Investing for alpha in EM fixed income over the full cycle

By Jan Dehn

Alpha in EM investments comes from multiple sources across the full investment cycle. High yield contributes alpha in normal market conditions, price inefficiencies produce opportunities during shocks and higher than expected recovery values result in potential outperformance from distress situations. It is three strikes, but not quite out in South Africa. AMLO sticks to a prudent fiscal script in Mexico. South Korea's economy shows signs of stabilisation. Ukraine moves to break up Naftogaz. The US House of Representatives approve Turkey sanctions. China gives more detail on opening its economy amidst mounting China phobia in the West. Peru's Vizcarra looks to exploit a suspension of parliament to implement a series of economic reforms using special decrees. In the global backdrop, the US slows further, UK heads to the polls and the economic data stabilises in the European Union.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	1.30%
MSCI EM Small Cap	11.1	–	0.98%
MSCI Frontier	9.3	–	0.71%
MSCI Asia	12.7	–	1.84%
Shanghai Composite	10.7	–	0.11%
Hong Kong Hang Seng	8.0	–	1.49%
MSCI EMEA	9.3	–	-0.20%
MSCI Latam	13.0	–	1.08%
GBI-EM-GD	5.12%	–	0.18%
ELMI+	5.07%	–	0.24%
EM FX spot	–	–	0.21%
EMBI GD	5.06%	331 bps	0.20%
EMBI GD IG	3.54%	175 bps	0.24%
EMBI GD HY	7.14%	541 bps	0.15%
CEMBI BD	5.03%	337 bps	0.15%
CEMBI BD IG	3.66%	200 bps	0.18%
CEMBI BD Non-IG	7.00%	534 bps	0.12%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.9	–	1.49%
1-3yr UST	1.58%	–	0.15%
3-5yr UST	1.58%	–	0.32%
7-10yr UST	1.75%	–	0.60%
10yr+ UST	2.23%	–	1.45%
10yr+ Germany	-0.36%	–	0.02%
10yr+ Japan	-0.18%	–	0.84%
US HY	5.64%	385 bps	-0.13%
European HY	3.90%	432 bps	0.07%
Barclays Ag	1.36%	-39 bps	0.58%
VIX Index*	12.30	–	-0.35%
DXY Index*	97.18	–	-0.58%
EURUSD	1.1172	–	0.65%
USDJPY	108.31	–	-0.60%
CRY Index*	180.27	–	1.91%
Brent	61.5	–	-0.15%
Gold spot	1512	–	1.34%

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

Emerging Markets

- **Alpha generation in EM fixed income:** Alpha sources in Emerging Markets (EM) fixed income are numerous and tend to be distributed over the full investment cycle. In normal market conditions, it usually pays to be overweight high yield. During shocks, it often pays to add to positions because markets are prone to severe albeit temporary mispricing. Even after the occasional credit impairment, it usually pays to be long the most default-prone credits, because markets systematically under-estimate final recovery values in distress situations. Given the ubiquitous nature of EM alpha sources, it follows that good EM investment management requires a long-term view in order to maximise returns.

The investment cycles in EM can be thought of as normal market conditions punctuated by shocks and subsequent recoveries. The shocks can have various degrees of predictability, which may or may not result in impairment. Recoveries can see bonds return to par or some fraction of par.

In normal market conditions, positive alpha generation usually favours investment managers who are biased towards higher yielding bonds. Yield contributes some 70% of total return over the long term as shown in a recent study of bond performance since 1815 by Josefin Meyer, Carmen Reinhart and Christoph Trebesch. During normal markets, investment managers use scenario analyses to examine the potential risks around a central base case. The central base case rests on a solid understanding of current economic and political circumstances. In the course of normal market conditions, a good understanding of the fundamentals puts the

[1] See page 20 in: http://econ.sciences-po.fr/sites/default/files/file/CEPR-DP13514.pdf

