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WEEKLY INVESTOR RESEARCH

Ashmore

The writing is on the wall

By Jan Dehn

The writing is on the wall. Ignore it at your peril. The stimulus-led party in developed economies is nearing the end as growth wanes and the effectiveness of monetary stimulus diminishes. However, the outlook for many EM countries now looks set to improve further. We outline the main reasons to be cheerful. The Weekly also covers economic activity in Argentina and Brazil, the big rate cut in Turkey, South Africa's ESKOM bailout, political news in Dominican Republic, economic news in Mexico and Singapore and some perspectives on EM bond indices. We also congratulate Egan Bernal and Colombia for securing the first ever EM victory in the Tour the France.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.4	–	-0.75%
MSCI EM Small Cap	10.0	–	-1.22%
MSCI Frontier	11.2	–	-0.06%
MSCI Asia	12.4	–	-0.66%
Shanghai Composite	10.3	–	0.80%
Hong Kong Hang Seng	7.9	–	-0.52%
MSCI EMEA	8.9	–	-1.64%
MSCI Latam	11.8	–	-1.85%
GBI-EM-GD	5.51%	–	-0.85%
ELMI+	4.76%	–	-0.46%
EM FX spot	–	–	-0.95%
EMBI GD	5.44%	334 bps	0.48%
EMBI GD IG	3.82%	169 bps	0.32%
EMBI GD HY	7.37%	529 bps	0.65%
CEMBI BD	5.20%	321 bps	0.22%
CEMBI BD IG	3.90%	192 bps	0.16%
CEMBI BD Non-IG	7.02%	502 bps	0.31%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.5	–	1.66%
1-3yr UST	1.85%	–	-0.08%
3-5yr UST	1.84%	–	-0.18%
7-10yr UST	2.07%	–	-0.22%
10yr+ UST	2.59%	–	-0.31%
10yr+ Germany	-0.38%	–	1.11%
10yr+ Japan	-0.15%	–	0.36%
US HY	5.82%	364 bps	0.49%
European HY	3.82%	412 bps	0.66%
Barclays Ag	1.47%	-60 bps	-0.32%
VIX Index*	12.16	–	-2.29%
DXY Index*	98.03	–	0.77%
EURUSD	1.1125	–	-0.75%
USDJPY	108.66	–	0.73%
CRY Index*	177.16	–	-1.43%
Brent	63.1	–	-0.19%
Gold spot	1419	–	-0.44%

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

Emerging Markets

The writing is on the wall. Ignore it at your peril. The stimulus-led party in developed economies is clearly nearing the end as growth wanes and the effectiveness of monetary stimulus diminishes – see the global backdrop section.

By contrast, the outlook for many EM countries can be expected to improve in the coming months for the following reasons. Firstly, following US President Donald Trump's retreat from his ill-advised trade war experiment after the G20 (although he may of course resume his trade war at any time), there is now some room for upside in Asian manufacturing and exports – and hence equities. Secondly, with the Fed hiking cycle being over many EM central banks are now poised to cut interest rates, which increases returns for bond holders and stimulates domestic demand. Thirdly, flows to EM are strong and likely to continue, because institutional investors are still massively under-invested and returns are likely to be much better than in developed markets. Fourthly, late-cycle weakness in US company earnings is likely to bring to a close the long period of Dollar-strength versus EM currencies. Fifthly, key economies in Latin America, such as Argentina and Brazil, are embarking upon positive business cycle dynamics (see below) following important reform efforts. Similarly, in Asia, voters have re-elected very reform-minded governments in important economies, such as Indonesia and India. Sixthly, prospects for a significant expansion in the number of countries in the main EM local currency fixed income benchmark indices are improving with potential entrants as Nigeria, China, Serbia, Ukraine, Kazakhstan and Egypt (see below).

Finally, it is worth bearing in mind that EM has already faced down most of the main challenges typically cited as reasons not to invest, including a 50% Dollar rally, massive outflows in the Taper Tantrum, the entire Fed hiking cycle, a halving of commodity prices and a few iterations of Trump's Trade War. The main risk facing EM today is a sharp re-acceleration of US growth, but we think the odds favour a gradual slowing of US growth at this late stage of the business cycle rather than a productivity miracle.

