Ecuador: a case study of EM price inefficiency

By Gustavo Medeiros

Ecuadorian President Lenin Moreno submits a new fiscal consolidation bill and gets support from the IMF. Chile's GDP surprised on the upside as parliament approves reforms. China FDI improves as GDP is revised higher. South Africa's inflation surprised on the downside, but the Central Bank keeps rates unchanged. In Brazil, the job market, fiscal accounts and earnings growth improved. Argentina's reserves increase as the IMF signals support. Pro-democracy parties won a landslide victory in Hong Kong. Bolivia's credit rating downgraded to B+. FX reserves inch higher in Zambia. Scheduled general strike in Colombia closes the cycle of protest across Latin America.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.0	–	-0.01%
MSCI EM Small Cap	11.2	–	-0.64%
MSCI Frontier	11.2	–	0.31%
MSCI Asia	12.7	–	-0.14%
Shanghai Composite	10.6	–	-0.20%
Hong Kong Hang Seng	7.9	–	0.78%
MSCI EMEA	9.5	–	0.38%
MSCI Latam	13.0	–	0.86%
GBI-EM-GD	5.23%	–	-0.26%
ELMI+	4.66%	–	-0.22%
EM FX spot	–	–	-0.19%
EMBI GD	5.22%	341 bps	-0.23%
EMBI GD IG	3.58%	174 bps	0.54%
EMBI GD HY	7.50%	572 bps	-1.13%
CEMBI BD	5.06%	333 bps	0.21%
CEMBI BD IG	3.69%	197 bps	0.24%
CEMBI BD Non-IG	7.00%	528 bps	0.18%

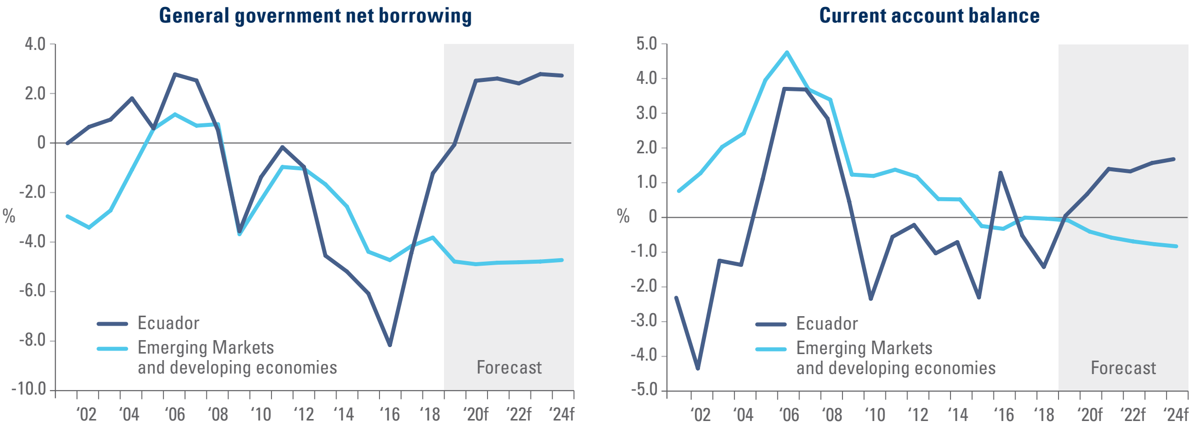
Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.2	–	-0.29%
1-3yr UST	1.63%	–	0.00%
3-5yr UST	1.64%	–	0.09%
7-10yr UST	1.78%	–	0.43%
10yr+ UST	2.23%	–	1.55%
10yr+ Germany	-0.36%	–	0.44%
10yr+ Japan	-0.07%	–	0.41%
US HY	5.78%	391 bps	-0.23%
European HY	3.86%	425 bps	0.06%
Barclays Ag	1.41%	-37 bps	0.11%
VIX Index*	12.34	–	0.29%
DXY Index*	98.23	–	0.43%
EURUSD	1.1026	–	-0.42%
USDJPY	108.84	–	0.15%
CRY Index*	180.37	–	-0.63%
Brent	63.7	–	1.95%
Gold spot	1459	–	-0.86%