Continued overleaf

Emerging Markets

manager in a strong position on a daily basis to generate alpha by distinguishing between noise and signals in the news, that is, distinguishing between actual risks (i.e. large permanent loss) and mere volatility (up and downwards movement of prices). Under normal market conditions, a special source of alpha potential arises within EM when things go awry in developed economies. For example, the surprise result of the UK's Brexit Referendum in June 2016 caused a spike in risk aversion, which prompted some investors to off-load EM assets. However, the UK's self-inflicted economic problems did not and still have not caused any impairment in fundamentals in EM countries. Those who bought into the temporary weakness caused by the Brexit surprise in June 2016 have been rewarded with positive alpha.

Unfortunately, the heady mix of finance, economics and politics in the global market produces so many and such diverse shocks that it is impossible to predict every one of them. Nor is it possible to know ahead of time whether some of the shocks are benign or more serious. Due to the existence of this residual element of irreducible uncertainty, investment managers must always ensure that their investment strategies are flexible enough to cope with completely unexpected events and not rely solely on 20-20 vision and positioning portfolios correctly ahead of every conceivable shock for alpha generation.

Fortunately, alpha generation in EM does not hinge solely on being long high yield and minimising risks through perfect foresight. EM throws up at least two other sources of potential alpha. One is to take advantage of inefficiencies in the pricing of EM assets during shocks. The other is to exploit the tendency for markets to under-estimate the recovery value of EM assets in distress situations. Consider each in turn.

During shocks, the potential for alpha generation increases sharply for two reasons:

1) Investment managers can bring new information to bear to improve the quality of decisions. By meeting with policy makers, gathering information from well-informed locals and analysing incoming data pertaining to public finances and the economy, managers can make far better informed decisions than would be possible during the shock itself;
2) Price action during shocks can be wildly inaccurate for two specific reasons. One is that shocks in EM are often accompanied by media hysteria, which can prompt weak hands to capitulate.[2] The other is that liquidity tends to dry up during shocks, which makes selling highly unfavourable due to widening bid-offer spreads, but correspondingly buying becomes very attractive;

Even when a shock results in actual impairment of credits, it often pays to add to positions. This is because the interest on bonds issued by serial defaulters tends to be so high that it more than compensates for the losses incurred during occasional defaults. As Josefin Meyer, Carmen Reinhart and Christoph Trebesch put it in their paper:

> *"sovereign bonds of serial defaulters provided significantly higher returns compared to UK/US government bonds as well as in comparison to 'other' periphery countries which have never defaulted, or only briefly."* [3]

Indeed, when shocks precipitate actual defaults, where bond prices do not return to par, there is often huge positive alpha potential to be realised, because markets systematically price excessive haircuts.[4] The total mismatch between the haircuts initially priced into Ukrainian bonds in 2014, Ivorian bonds in 2011 and Argentinian bonds in 2015 relative to the eventual exit prices are perfect cases in point. In both Ukraine and Ivory Coast, the recovery value was far higher than the haircut initially priced in, while in Argentina in 2015 there was no haircut at all.

Due to the multiple sources of alpha generation throughout the investment cycle in EM, the worst possible thing to do is to pull money from EM during shocks. Shocks offer some of the richest seams of future alpha. EM investment managers are long high yielding bonds not because they are naïve or reckless, but because the long-term record clearly shows that being long high yield is alpha positive. They understand that shocks occur and that some are simply impossible to predict, but they also know that keeping a cool head at such times can produce some of the best alpha opportunities of all. And should the worst happen, i.e. credit defaults, there may well be yet more alpha to be made due to the market's systematic bias towards under-estimating recovery value.

Recent volatility in several high profile EM sovereigns, such as Ecuador, Lebanon and Argentina suggest that the alpha potential in EM sovereign credit has now increased significantly. The political situation in Ecuador is already showing signs of normalising. The situations in Lebanon and Argentina are still fluid. Tensions are also running high in Chile and Hong Kong, which are two countries usually regarded as stable, safe investment destinations.

[2] See: *'Media! What is it good for?'*, Market Commentary, 11 June 2019.
[3] See page 20 and page 25 in: http://econ.sciences-po.fr/sites/default/files/file/CEPR-DP13514.pdf
[4] The median haircut in in sovereign defaults is well below 50%, but bond prices in distress situations often fall far below levels consistent with actual recovery values. See page 12 in: http://econ.sciences-po.fr/sites/default/files/file/CEPR-DP13514.pdf

Continued overleaf

Emerging Markets

History shows that political noise rarely results in defaults. Rather, the causality tends to be the other way around. Noise is an integral part of the political process and the vast majority of political noise comes and goes without impacting debt service. Ecuador's debt to GDP ratio is below 50% and the recent political noise was the reaction to a proposal for aggressive fiscal reform. The government has scaled back some of its measures, but Ecuador should still end up with a stronger fiscal situation than before, while bond prices are now lower. In other words, investors can now buy better credit at a lower price. The government budget for 2020, presented at the weekend, is somewhat at odds with the current IMF programme, which is likely to be revised in light of the recent protests, in our view.

A similar type of opportunity may ultimately emerge in Lebanon, although it may take a bit more time before this becomes fully apparent. Prime Minister Saad al-Hariri offered to resign last week and Lebanon's President Michel Aoun called for the creation of a technocratic government. Technocratic governments have often been successful at undertaking reforms. In the latest news, Lebanese banks re-opened last week, the US White House announced that arms sales to the Lebanese army will be suspended and the central bank of the United Arab Emirates is studying the possibility of extending financial aid to Lebanon.

Argentina's situation also remains fluid and may continue to be so for some time. President-elect Alberto Fernandez's transition team has started to work with former President Mauricio Macri's economic team to ensure a smooth handover. Our view is that the incoming Fernandez Administration wants to steer clear of a market-unfriendly default to avoid massive political and economic upheaval. A maturity extension could see the fair value of Argentinian bonds decline by 20 to 30 points relative to par. If so, bond prices could double from current levels in the 40s.

Two other EM trouble spots – Hong Kong and Chile – recorded negative economic news last week. Hong Kong's economy contracted at a formidable yoy rate of 2.9% in Q3 2019 and retail sales were 18.3% lower in September than in the same month the year before. In Chile, industrial production (IP) contracted 3.9% in the month of September, which was a marked set-back from the previous two months, where the combined increase was 2.4%. Sebastian Pinera, President of Chile, replaced key ministers and cancelled a meeting of APEC (Asia-Pacific Economic Corporation), which was scheduled to be held in Santiago. The cancellation of the summit may go some way towards de-escalating tensions simply because the world's attention will now shift away from Chile. However, Pinera's approval rating has dropped to just 14%, according to local polling agencies. The situations in Hong Kong and Chile are different from those of Ecuador, Argentina and Lebanon in one important respect: little risk had been priced into markets in Hong Kong and Chile ex-ante (in much that same way that markets rarely price in much risk for assets in developed economies). The best thing about high yield is that risk is always priced in, although one can disagree if the risk is priced correctly. In perceived lower risk economies, such as Chile and Hong Kong, risk is rarely priced in, which naturally makes them more risky.

- South Africa: Three strikes, but not quite out. The news out of South Africa last week amounted to a triple-whammy. First, the government's proposal to reform ESKOM, a loss-making energy company, underwhelmed by failing to deal with the company's structural debt problem. Second, as a result of the weak ESKOM plan, investors looked to the Government's budget for next year to identify savings to pay for the larger ESKOM-related quasi-fiscal burden, but no such savings were forthcoming. Thirdly, Moody's downgraded the outlook for South Africa's sovereign credit rating to negative. For now, South Africa still maintains a slim toehold on the lowest tier of investment grade (Baa3), but for how long? The only good news was that South Africa's awesome rugby union team thrashed England to win the World Cup. As the credit rating of the South African government moves with seeming inexorability towards junk status, it could do well to learn from the amazing defensive skills of the Springboks.