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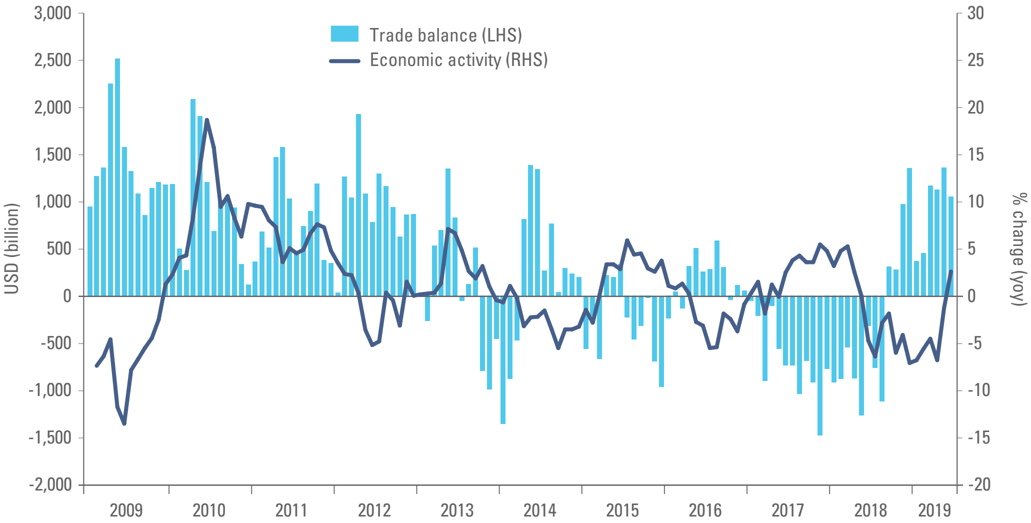
Emerging Markets

- Argentina: The good economic data keeps coming. Last week, the monthly economic activity indicator surged to +2.6% yoy from -1.3% yoy in the prior month. This was much better than expected (0.3% yoy). Moreover, activity picked up across a range of economic sectors, not just agriculture. In addition, Argentina clocked up a USD 1.06bn trade surplus for the month of June (Figure 1). Consumer confidence also surged at a mom rate of +9% in the month of July. The recent improvement in Argentina's economic indicators are important for two reasons. Firstly, they show that the IMF program of macroeconomic adjustment is working with the worst of the pain now in the past. Secondly, stronger economic data increases the odds that President Mauricio Macri gets re-elected on 27 October or at least that he advances to a second round run-off in November.

Fig 1: **EM bonds versus DM bonds since Q1 2016**



Source: Ashmore, Bloomberg. Data as at 26 July 2019.

- Brazil: President Jair Bolsonaro has approved a measure, which will enable Brazilians to make modest withdrawals from their personal social security funds. The measure could increase growth by 0.3%-0.4% of GDP over the next twelve months, all else even. In other news, July mid-month CPI inflation slowed to 3.37% from 4.84% yoy in mid-June, this in combination with the good progress on the pension reform, which increases the likelihood of rate cuts by the central bank. The current account deficit was USD 2.9bn in June versus an expected deficit of USD 1.5bn, while net FDI inflows in June dropped sharply to USD 2.2bn from USD 7.1bn in May. The drop in net FDI was due to an usually large one-off repatriation of profits and dividends. Meanwhile, there was good economic news on the jobs front, where 48,000 new jobs were created in June compared to 32,000 in May and 30,000 expected. Also, private credit expanded at a healthy 5.1% yoy rate in June following a solid 5.4% yoy expansion in May.

- Turkey: The Turkish central bank cut the one-week repo rate by 425bps from 24% to 19.75%. This cut was a great deal larger than the market had expected (300bps). The central bank now clearly answers to President Erdogan with no further pretence of being independent. The rate cut should result in further weakness of the Lira over time and greater pass-through from the currency to inflation due to the lack of central bank credibility. Assets denominated in TRY are at risk and we expect continuing pressures for capital flight.