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

Emerging Markets

- **Ecuador:** It is hard to justify the valuations on Ecuadorian sovereign debt and recent market price action when closely examining the country's credit metrics. The debt/GDP ratio was at 46% GDP in 2018, which is lower than the average Emerging Markets (EM) country by 5% GDP. Ecuador doesn't have a significant external imbalance. Its current account had a marginal 1.5% GDP deficit in 2018, and is expected to swing into a surplus. Most importantly, President Lenin Moreno has implemented a robust fiscal consolidation plan, reducing the non-financial public sector fiscal deficit from 8.0% GDP in 2016 to 1.2% deficit in 2018. The Central Government deficit has followed the same adjustment trajectory, and is course for a moderate 3.3% deficit in 2019.

Fig 1: **Ecuador's fiscal and external balances (% of GDP)**



Source: IMF, Ashmore.

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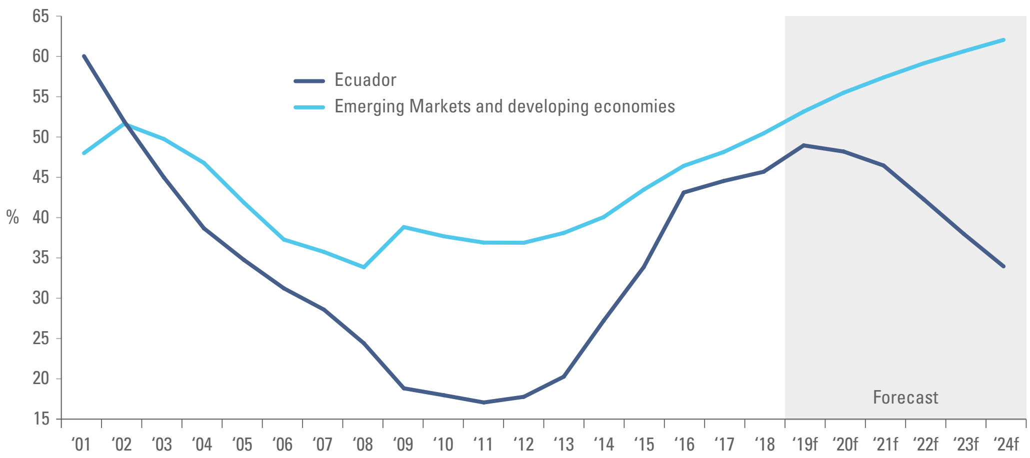
Emerging Markets

Furthermore, President Moreno decided to enter into an IMF programme to bring the fiscal balance into a permanent surplus and sustainably reduce the country's debt/GDP profile. If fully implemented, the debt/GDP is forecasted to decline to a mere 35% by 2024 (Figure 2).

Fig 2: **Gross general debt to GDP (%)**



Source: IMF, Ashmore.

In spite of the constructive policy stance and reform efforts, markets have massively penalised the country precisely when the Government has been doing the right thing. For example, in early October, Moreno announced the end of gasoline and diesel price subsidies. If fully enacted, the subsidy cut would bring a total saving of approximately 3.0% GDP per year, which is much larger than the 1.5% consolidation agreed with the IMF for 2020.

Unfortunately, the subsidy cut was a step too far. Indigenous groups in the countryside would have been heavily impacted by the subsidy reduction as their lives depend on agricultural production. The increase in transportation costs threatened the profitability of their businesses. Importantly, a small part of the population also profits from fuel smuggling to neighbouring countries. These groups enticed their communities to take to the streets, forcing the Government to repeal the proposed subsidy cuts.

A second blow occurred on Sunday 17 November, when parliament rejected, by one single vote, the Government's comprehensive economic reform proposal. The reform package included tax reform, a bill to enshrine central bank autonomy, and an overhaul of the public finance code. Even parliamentarians from the Government's coalition were discouraged from voting on the bill, which was extremely complex and technical in nature, with more than 400 articles on a range of controversial issues. President Moreno acknowledged the political miscalculation and promptly submitted a new simplified and urgent economic law to raise USD 600m per year. The new bill will further consolidate the fiscal accounts and keep Ecuador in compliance with the IMF programme. The damage was done however. Ecuador had become a key overweight in many weak hands, which wanted out. The thin liquidity towards year-end exacerbated the irrational selling, leading to sharply lower prices amidst wide bid-offer spreads (Figure 3).