- Mexico: The government of Andres Manuel Lopez Obrador ('AMLO') continues to defy the sceptics by following a very orthodox fiscal stance. The fiscal deficit for the year to September was 0.6% of GDP, which is consistent with a primary surplus of 1.1% of GDP. This marks an improvement relative to last year at the same time and puts Mexico on track to outperform its own fiscal deficit target of 1.0% of GDP for the year. On the other hand, the economy continues to be sluggish. Real GDP growth was only 0.1% in Q3 2019 (sa), which was slower than expected (0.2% qoq sa).

- South Korea: A slew of economic data pointed to stabilisation of the South Korean economy. In particular, South Korean IP expanded at a yoy rate of 0.4% in September following -3.3% yoy in August. The market was expecting contraction in September (-1.1%yoy). Also, the yoy rate of inflation was 0.0% in October, which means that South Korea appears to have escaped deflation (the market had expected -0.3% yoy). Trade remains weak, however. Exports were 14.7% lower on a yoy basis in October versus -13.6% yoy expected. The main drag on exports in South Korea, a key US ally in Asia, is lower demand from China, which is directly attributable to US President Trump's tariffs on imports from China many of which originate in South Korea.

- Ukraine: The Parliament approved a reform to break up Naftogaz, the state gas company. Transmission will be spun off. This is part of a plan to reduce corruption in the company and depoliticise it. Naftogaz plays a central role in the transmission of gas from Russia to the European Union (EU).

Continued overleaf

Ashmore

Global backdrop

- **Turkey:** The US House of Representatives approved sanctions against Turkey in contradiction to the wishes of the US White House. The sanctions bill imposes financial and visa penalties on officials connected to Turkey's offensive in Syria and state-owned bank Halkbank.

- **China:** Chinese officials offered further clarification about recent announcements pertaining to the opening of China's economy to foreign investors. Specifically, officials said that all restrictions on foreign investment will be eliminated barring items on a negative list. They also confirmed that there will be no forced transfer of technologies. Political rhetoric in the West towards China is hardening for political reasons, mainly because it is useful to have a foreign bogyman when domestic conditions are worsening. In reality, no foreign company has ever been forced to do business in China. Any transfer of technology has therefore been a part of a voluntarily entered-into business term. The main effect of the West's China phobia will be to exclude Western companies from the most important growth story in world history. In other news, the Caixin PMI increased to 51.7 in October. This is now the third consecutive month of expansion of the index, which captures performance in smaller to medium sized Chinese enterprises. Official PMI softened to 49.3 in October from 49.8 in September.

- **Peru:** President Martin Vizcarra announced a series of economic measures, which the government will implement by special decree, taking advantage of the current dissolution of the parliament. The measures include recommencement of various public works, better provision of medicines, adoption of technical criteria for determining minimum wages to reduce the scope for political opportunism, better public disclosure of information about political candidates and measures to improve competitiveness.

Snippets:

- **Angola:** The draft budget for 2020 is based on a USD 55 per barrel oil price, which should deliver a prudent overall fiscal surplus of 1.2% of GDP.
- **Brazil:** The central bank cut the policy rate by 50bps to 5.0% in line with expectations. IP recovered on a yoy basis from -2.1% in August to 1.1% in September, although on a monthly basis IP expanded at a slower rate than expected.
- **Colombia:** The central bank left the policy rate unchanged at 4.25%. Standard & Poor's affirmed Colombia's foreign currency sovereign credit rating at BBB- with stable outlook. Manufacturing PMI picked up from 50.9 in September to 51.1 in October. FX reserves set an all-time high of USD 52.9bn.
- **Croatia:** The rate of growth of retail sales accelerate to 3.6% in yoy terms in September from 1.2% yoy in August.
- **India:** The Nikkei PMI increased marginally to 50.6 in October.
- **Indonesia:** The rate of CPI inflation declined to 3.1% yoy in October from 3.4% yoy in September.
- **Kenya:** The yoy rate of CPI inflation picked up to 4.95% in October from 3.83% yoy in September. The World Bank forecast strong growth of 6% in 2020, higher if Kenya lifts a controversial cap on interest rates.
- **Malaysia:** Imports were stronger than expected in September, rising at a yoy rate of 2.4%. However, exports were 6.8% lower than in the same month last year, so the trade surplus was only MYR 8.3bn versus an expectation of MYR 14.2bn.
- **Mozambique:** The government has completed the restructuring of its sovereign bond. This paves the way for new credit from donors, though bond holders may be a bit wary given that Mozambique defaulted on the very first payment.
- **Peru:** Inflation based on prices in Lima was 0.11% in the month of October versus 0.12% mom expected. On a yoy basis, inflation picked up from 1.85% in September to 1.88% in October.
- **Serbia:** The rate of expansion of IP increased to 1.6% yoy in September from 0.5% yoy in August. Retail sales expanded at a solid rate for the second month in September (7.3% yoy compared to 7.6% yoy in August).
- **Taiwan:** The economy bounce-back continued in Q3 2019, where the economy expanded at yoy a rate of 2.9%, up from 2.4% yoy in Q2 2019.
- **Thailand:** The yoy rate of CPI inflation declined to 0.1% in October versus 0.3% yoy expected.
- **Turkey:** Fitch affirmed Turkey's long-term sovereign credit rating at BB-, but revised the outlook to stable from negative.

Continued overleaf

Global backdrop

Optimism about a deal on trade between the United States (US) and China is increasing. US Commerce Secretary Wilbur Ross indicated a deal could be struck this month. He also indicated that Huawei could be allowed to supply US companies soon. Many investors will be hoping that an end to President Trump's misguided policies towards China will arrest the continuing deceleration of the US economy. So far, there is no indication that this is happening, however. Real GDP growth in Q3 2019 was 1.9% qoq saar compared to 2.9% qoq saar in the same quarter of 2018. The Fed cut the policy rate by 25bps to 1.75% as claims for unemployment benefit edged higher. Job creation as reflected in the payroll number also declined relative to last month. Indeed, the twelve-month average for payrolls has now declined since January 2019.[5] ISM and PMI declined and consumer confidence decelerated. How realistic is it that a trade deal will turn things around? Not very, in our view. The real problem facing the US economy is that it suffers from a classic case of real effective exchange rate overvaluation. Such ailments are best cured with a recession to help bring prices into line with productivity growth (assuming no major fiscal and other structural reforms) and some currency debasement to improve external competitiveness. At best, a US-China trade deal may help to prevent further damaging nominal appreciation of the Dollar, but the broader real misalignment of the Dollar would not be fixed. To add political insult to economic injury, the House of Representatives commenced impeachment proceedings against President Trump, which clearly raises the level of political noise.

The EU granted yet another Brexit extension to the UK until the end of January next year. UK voters will now go to the polls on 12 December to elect a new parliament in a bid to break the Brexit deadlock. The Conservative Party will campaign on 'getting Brexit done' as Prime Minister Boris Johnson is fond of saying. The opposition Labour party will struggle to overcome a lack of trust in its leader, Jeremy Corbyn. Its best strategy may be to try to neutralise the whole Brexit issue by arguing that Brexit is already a done deal, so that the focus should shift to what kind of Britain comes after Brexit. This tactic will be challenged by the fact that Labour still officially does not support Boris's Brexit deal and wants to negotiate yet another version. Pollsters expect a big win for Boris. If so, Britain will crash out of EU without a customs union and things could get sweaty in Northern Ireland. Recession in the UK therefore looks very likely, especially due to the long period of uncertainty until the UK has rebuilt trade ties with other countries, including the EU. Finally, it's worth noting that EU economic data improved relative to expectations as the rate of core inflation increased to 1.1% yoy in October from 1.0% yoy in September, while growth stabilised at 0.2% qoq (non-annualised).