- South Africa: The South African announced last week that USD 4.2bn in financial support have been earmarked for Eskom, the state-owned energy monopoly. Eskom's perilous finances now constitute an annual drain to South Africa's public finances of about 1% of GDP. Obviously, a monopoly ought to generate surpluses, but Eskom is making massive losses due to political interference in almost all aspects of its business. This interference means that Eskom is now the single greatest reason for the steady deterioration in South Africa's public finances (government debt to GDP is expected to hit 60% of GDP this year and 66% of GDP by 2022). The Ramaphosa Administration has appointed a Chief Restructuring Officer, whose proposal for reform of ESKOM – not yet available – may yet alter the current worrisome debt dynamic. Ratings agencies are increasingly expressing concerns about South Africa's deteriorating public finances. In other news, inflation in June was unchanged from May at 4.5% yoy.

- Dominican Republic: The political outlook in the country has become a bit more uncertain following the announcement by President Danilo Medina that he does not intend to pursue a constitutional reform, which would allow him to seek re-election. Dominican Republic is expected to be the fastest growing country in North and South America this year with real GDP growth above 5%.

- Singapore: Industrial production rose 1.2% mom in June in a sign that the truce in the trade war following the recent G20 meeting is beginning to have a positive effect on Asian economies. In yoy terms, industrial production declined at a noticeably lower rate than anticipated (-6.9% yoy versus -8.5% yoy expected). Core CPI inflation was in line with expectations in June (1.2% yoy).

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Emerging Markets

- **Mexico:** The latest Mexican data releases have been surprising to the upside. Firstly, the trade surplus was USD 2.6bn in June, which was far higher than consensus (USD 0.4bn).Secondly, retail sales in May surged far ahead of expectations, rising at a yoy rate of 2.8% versus 1.4% yoy expected. Thirdly, the economic activity index in May (0.0%) also beat the consensus (-0.25% mom). Finally, inflation in H1 July declined to 3.84% yoy from 3.89% yoy in H2 June.

- **Index perspectives:** As a general rule, the speed at which EM markets are included in benchmark indices reflects the popularity of the asset class rather than, say, whether markets exist or not. The index providers add new countries to the benchmark indices if they feel they can make money by making markets there, otherwise not. This general rule is clearly evident in the evolution of JP Morgan's GBI EM GD index, which has become the go-to benchmark for investors in EM local bond markets. For example, index coverage expanded sharply during the heyday of local bonds from early 2000 to 2007, when the number of countries in the index expanded from zero to twelve. Index inclusion then stopped entirely in 2008 and 2009, when investors became wary of EM due to the US Sub-prime Crisis. This was followed by a small improvement in 2011 and 2012, when the number of countries in the index went up to 15. However, index inclusion then went into reverse during the Taper Tantrum. Index inclusion only began to recover after the Fed hiking cycle began, which is usually when EM outperforms. Thus, the number of countries in the index went up from 14 to now 19. Going forward, as EM local currency markets continue to gain greater favour with investors, it is likely that EM local bond indices once again begin to expand significantly. The countries that could potentially enter the GBI EM GD in the coming months and years include Nigeria, China, Serbia, Ukraine, Kazakhstan and Egypt.

- **Colombia:** Congratulation to the 22-year old super talent Egan Bernal and Colombia for winning the Tour de France of 2019! Bernal is the first ever winner from an EM country of this the toughest bicycle road race in the world.In other news, the Colombian central bank left the policy rate unchanged at 4.25% with no signs of further cuts expected.