Fig 3: **Ecuador sovereign debt spreads versus other markets**

Source: Ashmore, Bloomberg.

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Emerging Markets

The sharp sell-off in Ecuadorian bonds is a perfect example of how inefficient EM pricing can become in a difficult technical positioning backdrop. Investors feared the IMF programme was off the rails after the second failed attempt at consolidating the fiscal accounts. Since then however, the IMF restated its intention to advance Ecuador's economic reform plans. If the IMF programme was to be disrupted, Ecuador could still refinance its obligations using alternative mechanisms such as oil-backed loans. The country produces 550k barrels of oil per day and is looking to increase output to 600k in 2020.

We strongly believe the Government will be able to approve a fiscal consolidation reform package, which will be sufficient to satisfy the IMF requirements. If so, disbursements from multilateral agencies will also be unaffected, which covers half of Ecuador funding needs for both 2020 and 2021. The next Eurobond repayment is a modest USD 325m in March 2020 followed by a USD 2bn Eurobond repayment, due in March 2022. This gives the government plenty of time to refinance its obligations on account of the lengthy period with no need to issue debt for new financing needs.

Today Ecuador has better credit metrics than the average EM economy, yet it trades at four times the average EM sovereign credit spread over US Treasuries or two times the average high yield sovereign spread. It is likely that the violent price action partly reflects Ecuador's long history of sovereign defaults, but we believe that history is irrelevant in the current context of solid credit fundamentals. We believe that Ecuador is one of the most mispriced sovereign credits in EM and the current volatility is temporary.

- Chile: Real GDP growth accelerated to 3.3% on a yoy basis in Q3 2019 from 1.9% in the previous quarter. Private consumption and investment were the main drivers of the growth acceleration. The economy is likely to slow in the coming quarters as a result of the on-going protests. In other news, parliament agreed on several initiatives demanded by protesters, including cutting medicine prices and increasing minimum pensions. The reforms show there is room for consensus building in parliament in spite of the growing focus on the 2020 Constitutional Assembly, which will be tasked with modernising Chile's Pinochet-era constitution.
- China: Foreign direct investment (FDI) growth increased at a yoy rate 7.4% in October, which marked a significant acceleration from the previous month (3.8% yoy). Manufacturing FDI contracted while high tech and services FDI accelerated sharply. The data is consistent with the trend of low value-added manufacturing relocating to other countries, while China moves up the value chain on the back of substantial investment in the high technology, pharmaceutical and services industries. The National Bureau of Statistics revised its 2018 GDP number up by RMB 1.9tn to RMB 90tn (USD 13tn). On the back of the upwardly revised GDP numbers, China remains on track to achieve the objective of doubling the size of its economy from 2010 to 2020.
- South Africa: The Consumer Prices Inflation (CPI) index slowed to a yoy rate of 3.7% in October, down from 4.1% yoy in September. This was a meaningful downside surprise. Core inflation was unchanged at 4.0% yoy. The South Africa Reserve Bank (SARB) kept its policy rate unchanged at 6.5% citing the risk of a credit shock in case Moody's downgrades the country below investment grade. The SARB has room to cut rates next year as a downgrade is mostly priced into market prices, in our view.
- Brazil: The jobs market keeps improving with 71k new jobs created in October. The rate of unemployment declined to 11.8% in Q3 2019 from 12.0% in Q2 2019. On the fiscal front, the Independent Fiscal Institute estimates the 2019 budgetary deficit will be BRL 95bn (USD 24.1bn), which is a significant outperformance versus the government's own target of BRL 139bn (USD 35.3bn). Last week, the Senate approved the so-called Parallel Pension Reform bill, which applies the same rules as the recently approved Federal Pension Reform to states and municipalities. The parallel law will improve the fiscal accounts of Brazil's states and municipalities by BRL 300bn (USD 76.1bn) over the next ten years. In other news, Q3 2019 company earnings increased by 7% on a yoy basis and a robust 22% yoy excluding Petrobras and the materials sector. Homebuilders surprised with accelerated launches and increased earnings guidance. The economic data is consistent with a broad-based cyclical recovery in the Brazilian economy.
- Argentina: The Development Bank of Latin America (CAF) committed itself to disburse more than USD 4bn in loans over the next four years. The loans are aimed at developing infrastructure, urban mobility and other sectors. The Managing Director of the International Monetary Fund (IMF) Kristalina Georgieva said last Tuesday that the IMF is open and willing to start negotiations with President-elect Alberto Fernandez and encouraged stronger support for the most vulnerable part of the population. Argentina's FX reserves have increased from USD 43.51bn to USD 43.58bn since 29 October when capital controls were tightened, restricting individual purchases to USD 200/month.
- Hong Kong: The pro-democracy candidates won the local district council elections in Hong Kong by a landslide, taking more than 85% of the 444 seats. Pro-government parties won only 57 seats, a loss of 243 seats from the last election in 2015. The vote saw a record 71.2% turnout from 47.0% in 2015.
- India: Finance Minister Nirmala Sitharaman unveiled a series of measures to improve fiscal visibility. The privatisation of Bharat Petroleum and Shipping Corp of India will help the government to meet its INR 1.05tn (USD 14.5bn) privatisation target. Changes in the model for road tolls will also allow for more flexible terms and financing options for construction companies. A two-year deferral of spectrum fee payments for telecom companies should also provide some relief to that sector.