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	0.70%	4.95%	11.43%	11.23%	8.09%	3.47%
MSCI EM Small Cap	0.36%	4.23%	6.34%	8.88%	3.57%	1.29%
MSCI Frontier	0.74%	1.56%	12.36%	10.00%	7.58%	-0.11%
MSCI Asia	0.59%	5.16%	11.40%	12.55%	8.83%	5.20%
Shanghai Composite	0.99%	1.83%	21.50%	16.29%	0.49%	6.30%
Hong Kong Hang Seng	0.85%	4.14%	8.88%	7.25%	7.14%	3.59%
MSCI EMEA	0.75%	3.58%	9.42%	10.06%	5.70%	-0.15%
MSCI Latam	1.64%	6.17%	13.12%	7.66%	7.17%	0.74%
GBI EM GD	0.44%	3.35%	11.47%	15.06%	4.66%	0.90%
ELMI+	0.21%	2.26%	3.71%	5.63%	2.85%	0.33%
EM FX Spot	0.39%	2.39%	-0.16%	0.24%	-2.66%	-5.90%
EMBI GD	0.27%	0.55%	13.61%	14.37%	5.30%	5.49%
EMBI GD IG	0.08%	0.40%	15.68%	17.47%	5.91%	5.36%
EMBI GD HY	0.48%	0.72%	11.49%	11.23%	4.66%	5.47%
CEMBI BD	0.04%	0.89%	11.63%	12.13%	5.39%	5.20%
CEMBI BD IG	0.04%	0.39%	11.97%	13.18%	5.02%	4.72%
CEMBI BD Non-IG	0.05%	1.60%	11.13%	10.70%	6.04%	5.86%

[5] The payroll number was greater than expected, which reflects the fact that forecasting is poor. The key message from payrolls is that, yet again, the number declined.

Continued overleaf

Ashmore

Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	0.98%	3.16%	24.36%	14.23%	15.53%	10.97%
1-3yr UST	-0.07%	0.26%	3.34%	4.50%	1.62%	1.32%
3-5yr UST	-0.14%	0.16%	5.35%	7.71%	1.99%	2.15%
7-10yr UST	-0.27%	-0.11%	9.73%	14.11%	2.81%	3.39%
10yr+ UST	-0.63%	-1.48%	17.99%	26.44%	5.00%	5.88%
10yr+ Germany	-0.62%	-3.60%	12.97%	16.02%	4.77%	6.33%
10yr+ Japan	0.71%	0.07%	6.25%	8.97%	1.92%	4.64%
US HY	0.12%	0.40%	11.85%	8.42%	6.25%	5.20%
European HY	0.02%	-0.14%	8.56%	5.30%	3.87%	4.37%
Barclays Ag	-0.04%	0.63%	6.99%	9.18%	2.68%	2.12%
VIX Index*	-6.96%	-24.26%	-51.61%	-36.96%	-45.36%	-17.39%
DXY Index*	-0.18%	-2.21%	1.05%	0.66%	0.12%	11.72%
CRY Index*	1.91%	3.64%	6.17%	-6.25%	-1.22%	-32.60%
EURUSD	0.18%	2.50%	-2.59%	-2.07%	0.26%	-10.95%
USDJPY	0.26%	0.21%	-1.27%	-4.31%	5.04%	-4.66%
Brent	2.08%	1.15%	14.28%	-15.58%	34.88%	-25.77%
Gold spot	-0.03%	2.72%	17.93%	22.81%	15.93%	29.45%

*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.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Dublin
T: +353 1588 1300

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Other locations

Lima

Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper