Issued: 24 February 2020

WEEKLY INVESTOR RESEARCH

Ashmore

The option value of waiting

By Jan Dehn

High levels of uncertainty are not only associated with a scarcity of facts, but also with high trading costs. This makes the value of an option to wait for more and better information upon which to base investment decisions extremely high at such times, a fact worth remembering as Coronavirus fears continue to obscure the outlook in global markets.

In Emerging Markets (EM) specific news, inflation picked up in January, so should investors be worried that the multi-year disinflation in EM is over? China has made significant progress in combatting Coronavirus, but concerns are now shifting to other countries, whose response may not be as decisive as China's. In Brazil, the technical factors driving a wedge between fundamentals and the value of the currency continue to be felt. The International Monetary Fund confirmed that Argentina must restructure its debt, a fact known to bondholders for some time. Lebanon's sovereign credit rating was downgraded as the government announced that it is seeking financial advice. Malaysia's Prime Minister resigned in a move seemingly designed to thwart current succession plans.

In index-related news, the JP Morgan EMBI GD looks set to add its 74th country, Barbados. In the global backdrop, manufacturing did better in Europe than in the US and Bernie Sanders clinched Nevada, showing he can win support among minorities, women and younger voters.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	-1.96%
MSCI EM Small Cap	10.6	–	-1.60%
MSCI Frontier	10.7	–	-0.37%
MSCI Asia	12.1	–	-2.13%
Shanghai Composite	9.9	–	4.21%
Hong Kong Hang Seng	7.4	–	-0.67%
MSCI EMEA	9.3	–	-0.69%
MSCI Latam	12.4	–	-2.53%
GBI-EM-GD	4.91%	–	-0.74%
ELMI+	3.88%	–	-1.03%
EM FX spot	–	–	-1.03%
EMBI GD	4.67%	317 bps	0.49%
EMBI GD IG	3.16%	164 bps	1.00%
EMBI GD HY	6.76%	529 bps	-0.12%
CEMBI BD	4.55%	313 bps	0.37%
CEMBI BD IG	3.30%	188 bps	0.49%
CEMBI BD Non-IG	6.32%	491 bps	0.21%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.3	–	-1.03%
1-3yr UST	1.31%	–	0.20%
3-5yr UST	1.27%	–	0.47%
7-10yr UST	1.42%	–	1.12%
10yr+ UST	1.88%	–	2.88%
10yr+ Germany	-0.46%	–	1.08%
10yr+ Japan	0.00%	–	0.71%
US HY	5.16%	359 bps	0.10%
European HY	3.17%	361 bps	0.09%
Barclays Ag	1.22%	-20 bps	0.15%
VIX Index*	17.08	–	2.93%
DXY Index*	99.60	–	0.59%
EURUSD	1.0817	–	-0.18%
USDJPY	111.57	–	1.54%
CRY Index*	174.65	–	2.37%
Brent	56.8	–	-1.47%
Gold spot	1667	–	5.46%

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

Emerging Markets

The sky high option value of waiting

In 1994, Avinash Dixit and Robert S. Pindyck wrote "Investment under uncertainty", a seminal work of economic theory, which pushed forward the understanding of how companies invest. One of the key insights of Dixit and Pindyck was that elevated levels of uncertainty increase the value of the option to postpone decisions, i.e. to wait for more information before making any serious investment decisions. The reason why the option to wait gains value at such times is that the probability of getting investment decisions seriously wrong is particularly high. Also, trading costs are higher and liquidity is highly asymmetric. During spikes in risk aversion, Dixit and Pindyck would say, "Take a chill pill! Sit back and wait for more information before you make a decision!"

In reality, large numbers of investors behave in direct opposition to the recommendations of Dixit and Pindyck. Outbreaks of uncertainty are, almost by definition, associated with a profound lack of concrete information upon which to base decisions, yet they often trigger abnormally large flows. Many investors, even those who spent years undertaking careful due diligence prior to deciding to invest, sometimes lose all sense of perspective and make rash decisions based on the sparsest of information. This is irrational and rarely enhances returns.

Continued overleaf

Emerging Markets

There is no doubt that such irrationality gets exploited by the media, which is intensely aware of the potential to exploit the fickle nature of investor sentiment. The media often fuel a sense of panic in the markets, using whatever information is at hand, even low quality sources, such as vested interests. After all, just like in market making, there is big money to be made when the herd starts to move in response to market panics, in our opinion.