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Emerging Markets

- Bolivia: Fitch downgraded Bolivia's credit rating to B+ with a negative outlook due to recent political uncertainties and an erosion of the country's external buffers. FX reserves have declined from USD 9bn at the end of 2018 to USD 7bn as of the end of October 2019. Interim President Jeanine Anez agreed to withdraw the military from the streets as part of a deal with protests leaders to pacify the country. Subsequently a bill agreeing on new presidential elections without Evo Morales was approved by both houses. Congress will agree on a new seven-member electoral court before a new election date is set.
- Colombia: A scheduled general strike took place last Thursday with hundreds of thousands of Colombians demonstrating against the Duque Administration. The protesters are objecting to pension and labour reforms as well as alleged corruption and the failure to honour a 2016 peace accord with left-wing FARC rebels. The demonstrations were mostly peaceful, albeit confrontations with the police took place in Bogota, and there were isolated cases of looting in Cali. On Saturday, the mayor of Bogota imposed a curfew in the city as police dispersed protesters using tear gas.
- Zambia: The Bank of Zambia announced that international reserves increased further to USD 1.5bn in September 2019 from USD 1.4bn in August 2019 and USD 1.3bn in April 2019. Bank of Zambia also raised its policy rate by 1.25% to 11.5%. The IMF concluded a staff team visit and highlighted "the need for a large, front-loaded fiscal adjustment to set debt on a downward path and reduce domestic arrears".
- Sri Lanka: President Gotabaya Rajapaksa appointed an interim Cabinet until next parliamentary election. The 16-member Cabinet includes his brother and former president Mahinda Rajapaksa on the Prime Minister and Defence and Finance Minister positions. A new parliamentary poll is scheduled for H2 2020, but the date of the election could be brought forward by the current parliament.

Snippets:

- Czech Republic: PPI inflation declined to a yoy rate of 0.9% in October from 1.9% yoy in September.
- El Salvador: The government announced an agreement with US tech company Amazon to train up to 80k Salvadorans in cloud computing services, creating up to 5k new jobs.
- Ethiopia: A referendum was held in the region of Sidama with 98.5% of its residents opting for a semi-autonomous rule. Polls granting autonomy to different areas was a key promise by Prime Minister Abiy Ahmed to maintain peace and stability in a country, which has a long history of ethnic tension.
- Hungary: The key policy rate was left unchanged at -0.05% by the National Bank of Hungary left, in line with consensus expectations.
- Indonesia: Bank Indonesia kept its 7-day reverse repo policy rate unchanged at 5.0%, in line with consensus expectations. The reserve requirement ratio for banks was cut by 0.5%.
- Lebanon: The Speaker of Parliament called a session next week to vote on pressing legislation. US President Donald Trump said the US was ready to work with a new Lebanese government.
- Malaysia: CPI inflation on a yoy basis was unchanged at 1.1% in October, slightly above consensus expectations.
- Mexico: The yoy rate of CPI inflation declined to 3.10% in the first half of November, down from 3.03% yoy the previous fortnight. The yoy rate of core CPI inflation declined marginally to 3.66% in the first half of November from 3.69% during the previous two weeks.
- Nigeria: Nigerian real GDP growth was 2.3% on a yoy basis in Q3 2019 compared to 2.1% yoy in Q2 2019.
- Singapore: GDP growth was revised up to 0.5% on a yoy basis in Q3 2019 from an initial estimate of 0.1% yoy due to better manufacturing and construction numbers. CPI inflation inched lower to a yoy rate of 0.4% in October from 0.5% yoy in September. Core inflation slowed to a 0.6% yoy rate from 0.7% yoy over the same period.
- Tunisia: Producer Prices Index (PPI) inflation declined to a 4.3% on a yoy basis in August from 4.4% yoy in July. Inflation has declined sharply since August when it registered a rate of 9.6% on a yoy basis.
- Romania: President Klaus Iohannis won the presidential election run-off on Sunday by a large majority, in line with expected. Iohannis pledged to resume judicial reforms, slowed down by Social Democrat (PSD) governments.
- South Korea: Exports in the first 20 days of November declined by 9.6% on a yoy basis, which was an improvement compared to -19.7% yoy in October. Shipbuilding continues to suffer, but the auto sector posted positive yoy export growth numbers.
- Thailand: GDP growth accelerated to a rate of 2.4% yoy in Q3 2019 from 2.3% yoy in Q2 2019. The trade balance posted a USD 0.5bn surplus in October with imports declining faster than exports.
- Uruguay: With 99.4% of votes counted, the opposition candidate form National Party Luis Lacalle Pou led the presidential election run-off by 48.74% against 47.48% from ruling party candidate Daniel Martinez, a difference of 30k votes. The results are likely to be announced by mid-week.

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Ashmore

Global backdrop

In relation to the US-instigated trade war with China, both houses of the US Congress have now approved the Hong Kong Human Rights and Democracy Act with only President Donald Trump's signature required for the bill to become law. If enacted, the bill would give the US government the power to remove Hong Kong's special status yearly in case American politicians deem the city's autonomy to be under threat. The bill may complicate the process of reaching a deal on trade. On the other hand, the Trump administration has given permission to some US suppliers to resume shipping to the Chinese technology giant Huawei. The Trump Administration blacklisted Huawei in June, which adversely impacted the chip industry in the US, which sold USD 11bn of components to the Chinese company in 2018.

US economic data improved. US housing starts increased by 3.8% in the month of October, with building permits increasing by 5.0% over the same period. The Philly Fed survey increased from 5.6 in October to 10.4 in November. Finally, the Markit PMI surprised on the upside. Manufacturing PMI increased from 51.3 in October to 52.2 in November, while Services PMI improved from 50.6 to 51.6 over the same period.

Former New York Federal Reserve President Bill Dudley warned about higher long-term US Treasury yields due to larger issuance volumes on the back of large US fiscal deficits.[1] Furthermore, Dudley cautioned against high levels of leverage for BBB rated corporates, which are more likely to be downgraded to high yield in a recession.

In the UK, the Labour party unveiled an election manifesto including staggering tax increases and the renationalisation of energy utilities, the rail network and the Royal Mail. The Labour Party's manifesto also promises to boost wages in a bid to reduce inequality. The battle between far-left and far-right populism ahead of the 12 December General Election illustrates how the rising income disparities in the developed world are now directly contributing to greater political and economic risks.

In Europe, Christine Lagarde delivered her first major speech as President of the European Central Bank (ECB). She pledged to keep monetary policy accommodative and asked for higher public spending in the euro area to boost growth. Importantly, she asked for the completion of a single market for digital technologies, banking union, capital markets and services union to increase innovation and productivity. Eurozone Markit PMI deteriorated from 50.6 in October to 50.3 in November, but manufacturing PMI rose from 45.9 to 46.6 over the same period. French manufacturing accelerated while German manufacturing remained weak.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	0.67%	4.92%	11.40%	10.64%	9.93%	3.70%
MSCI EM Small Cap	-0.99%	2.82%	4.91%	5.06%	4.81%	1.24%
MSCI Frontier	1.22%	2.04%	12.89%	10.38%	7.99%	0.88%
MSCI Asia	0.48%	5.06%	11.28%	11.09%	10.42%	5.52%
Shanghai Composite	-1.48%	-0.67%	18.52%	11.74%	-1.64%	5.20%
Hong Kong Hang Seng	-0.26%	3.00%	7.69%	4.38%	6.94%	3.97%
MSCI EMEA	2.46%	5.34%	11.28%	9.06%	7.81%	-0.10%
MSCI Latam	-2.15%	2.20%	8.89%	8.48%	8.57%	0.11%
GBI EM GD	-1.19%	1.68%	9.67%	10.99%	6.46%	0.67%
ELMI+	-0.47%	1.57%	3.01%	3.73%	3.71%	0.48%
EM FX Spot	-0.98%	1.00%	-1.52%	-1.97%	-1.58%	-5.90%
EMBI GD	-0.61%	-0.33%	12.62%	14.61%	6.31%	5.34%
EMBI GD IG	-0.04%	0.29%	15.55%	18.02%	7.37%	5.30%
EMBI GD HY	-1.28%	-1.04%	9.54%	11.05%	5.15%	5.26%
CEMBI BD	0.23%	1.08%	11.83%	12.70%	6.20%	5.33%
CEMBI BD IG	0.04%	0.39%	11.97%	13.43%	5.87%	4.73%
CEMBI BD Non-IG	0.48%	2.03%	11.61%	11.71%	6.77%	6.22%

[1] We agree with the worrisome fiscal outlook in developed economies, including the US, which we see as a major blind spot for current generations of policy makers. See the global backdrop section of: *'The blind spot'*, Weekly investor research, 27 August 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	2.57%	4.79%	26.33%	19.77%	14.43%	10.78%
1-3yr UST	-0.09%	0.24%	3.32%	4.28%	1.76%	1.31%
3-5yr UST	-0.30%	0.00%	5.18%	7.16%	2.47%	2.08%
7-10yr UST	-0.61%	-0.45%	9.35%	12.91%	3.98%	3.25%
10yr+ UST	-0.88%	-1.73%	17.69%	24.11%	7.48%	5.62%
10yr+ Germany	-0.72%	-3.70%	12.85%	15.68%	5.03%	6.08%
10yr+ Japan	-0.76%	-1.40%	4.70%	6.59%	2.04%	4.08%
US HY	-0.10%	0.18%	11.61%	9.46%	6.27%	5.32%
European HY	0.44%	0.28%	9.01%	7.81%	4.25%	4.35%
Barclays Ag	-0.78%	-0.12%	6.20%	8.25%	3.77%	2.13%
VIX Index*	-6.66%	-24.01%	-51.46%	-42.66%	0.00%	0.73%
DXY Index*	0.90%	-1.16%	2.13%	1.35%	-3.22%	11.72%
CRY Index*	1.97%	3.70%	6.22%	0.43%	-2.88%	-32.41%
EURUSD	-1.13%	1.16%	-3.86%	-2.67%	4.05%	-11.62%
USDJPY	0.75%	0.70%	-0.78%	-4.18%	-3.87%	-7.75%
Brent	5.69%	4.74%	18.33%	8.27%	34.76%	-18.73%
Gold spot	-3.58%	-0.92%	13.75%	19.34%	23.22%	21.47%

*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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