Snippets:

- **China:** Industrial profits declined at a yoy rate of 3.1% in June following a 1.1% yoy rise in May. The CNY share of global SWIFT payments increased to 1.99% in June from a low of 1.46% in late 2017. The all-time peak was 2.79% in late 2015. In 2010, no SWIFT payments were processed in CNY.
- **Hong Kong:** Protests continue.
- **Hungary:** The National Bank of Hungary left the policy rate unchanged 0.9%.
- **Malaysia:** CPI inflation was 1.5% yoy in June, which is slightly lower than expected (1.6% yoy).
- **Nigeria:** The Central Bank of Nigeria left the policy rate unchanged at 13.5%, in line with market expectations.
- **Russia:** The Central Bank of Russia cut the benchmark interest rate by 25bps to 7.25% in line with expectations. Further cuts are widely expected.
- **South Korea:** The economy expanded 1.1% qoq in Q2 2019 after contracting 0.4% qoq in Q1 2019. On a yoy basis, the economy expanded at a rate of 2.1% versus 1.9% yoy last quarter.
- **Taiwan:** Industrial production increased 0.85 mom in June compared to a decline of 0.3% mom in May.
- **Thailand:** Moody's raised the outlook for the sovereign credit rating to positive from stable, affirming the government's strong Baa1 (IG) rating.
- **Tunisia:** President Beji Caid Essebsi has died. Elections are scheduled for November this year. The speaker of parliament will take over an interim president.

Global backdrop

Ahead of important central bank decisions in Europe and the United States, sentiment towards EM weakened a bit last week after strong performance in recent weeks. Markets were also nervous about the upcoming resumption of talks between the US and China, which are due to re-start this week in China.

Away from these very near-term factors, the bigger picture as far as developed countries are concerned remains deeply worrisome. Firstly, manufacturing indices in developed countries are weakening as a result of slower late-cycle growth rates and protectionist policies in the US. US Markit PMI dropped to 50 in July, which is the lowest level since 2009, while German PMI dropped to a cycle low of 43.1. EM-wide PMI data is not yet available for the month of July, but, as Figure 2 shows, in the period up to June of this year, EM PMIs have actually been improving relatively to both European and US PMIs. EM PMI have been improving relative to German and UK PMIs since H2 2017, coinciding roughly with the resumption of net institutional inflows to the EM asset class, while EM PMIs began rising versus US PMIs around September 2018, which marked the start of the implementation of US President Donald Trump's deeply misguided protectionist policies.

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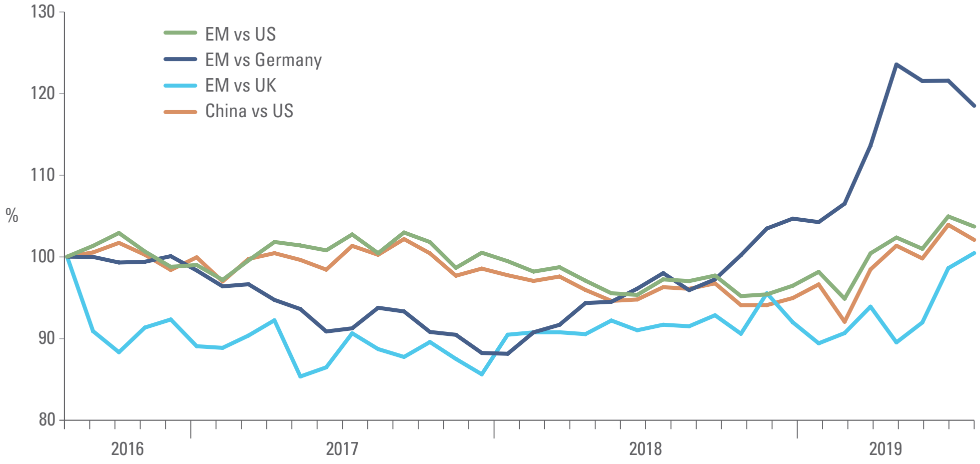
Global backdrop

Fig 2: **PMIs: EM vs US, UK and Germany; China vs US (as of June 2019)**

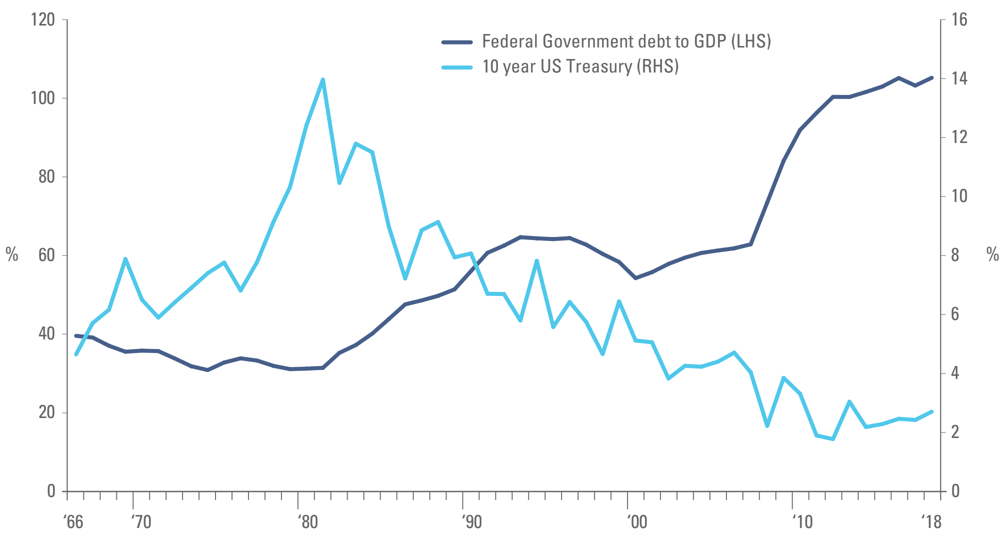


Source: Ashmore, Bloomberg.

Secondly, the weakness in manufacturing, especially in Germany, prompted ECB President Mario Draghi to say that the outlook in Europe is just 'getting worse and worse'. In response, he left the door open for all kinds of stimulus in Q3 2019, including, possibly, tiered interest rates and more asset purchases. However, it is clear that at this point he and other central bankers in developed economies are pushing on a string. Even in the US, where the US ten-year bond yield is no higher than the US core inflation rate, is the room for stimulus very limited. In Europe, of course, monetary policy has even less potency. Draghi, more so than any other central banker in the developed economies, has called on governments to address the structural impediments to growth, but his pleas have fallen on deaf ears. In fact, governments have only become more populist and myopic during his time in office. The reality is that growth rates are diminishing across developed economies – witness the US real GDP growth rate of 2.1% qoq saar in Q2 2019, which is literally half of the growth rate in the same quarter last year – and central banks are running out of ways to do anything about it.

Thirdly, the fiscal situation is not going to improve. Predictably, the US Congress and the Trump Administration last week agreed to lift the US government's debt ceiling until July 2021. This paves the way for hundreds of billions of Dollars of additional debt financed spending. The US Federal Government debt to GDP ratio has already exploded from 63% in 2007 to 105% at the end of 2018, but the debt burden will only rise further in the coming years. No one is suggesting that the US is about to default, but it is clear that the US government will find it hard to repay so much debt, so it will likely have to be inflated and devalued away. Despite the prospect of significant erosion of purchasing power, the compensation for anyone lending money to the US government today continues to fall in almost perfect inverse correlation to the stock of the debt in GDP terms (Figure 3). This is not a sound investment proposition.

Fig 3: **US Federal Debt and 10-year Treasury yield**



Source: Ashmore, Bloomberg. Data as at December 2018.

Global backdrop

Finally, markets continue to inadequately price the clearest and most immediate threat to global financial stability, Brexit. Following his confirmation as Conservative Party leader and Prime Minister of Great Britain, Boris Johnson has wasted no time surrounding himself with a strongly pro-Brexit Cabinet, which will tie him to his promise of leaving the European Union (EU) by 31 October 2019. Over the weekend, members of the Cabinet re-iterated the government's willingness to countenance Hard Brexit. This follows a statement from Michel Barnier last week that Boris Johnson's terms for exiting the EU are unacceptable. Hence, barring a major shift from either party the probability of Hard Brexit is now extremely high. It is possible that the UK government is playing hard ball in order to drum up support ahead of a snap general election. However, if EU does not blink and Hard Brexit happens it would be an unmitigated disaster for the UK economy comparably only to the economic crisis of the 1970s or even the Second World War, in our view. Despite the huge risks associated with leaving the EU – comparable to Mexico unilaterally pulling out of NAFTA – the UK government continues to play down the risks involved, while large sections of the public appear to linger in denial or ignorance of the consequences. Boris Johnson has promised fiscal stimulus and deregulation to mitigate any fallout from Brexit, but is this feasible? Large tax cuts for the wealthy and business would either explode the public debt or require deep cuts in public services, which may prove socially unsustainable, since so many Brits depend on health care, schooling and other services provided by the state. Slashing regulations in a bid to encourage more inward investment is a double-edged sword. Regulations exist for a reason, so if they are slashed it may invite various abuses. Also, it is likely to take a long time for 'de-regulated Britain' to attract new investment and trade, because they require formal agreements, which first have to be negotiated with other countries. This tends to take a very long time.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.07%	-0.07%	10.62%	-0.92%	9.31%	2.22%
MSCI EM Small Cap	-0.53%	-0.53%	6.22%	-6.48%	4.27%	0.19%
MSCI Frontier	2.25%	2.25%	14.32%	2.98%	8.88%	-0.73%
MSCI Asia	-0.11%	-0.11%	10.63%	-1.70%	9.87%	4.42%
Shanghai Composite	-0.28%	-0.28%	20.63%	4.74%	1.10%	9.02%
Hong Kong Hang Seng	0.44%	0.44%	10.56%	2.08%	10.25%	3.53%
MSCI EMEA	-0.39%	-0.39%	12.94%	4.05%	7.36%	-1.00%
MSCI Latam	0.69%	0.69%	13.62%	9.38%	9.94%	-1.37%
GBI EM GD	0.83%	0.83%	9.63%	8.13%	4.90%	-0.49%
ELMI+	-0.17%	-0.17%	3.40%	2.75%	3.14%	-0.62%
EM FX Spot	-0.54%	-0.54%	1.17%	-2.83%	-1.91%	-6.97%
EMBI GD	1.21%	1.21%	12.66%	10.89%	5.34%	5.36%
EMBI GD IG	0.69%	0.69%	11.74%	11.43%	4.56%	4.88%
EMBI GD HY	1.77%	1.77%	13.72%	10.42%	6.23%	5.56%
CEMBI BD	0.69%	0.69%	9.59%	9.56%	5.28%	4.93%
CEMBI BD IG	0.70%	0.70%	9.43%	10.14%	4.42%	4.50%
CEMBI BD Non-IG	0.68%	0.68%	9.79%	8.84%	6.69%	5.45%

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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	2.97%	2.97%	22.06%	8.81%	14.00%	11.11%
1-3yr UST	-0.11%	-0.11%	2.36%	3.97%	1.32%	1.21%
3-5yr UST	-0.32%	-0.32%	3.76%	6.40%	1.43%	2.02%
7-10yr UST	-0.47%	-0.47%	6.43%	10.32%	1.31%	3.09%
10yr+ UST	-1.04%	-1.04%	9.83%	13.18%	0.94%	5.09%
10yr+ Germany	1.10%	1.10%	11.90%	15.10%	2.85%	7.34%
10yr+ Japan	0.29%	0.29%	5.74%	7.40%	0.60%	4.92%
US HY	0.55%	0.55%	10.54%	7.13%	6.68%	4.90%
European HY	0.71%	0.71%	8.35%	4.12%	4.54%	4.20%
Barclays Ag	-0.50%	-0.50%	5.04%	5.50%	1.67%	1.17%
VIX Index*	-19.36%	-19.36%	-52.16%	-6.68%	2.44%	-8.43%
DXY Index*	1.98%	1.98%	1.93%	3.55%	2.62%	20.71%
CRY Index*	-2.14%	-2.14%	4.33%	-8.76%	-2.13%	-40.28%
EURUSD	-2.14%	-2.14%	-3.00%	-4.96%	-0.46%	-17.03%
USDJPY	0.71%	0.71%	-0.95%	-2.16%	6.46%	6.40%
Brent	-5.12%	-5.12%	17.36%	-15.01%	48.70%	-41.39%
Gold spot	0.65%	0.65%	10.61%	16.14%	5.00%	9.20%

*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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