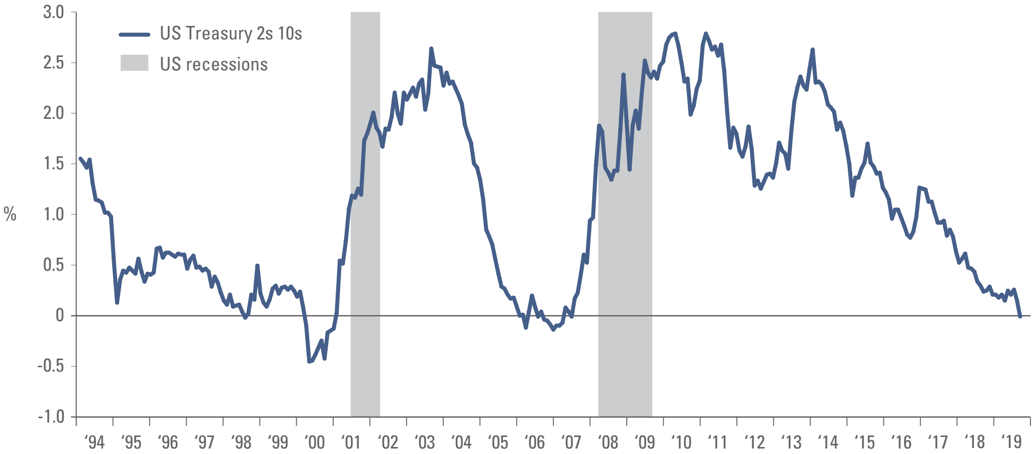
How will EM react to US recession?

The warnings signs of a US recession are clear for all to see. US stocks have delivered negative return over the past twelve months. US real GDP growth has halved over the same period. Most telling, the US yield curve has now inverted, which is a strong signal of impending recession (Figure 1). Moreover, there is every reason to believe that US productivity growth will decline further in the coming years as US fiscal deficits look set to continue to rise.[2] Hence, the next recession will almost certainly last longer than previous ones.

Fig 1: **US Treasuries (2s10s) and US recessions**



Source: Ashmore, Bloomberg. Data as at 31 August 2019.

How will recession come about? Think whimper, not bang. We see progressively lower yields hurting bank earnings leading to gradually tighter bank lending. Roll-over risks for corporate high yield bonds slowly pick up, which in turn begins to push up default rates. Leveraged loan investors redeem. Investment in the real economy comes to a halt. As layoffs begin to rise so consumption starts to slow. The only notably difference between the coming recession and conventional ones is that the US economy is dramatically more leveraged, less productive, has less policy room. Hence, it will take far longer to recover.[3]

We believe that Emerging Markets (EM), always the canary in the coal mine, has already begun to price in concerns about US recession as reflected in recent setbacks for EM stocks and local markets and strong outperformance of Treasury-sensitive external debt. Another sign of growing unease is that investors over-react to idiosyncratic stories, say Argentina or China. Market reticence is not just the normal summer lull and profit-taking after strong performance in June.

How will EM react when the US recession finally kicks in in earnest? The day US stocks really tank, EM assets will almost certainly display the same kneejerk negative reaction as always. Markets will also push commodity currencies lower, high yield spreads wider, increase the demand for US Treasuries and push up prices for gold, Swiss Franc and Japanese yen, because they are all the same emotional trade. This early stage of the recession is best exploited by doing exactly the opposite as the market, as we have illustrated countless times.[4]

Beyond trading against the initial kneejerk price action, investors should absolutely aim to remain invested in EM bonds during the US recession itself, because EM bonds have paid investors roughly twice as much as 10 year US Treasury bonds during recessions. Figure 2 details the annualised returns in EM bonds during the last two recessions. Indeed, it is quite possible that EM investors will do better in the coming recession than in past one, because US politics, valuations and fundamentals, policy room, all look worse today than in the past. A lot of the bull market money is sitting in US stocks and the Dollar and will have to leave. We expect US stocks and the Dollar both to decline, potentially by a very large amount.

Fig 2: **Annualised returns (in USD terms) during EM recessions**[5]

US recession	External debt	Local currency	Corporate high yield
2001	12%	–	–
2008/2009	7%	7%	8%

Source: Bloomberg, JP Morgan.

[2] See: *'The blind spot'*, Weekly investor research, 27 August 2019.

[3] Ibid.

[4] See: *'Picking up where we left off'*, Weekly investor research, 8 January 2018.

[5] There have been two US recessions in the lifetime of the EMBI GD (External Sovereign Debt Index). There has been one recession during the shorter lifetimes of the GBI EM GD (Local Currency Government Bonds Index). The results in Figure 2 measure returns from the quarter prior to the recession to the quarter after the recession is over..

By contrast, positioning in EM is light. Only about forty per cent of the money, which left EM during the Taper Tantrum has returned so far. Valuations in EM reflect this fact; EM bond yield are currently consistent with a Fed funds rate in excess of 4.1%, based on where EM bonds have traded in past Fed hiking cycles. This is mainly the result of inadequate buying, i.e. light exposure. EM currencies actually rallied outright versus the Dollar in H2 2018, when US stocks corrected sharply lower.

Fundamentally speaking, EM will also be a safer place to be, in our opinion. While developed economies have not been tested at all in the past decade of hyper-easy money, EM economies have very much had to prove their mettle. EM had to withstand massive capital flight in the Taper Tantrum, priced in a full normalisation of US monetary policy by time of the first Fed hike in December 2015, and survived the halving of commodity prices in 2014 and financed through a 50% Dollar rally since 2010. Prior to that, EM fundamentals had held up well in the synchronised depression-like slump of US and Europe in 2008/2009, despite a complete capital stop. Today, many EM governments have room to engage in fiscal stimulus and have room to cut rates. They control some 76% of the world's FX reserves, which can, if required, be pooled to support vulnerable nations as happened with the Chiang Mai Initiative in 2008/2009.

As mentioned above, we expect the US recovery from recession to be a slow affair. The Trump Administration has already blown its fiscal power on a massive, highly ineffective and extremely poorly timed stimulus in December 2017 and has since lost control of the House of Representatives, so obtaining political support for fresh fiscal stimulus is now more challenging. On the monetary side, the Fed can only cut rates by 225bps, which is about half of what has traditionally been required in order to extricate the US economy from recession over the past fifty years. Quantitative Easing (QE) will therefore have to stage a comeback, but without the same effect as in the past. In a contracting US economy with outright falling company earnings and a very high starting point for asset prices, which means that QE will not trigger the same stock market euphoria as it did in 2010 and beyond. Rather, QE may weaken the Dollar as Abenomics weakened the JPY in Japan. Indeed, the Trump Administration may well intervene to weaken the Dollar as well as engage in financial repression, say, by forcing US pension funds to buy more bonds.[6]

In short, when the dust settles the next US recession will deliver lower stocks, lower bond yields and a lower Dollar, in our opinion. This constellation, we believe, strongly favours exposure to:

- EM fixed income over stocks (due to the sharp fall in US stocks)
- Government bonds over corporate bonds (due to the risks associated with US high yield)
- Local currency bonds over Dollar bonds (due to the falling Dollar)
- EM equities over US equities (due to stronger EM domestic demand)

The tricky bit for investors to get their head around is the contrast between the initial pull-back in EM assets and the subsequent post-panic environment, which strongly favours EM. It is therefore critical that investors see through all the steps. The biggest risk is never the initial volatility. Rather, it is the failure to ruthlessly exploit this entry point as a gateway for the subsequent bull market.

[6] For a discussion of how the US government can influence the Dollar, see: *'From trade war to currency thaw?,* Weekly investor research, 15 July 2019.

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Ashmore

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-4.85%	-5.95%	4.15%	-4.01%	6.14%	0.77%
MSCI EM Small Cap	-4.95%	-6.30%	0.05%	-10.10%	1.37%	-1.17%
MSCI Frontier	-1.59%	0.90%	12.81%	7.90%	8.65%	-0.78%
MSCI Asia	-4.35%	-5.99%	4.17%	-6.08%	6.60%	2.92%
Shanghai Composite	-1.46%	-2.11%	18.41%	8.54%	0.05%	7.66%
Hong Kong Hang Seng	-5.35%	-6.49%	2.93%	-3.79%	5.82%	2.11%
MSCI EMEA	-7.31%	-7.77%	4.57%	2.29%	5.10%	-2.06%
MSCI Latam	-8.12%	-7.99%	3.81%	9.25%	5.96%	-3.78%
GBI EM GD	-2.64%	-1.74%	6.83%	11.92%	3.42%	-0.69%
ELMI+	-3.20%	-3.19%	0.27%	2.58%	1.70%	-1.05%
EM FX Spot	-3.80%	-4.24%	-2.59%	-1.79%	-3.45%	-7.31%
EMBI GD	0.75%	1.97%	13.50%	13.77%	4.91%	5.45%
EMBI GD IG	4.16%	5.07%	16.61%	16.15%	5.47%	5.53%
EMBI GD HY	-2.87%	-1.35%	10.24%	11.23%	4.33%	5.17%
CEMBI BD	0.13%	1.02%	9.95%	10.94%	4.89%	4.89%
CEMBI BD IG	1.96%	2.84%	11.74%	12.09%	4.73%	4.73%
CEMBI BD Non-IG	-2.39%	-1.47%	7.45%	9.19%	5.27%	5.08%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-1.58%	-0.17%	18.34%	2.92%	12.71%	10.09%
1-3yr UST	0.82%	0.70%	3.19%	4.42%	1.61%	1.34%
3-5yr UST	1.79%	1.51%	5.66%	7.65%	2.09%	2.31%
7-10yr UST	3.97%	3.86%	11.06%	13.72%	2.81%	3.74%
10yr+ UST	10.50%	10.68%	22.83%	24.19%	4.54%	6.87%
10yr+ Germany	5.53%	7.99%	19.53%	21.79%	5.08%	7.69%
10yr+ Japan	2.99%	3.39%	9.01%	11.35%	2.54%	5.39%
US HY	0.40%	0.97%	11.00%	6.56%	6.18%	4.85%
European HY	0.75%	1.37%	9.06%	4.56%	4.10%	4.24%
Barclays Ag	2.03%	1.75%	7.42%	7.77%	2.12%	1.62%
VIX Index*	0.00%	25.86%	-25.33%	47.59%	58.43%	54.94%
DXY Index*	-0.05%	2.85%	2.80%	3.92%	3.16%	19.13%
CRY Index*	0.00%	-5.90%	0.33%	-11.71%	-5.35%	-41.11%
EURUSD	-0.07%	-3.38%	-4.23%	-5.47%	-1.53%	-16.36%
USDJPY	-0.02%	-1.51%	-3.14%	-4.34%	2.23%	1.11%
Brent	-2.05%	-11.06%	10.02%	-23.55%	26.39%	-41.01%
Gold spot	0.07%	7.94%	18.63%	26.68%	14.82%	20.23%

*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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