In EM, the ongoing worries over Coronavirus have manifested themselves in a relatively predictable fashion. Fixed income has outperformed equities and Dollar-denominated bonds have outperformed local currency-denominated securities. Specifically, as of the close of business on Friday 21 February 2020, EM external sovereign debt was up 2.70% for the year (as measured by JP Morgan's EMBI GD), while EM corporate debt had returned 2.55% (based on the performance of the CEMBI BD). Investment grade versions of the two indices performed better than the broad indices with returns of 3.90% and 2.60% year to date (ytd), respectively. EM local currency bonds were down 1.52% ytd and EM currencies down 3.69% ytd (based on the GBI-EM GD). EM equities as measured by the MSCI EM are down 2.64% ytd with the small cap sub-index underperforming the broader indices.

There is clearly a media frenzy underway in response to Coronavirus. Weak hands are drawn into selling in an environment of lower than average trading volumes. Every erratic move in asset prices appears to reinforce the notion that something is wrong, making selling seem the right thing to do. Of course, when the sense of crisis dissipates, which it will, all the weak hands will have to buy back the assets they have just sold. The only winners in this game are the media and the market makers, who make money as investors cross the bid-offer spread on the way out and once again on the way back in.

It is precisely at times like these when investors need to brush up on their Dixit and Pindyck. Levels of uncertainty are unusually high and the final outcome not yet well defined. Highly volatile prices are probably the worst possible guide to anything. In these circumstances, the only thing that is absolutely certain is that the option to wait is extremely valuable, because it is very easy to make a mistake. There is very little hard information. It is costly to trade due to the widening of bid-offer spreads. Prices are distorted. And although the possibility that the world will end cannot be ruled out entirely, it is likely that the Coronavirus too will go away. Getting drawn into rash and expensive investment decisions at this time, particularly of the selling variety, and thereby ditching an extremely valuable option to wait for more information and potentially extremely lucrative entry points makes no sense. So listen to Dixit and Pindyck: take the chill pill!

Uptick in EM inflation

There has been a notable uptick in the yoy rate of EM Consumer Prices Index (CPI) inflation in recent months. Weighted by the JP Morgan GBI-EM GD index, EM CPI inflation rose to 3.56% on a yoy basis in January from 3.37% yoy in December 2019. This marks a continuation of a gentle rise in inflation, which began from the multi-year lows recorded around October last year (2.95% yoy). In fact, the October 2019 print was the second lowest inflation print ever since the launch of the GBI-EM GD index in December 2002.
The lowest recorded inflation print was in July 2009 (2.82% yoy).

So, does that uptick in inflation mean that the best of EM disinflation is behind us? Unlikely, in our view. As Figure 1 shows, the January 2020 inflation print is actually lower than the inflation rate recorded in the same month of last year. Hence, based solely on this one observation, 2020 could end up delivering even lower inflation than last year.

It is also worth bearing in mind that EM CPI inflation displays clear seasonality in the course of the calendar year. Inflation prints tend to be relatively high around mid-year and low on either side of year-end. Based on this pattern, investors should expect inflation to pick up some more in the next few months, albeit purely for seasonal reasons. Altogether, however, we do not see the era of low inflation in EM coming to an end just yet.

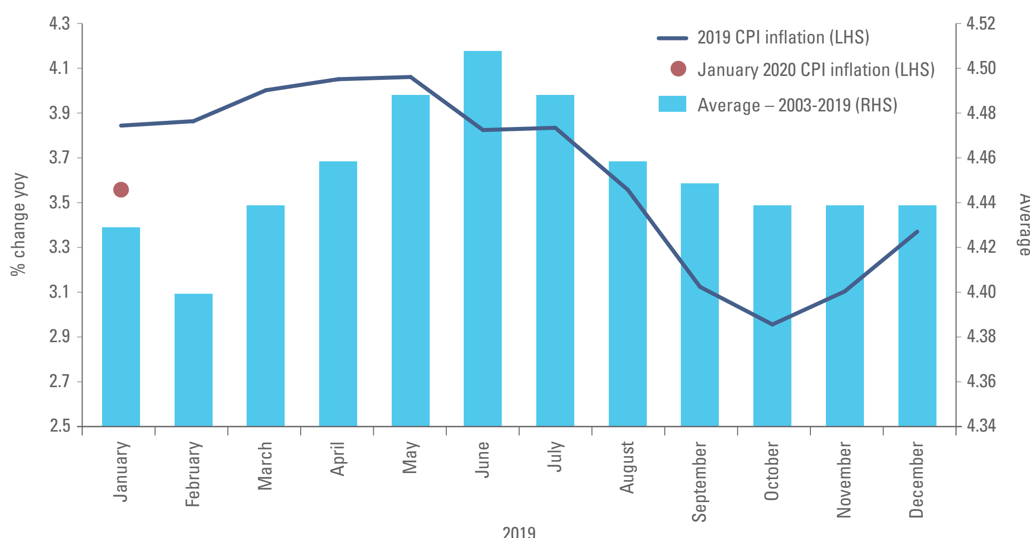
What, then, could push up inflation in EM? The persistent low inflation in EM in recent years can largely be attributed to weak domestic demand, which, at the margin, largely reflects severely binding finance constraints across the EM universe. The ratio of financial markets to GDP in EM is only 0.9 compared to 3.6 in developed countries. In addition to being finance constrained, EM gets just shy of 90% of its financing in local markets, which have been out of favour among international investors during the last decade on account of the strong Dollar.

Our view is therefore that EM inflation rates are likely to pick up significantly once the Dollar loses momentum. At this point, inflows to local markets will pick up significantly and inject life into domestic demand. Even when this happens, however, we believe that investors can continue to expect to make good money in local bonds, because inflation rates are low and real yields are high. EM local currency bonds returned 13.5% in Dollar terms in 2019 and have returned 11.4% annualised (also in USD terms) over the 2016-2019 period. EM FX outperformed the US Dollar in three of the last four calendar years (2016, 2017 and 2019). Hence, do not write off EM local bond markets. You just may be looking at the one of the most attractive entry point for some time, in our opinion.

Continued overleaf

Emerging Markets

Fig 1: **EM CPI inflation rates (% change, yoy)**



Source: Ashmore, Bloomberg, JP Morgan.

- **China:** Chinese authorities are not yet acknowledging a turning point in the fight against Coronavirus yet, but the outbreak in China increasingly looks contained. China took very decisive steps to contain the virus. This effort now appears to have borne fruit. The economic fallout in China is yet to be quantified and due to the long lags involved in collecting and preparing macroeconomic data for release the market may well receive a slew of bad economic numbers just as the Chinese economy actually starts to recover. In any case, the Chinese authorities are not taking any risks. Last week, the Politburo ordered further fiscal and monetary policy measures to support the economy during the expected temporary drop in economic activity in the months ahead. In January, total social financing was ramped up sharply, beating expectations by reaching RMB 5.07trn compared to RMB 2,103trn in December. M1 money growth on a yoy basis fell to 0% in January, which is the lowest recorded level, so action seems very justified. Meanwhile, the incidence of disease continues to rise in other countries and the big question is now whether these other countries will be able to act as decisively as China. Last week a shudder went through technology stocks on the news that Japan recorded two deaths and South Korea confirmed its first fatalities from the disease. The outbreak has also spread to Italy, Bahrain, Lebanon and Kuwait. Japan and South Korea are vital suppliers of inputs to US tech giants.

- **Brazil:** While BRL continues to be under pressure due to large volumes of refinancing of Dollar corporate bonds into local currency denominated bonds as well as the negative risk sentiment in global markets, Brazil's underlying credit fundamentals continue to improve. The Finance Committee of the Senate approved the central bank independence bill, which now goes to a vote in the Senate plenary. Tax collection in January 2020 was up 4.7% yoy in real terms, which is the best result ever for January tax collections. Business confidence hit 99.8 in February compared to 98.1 in January. The Brazilian central bank eased the reserve requirement ratio for banks by 6 points to 25%. This is a very substantial easing, which together with other measures could increase liquidity by nearly 2% of GDP. Mid-month CPI inflation was just 0.22% in February, which is consistent with 4.2% inflation on a yoy basis, lower than the 4.3% yoy print recorded in January. The current account deficit was USD 11.9bn in January, thus taking the 12 months rolling current account deficit to USD 52.3bn. This is easily financed by foreign direct investment, which was USD 78.3bn in the past twelve months.

- **Argentina:** The International Monetary Fund (IMF) announced that it agrees with the idea of imposing a haircut on bondholders. Most bondholders have been operating on this assumption for some time. In the last week, the local media issued various estimates of haircuts and maturity extensions and grace periods and net present value losses, etc. However, until the government's actual proposal has been published and negotiations concluded much of the media hype can only be classified as highly speculative noise. In a clear positive, however, Argentina agreed to an Article IV consultation with the IMF. Article IV consultations produce detailed standardised reports covering the fiscal balances, the outlook for the economy, balance payments and debt sustainability analysis. Such information is often of great value to investors. However, it is unlikely that the Article IV report will be ready prior to the launch of the government's debt restructuring proposal.

- **Lebanon:** S&P cut Lebanon's sovereign credit rating from CCC to CC with a negative outlook, largely in response to market volatility and media noise. Markets have long since priced in the more challenging environment in Lebanon. The government has a Eurobond repayment of USD 1.2bn due on March 9. A total of USD 2.5bn in principal repayments fall due through to June plus USD 2.0bn of coupon payments for the

Continued overleaf

Emerging Markets

full year 2020. At least 60% of Lebanese Eurobonds are held locally. The government continues to service debt normally. Lebanon's central bank holds about USD 30bn in reserves plus gold worth about USD 14bn and about USD 8bn of bond holdings, mostly Lebanese Eurobonds. Over the weekend, the Lebanese government appointed advisors to offer guidance on how to deal with the government's debt burden. In other news, the government confirmed one case of Coronavirus and said it was monitoring two other potential cases.

- Malaysia: Prime Minister Mahathir Mohamad has resigned. His resignation appears to be designed to annul an agreement that Anwar Ibrahim, another heavy weight politician in Malaysia, should succeed him ahead of the next election scheduled for 2023. Even if Mohamad's move succeeds, it will create some near-term uncertainty on at least three fronts. First, the question of succession will suddenly be wide open. Second, Mohamad's new coalition will probably be weaker than the last one. Third, fiscal risks could increase as a result. In other news, the yoy rate of CPI inflation was 1.6% in January, which was slightly lower than expected (1.7% yoy).

- South Korea: Exports in the first 20 days of February were 12.4% higher than in the same month of 2019. This was significantly better than expected, particularly taking into account the Coronavirus. President Moon Jae-in signalled that special measures will be taken to support the economy during the outbreak and the alert level was raised to 'red', which is the highest of four levels. South Korea has had 7 deaths from the virus so far.

- Index news: JP Morgan's EMBI GD index will shortly add another country, thus taking the total number of countries in the index to an all-time high of 74. Barbados is scheduled to join the index at the end of this month.[1] In other index news, JP Morgan issued a note that Greece could be classified as an EM country since the country's gross national income has been below the minimum threshold for high income countries for two years in a row. If this continues for another year then Greece could join the EM indices, according to JP Morgan's index criteria. On the other hand, Czech Republic's gross national income is now above the high income threshold, so if this continues for two more years the country could leave the EM universe.

Snippets:

- Colombia: Full year real GDP growth was 3.3% in 2019. This is the fastest pace of growth since 2014.
- Egypt: The Central Bank of Egypt left the policy rate unchanged at 12.25%. Core inflation was 2.6% in yoy terms in January.
- Nigeria: Q4 real GDP growth was 2.6% on a yoy basis compared to 2.2% yoy expected.
- Singapore: The government is gearing up for a large fiscal stimulus to combat the temporary effect of Coronavirus; the 2020 budget envisages a fiscal deficit of 2.1% of GDP compared to 0.3% of GDP in 2019.
- South Africa: The yoy rate of CPI inflation increased to 4.5% in January from 4.0% in December. However, the rate of core CPI inflation dropped to 3.7% yoy from 3.8% yoy.
- Turkey: The monetary policy committee of the Turkish central bank cut the policy repo rate by 50bps to 10.75%. The yoy rate of CPI inflation was 12.15% in January.

Global backdrop

The Eurozone purchasing managers index (PMI) increased by 0.3 points in February to 51.6, which was better than expected. The exact opposite happened in the United States, where the composite PMI dropped sharply to 49.6 from 53.3 in January. Bernie Sanders took a large step towards winning the Democratic Party presidential nomination by clinching the Nevada primary election. The race may well be decided on Tuesday 3 March, when 14 states will vote. Joe Biden, Sanders's main rival, will look to a strong performance in the South Carolina primary on 29 February to keep his hopes of nomination alive. The win in Nevada was significant, because it showed that Sanders was able to bring out the non-Caucasian vote, which is close to 50% in that state as well as the votes of women and young people. Only over-65s (who happen to exercise their right to vote more than any other demographic) failed to support Sanders.

[1] For a recent exposition of the enormous value of diversification in the EMBI GD, see: *'Delightful diversification'*, Weekly investor research, 6 January 2020.

Continued overleaf

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	2.12%	-2.64%	-2.64%	6.21%	7.57%	4.81%
MSCI EM Small Cap	0.70%	-3.31%	-3.31%	1.56%	2.52%	2.02%
MSCI Frontier	-2.33%	-2.38%	-2.38%	7.45%	5.73%	2.45%
MSCI Asia	2.80%	-1.78%	-1.78%	6.41%	8.91%	5.71%
Shanghai Composite	2.12%	-0.34%	-0.34%	13.16%	0.03%	0.78%
Hong Kong Hang Seng	5.37%	-3.37%	-3.37%	-0.93%	5.22%	1.56%
MSCI EMEA	-0.06%	-4.84%	-4.84%	3.65%	3.56%	1.33%
MSCI Latam	-1.32%	-6.84%	-6.84%	-2.13%	3.82%	3.70%
GBI EM GD	-0.24%	-1.52%	-1.52%	7.55%	5.24%	2.65%
ELMI+	-0.96%	-2.25%	-2.25%	0.82%	2.53%	1.56%
EM FX Spot	-1.03%	-3.69%	-3.69%	-4.70%	-2.82%	-4.35%
EMBI GD	1.15%	2.70%	2.70%	12.68%	6.65%	6.61%
EMBI GD IG	1.58%	3.90%	3.90%	17.48%	7.97%	6.12%
EMBI GD HY	0.65%	1.30%	1.30%	7.84%	5.24%	7.33%
CEMBI BD	0.99%	2.55%	2.55%	12.09%	6.39%	6.15%
CEMBI BD IG	1.00%	2.60%	2.60%	12.58%	6.29%	5.20%
CEMBI BD Non-IG	0.99%	2.48%	2.48%	11.42%	6.59%	7.71%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	3.63%	3.58%	3.58%	22.66%	14.40%	11.84%
1-3yr UST	0.06%	0.61%	0.61%	3.92%	1.99%	1.48%
3-5yr UST	0.08%	1.51%	1.51%	6.55%	2.96%	2.32%
7-10yr UST	0.40%	3.62%	3.62%	11.92%	5.03%	3.45%
10yr+ UST	1.87%	8.84%	8.84%	24.82%	9.73%	5.79%
10yr+ Germany	0.23%	5.12%	5.12%	12.29%	6.56%	4.41%
10yr+ Japan	0.23%	1.00%	1.00%	3.57%	3.44%	4.18%
US HY	1.18%	1.21%	1.21%	9.46%	5.94%	5.90%
European HY	0.83%	0.93%	0.93%	8.14%	4.02%	4.39%
Barclays Ag	-0.70%	0.56%	0.56%	6.45%	4.29%	2.64%
VIX Index*	-9.34%	23.95%	23.95%	26.42%	48.91%	24.76%
DXY Index*	2.27%	3.33%	3.33%	3.20%	-1.48%	5.40%
CRY Index*	2.55%	-6.00%	-6.00%	-5.11%	-8.53%	-21.42%
EURUSD	-2.48%	-3.54%	-3.54%	-4.75%	2.39%	-4.62%
USDJPY	2.96%	2.73%	2.73%	0.46%	-0.51%	-6.23%
Brent	-2.30%	-13.91%	-13.91%	-15.35%	1.48%	-3.14%
Gold spot	5.09%	9.90%	9.90%	25.60%	32.64%	38.90%

*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.

Continued overleaf

Ashmore

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

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2020.

Important information: This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised and regulated by the Financial Conduct Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. Past performance is not a reliable indicator of future results. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment.