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China's economic policies

By Jan Dehn

Where is China heading in economic policy terms and why? China will achieve global financial and economic hegemony before the middle of this century on account of the country's elevated rates of savings and investment, a larger population than any other country, and constant emphasis on structural reforms designed to remove impediments to development. By 2050, China's economy will be two to three times larger than the United States, in our view. Aware of China's special destiny, the overriding strategic objective of China's leadership is ensure that hegemony comes about. To this end, China is currently undertaking three major structural rotations in economic policy. In addition, China has deployed its policy instruments – fiscal, monetary, and FX policy – tactically to address the inevitable economic shocks that occur along the way towards the achievement of the long-term economic policy objective.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	14.4	–	1.79%
MSCI EM Small Cap	14.0	–	3.02%
MSCI Frontier	12.9	–	1.19%
MSCI Asia	15.4	–	1.50%
Shanghai Composite	13.1	–	0.91%
Hong Kong Hang Seng	8.8	–	2.25%
MSCI EMEA	10.7	–	1.85%
MSCI Latam	13.2	–	3.60%
GBI-EM-GD	4.35%	–	0.39%
ELMI+	1.73%	–	0.28%
EM FX spot	–	–	0.31%
EMBI GD	4.75%	384 bps	0.19%
EMBI GD IG	2.78%	181 bps	-0.31%
EMBI GD HY	7.39%	653 bps	0.80%
CEMBI BD	4.24%	354 bps	0.34%
CEMBI BD IG	2.86%	217 bps	0.07%
CEMBI BD Non-IG	6.18%	548 bps	0.70%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	21.3	–	1.60%
1-3yr UST	0.15%	–	0.03%
3-5yr UST	0.37%	–	0.09%
7-10yr UST	0.84%	–	0.12%
10yr+ UST	1.57%	–	0.05%
10yr+ Germany	-0.59%	–	-0.06%
10yr+ Japan	0.00%	–	-0.32%
US HY	4.71%	410 bps	0.64%
European HY	3.56%	425 bps	0.76%
Barclays Ag	0.86%	2 bps	0.27%
VIX Index*	20.84	–	-2.27%
DXY Index*	91.69	–	-0.70%
EURUSD	1.1963	–	1.03%
USDJPY	103.96	–	-0.54%
CRY Index*	160.97	–	5.94%
Brent	46.9	–	1.82%
Gold spot	1775	–	-3.42%

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

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Where is China heading in economic policy terms and why? China will achieve global financial and economic hegemony before the middle of this century on account of the country's elevated rates of savings and investment, a larger population than any other country, and constant emphasis on structural reforms designed to remove impediments to development. By 2050, China's economy will be two to three times larger than the United States, in our view. Aware of China's special destiny, the overriding strategic objective of China's leadership is ensure that hegemony comes about. To this end, China is currently undertaking three major structural rotations in economic policy. In addition, China has deployed its policy instruments – fiscal, monetary, and FX policy – tactically to address the inevitable economic shocks that occur along the way towards the achievement of the long-term economic policy objective.

China's economic policies are distinct from those of most other countries in that China places far greater emphasis on long-term policy objectives and the structural reforms required to achieve them than other countries. China also places comparatively less emphasis on short-term demand management through conventional fiscal, monetary, and FX policies, setting Chinese policy sharply at odds with policies in most developed economies. The over-riding long-term policy objective of China's current leadership is to ensure that China realises its potential as the world's next economic and financial hegemon. All China's policies – structural as well as tactical deployment of conventional fiscal, monetary, and FX policies – are designed to support China's attainment of this strategic objective.

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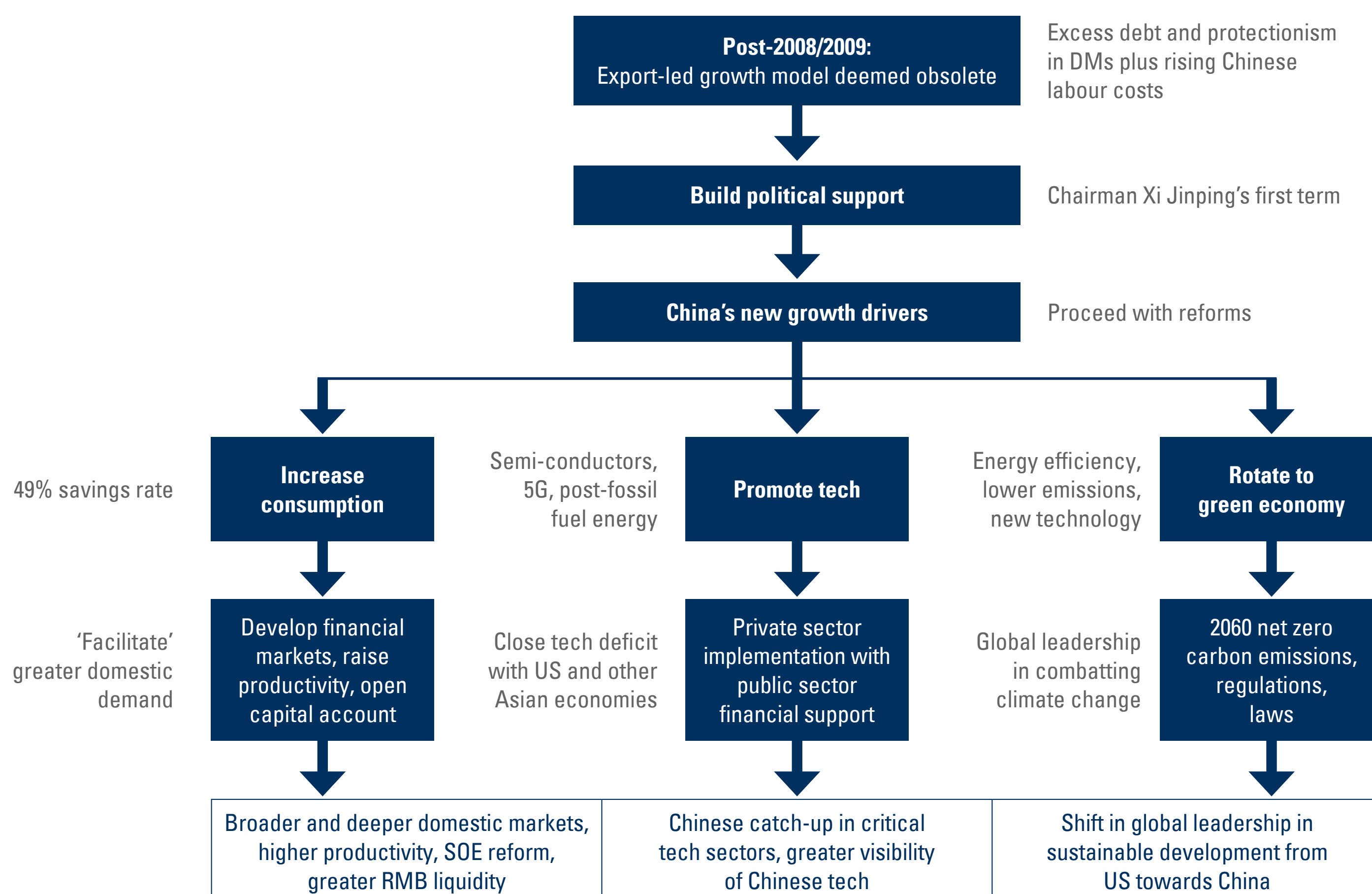
To support China's overall policy objective of realising its destiny as the world's most important economy, the country's economic policy regime is undergoing three major structural rotations. These are summarised in Figure 1. The most important of these structural rotations is the shift from exports to consumption growth as the country's main source of growth. This rotation, which has been underway since soon after the 2008/2009 Global Financial Crisis, helps China to continue to grow in an increasingly hostile external environment and plays to one of China core strengths, namely its saving rate of nearly 50%. The elevated rate of savings means that China has plenty of room to allow its consumers to spend more in order to contribute more towards demand. Indeed, the other two rotations, which we discuss below, can be seen as facilitating the rise in consumption by ensuring that macro-economic stability and the environment are not placed into jeopardy in the process of expanding domestic demand.

Fig 1: **China road map**



Source: Ashmore.

China is pulling three specific policy levers in order to shift the economy towards greater consumption:

a) Interest rate liberalisation and the development of domestic bonds markets: As China consumes more, it is increasingly important that China's policy makers have the necessary policy instruments to control consumption. To this end, China is freeing up interest rates and establishing an efficient transmission mechanism from rates to demand via the bond market. Much like the Federal Reserve in the US, the People's Bank of China (PBOC) will increasingly rely on interest rates to anchor the cost of capital. China's rapidly expanding and increasingly liquid and freely traded bond market will transmit monetary policy changes to the wider economy. Due to the central role of consumption in future growth, it is extremely likely, in our view, that China will continue to liberalise financial markets in order to make them ever deeper and broader, so that their efficiency as a policy conduit continues to improve. Indeed, this is why local governments in China are being made to raise financing in local bond markets rather than to continue to direct credit to themselves from the banking system. China is also stimulating the development of mortgage markets and other interest-rate sensitive credit markets.

b) Economic liberalisation and raising productivity growth: China is placing great emphasis on relying progressively more on productivity growth and correspondingly less on factor accumulation. The rationale for emphasising greater productivity growth is to ensure that consumption can be increased without jeopardising macroeconomic stability. Incremental domestic demand must be matched by greater domestic supply to ensure stability, so that costs do not rise in the face of greater demand. A failure to raise the rate of productivity growth in the face of greater domestic demand would quickly result in domestic disequilibrium in the shape of

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inflation and external disequilibrium in the form of unsustainable current account deficits. The shift towards greater productivity growth should be understood in the broadest possible terms. The single most important way for any country to increase productivity growth is to shift from a system of central planning to market-based resource allocation, which is why China is assigning an ever greater role to the private sector in production. Additionally, China is improving the performance of state-owned enterprises (SOEs) that are now required to operate on more commercial terms, including being allowed to fail (and default, if it cannot be helped). At the same time, China is subsidising activities that have large positive externalities, such as innovation and pushing for more openness to international trade, which has been proven empirically to be closely associated with faster growth.

c) Capital account liberalisation: As China starts to consume more, the Chinese economy will gradually start to run a current account deficit, just like the US (the classic consumption-led economy) does. This means that China will require external financing, which is why capital account liberalisation is integral to any policy of relying more on consumption. The thrust towards capital account liberalisation is evident in China's push to include its stock and bond markets in international benchmark indices, the deepening ties between mainland and foreign stock exchanges, including Hong Kong and global financial centres, such as London. It is also evident in China's work to make RMB more market determined and to ensure that RMB is used more and more in global transactions ('RMB internationalisation'). Indeed, China wants RMB to be seen as a safe haven currency, demand for which rises during bouts of risk aversion (just like the Dollar) because this dramatically reduces the risk associated with China's greater reliance on external financing of its current account. Still, the pace at which capital account liberalisation can be implemented is constrained by large pre-existing imbalances between the (large) demand of ordinary Chinese for global assets and the (still relatively small) demand of foreigners for Chinese assets. Although this imbalance is lessening, China will only be able to ease capital account restrictions at the pace at which foreigners demand more Chinese assets (since a 'Big Bang' would be highly disruptive).

In addition to the rotation towards consumption in support of China's future as global economic and financial hegemon, China is also making structural rotations in two other key areas, namely: (a) high-end semi-conductor technology, and; (b) 'green' economic development.

The urgency of the need for China to develop an indigenous world-beating capability in semi-conductor technology has recently become painfully evident following US attacks on Chinese tech giants, such as Huawei as well as restrictions placed on China's access to advanced semi-conductor technology in the US as well as Taiwan and South Korea. China has responded to this challenge in characteristic fashion by working hard on developing its own capability. China is throwing enormous amounts of money at the problem in a bid to catch up, including attractive offers to top engineers to join Chinese companies. It would be foolish to bet against China, in our view, although it will likely take some time before China gains the lead in the most cutting edge segments of the semi-conductor industry.

As for 'green' policies, China has made tremendous advances in recent years and this trend looks set to continue. The recent US withdrawal from the Paris Climate Accord has enabled China not only to snatch the initiative on climate change from the US, but has also enabled China to 'gain' four years on the US in terms of developing green policies. It is now China's official policy objective to be completely carbon neutral by 2060. China already leads in several areas of green technology, including modern batteries. Like all other EM economies, Chinese industries have great potential to leapfrog Western industries by shifting directly to the latest technologies without having to go through a long line of intermediate dirtier technologies.

China's emphasis on long-term policies means that conventional fiscal, monetary, and FX policies mostly play a supportive role in economic policy making. In general, they will be deployed as and when short-term shocks pose a risk to the general direction of travel as defined by structural reforms. Between fiscal, monetary, and FX policies, investors can expect monetary policy to gain in importance (to manage consumption), while fiscal policy will change from centrally directed credit towards more conventional tax and spend programs as seen in many Western economies. Finally, FX policy can generally be expected to become less interventionist as RBM becomes ever more established as a global reserve – and safe haven – currency.

In 2020, China deployed both fiscal and monetary policies heavily to help the economy through the double whammy of the coronavirus outbreak in Wuhan Province and the adverse external environment caused by US trade tariffs, US sanctions against key Chinese companies, and the collapse in global growth as the pandemic spread across the world. PBOC cut rates and extended liquidity very broadly. The government provided fiscal support for the property sector and rolled out major new infrastructure projects. By contrast, FX policy was not used extensively in this crisis. Yet, the combination of policies was highly successful: China managed to contain coronavirus far better than any Western economy and China will be one of the few countries in the world to record positive real GDP growth this year (IMF expects about 2% real GDP growth in 2020 according to the October World Economic Outlook).

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China's short-term policy mix will change next year. In 2021, base effects will give the impression of very strong growth in China with IMF now anticipating more than 8% real GDP growth. However, sequential growth rates are likely to be less formidable, though led clearly by improving business activity. The monthly rate of industrial profit growth hit 28.2% on a yoy basis in October after recording 10.1% yoy growth in September, which is the fastest pace of profit growth since early 2017. Manufacturing activity was also strong with the NBS manufacturing PMI rising 0.7 points to 52.1 in November, led by new orders, while services PMI rose 0.2 to 56.4, which is an eight-year high. Both sets of November PMI numbers beat expectations. However, private consumption and investment remain sluggish due to the many lingering global political and economic uncertainties. While PBOC will not need to ease monetary policy any further, the central bank is likely to be mindful of these risks and careful not to jeopardise the ongoing economic recovery, wherefore rate hikes look unlikely in the near term. Besides, inflation dynamics are extremely benign, perhaps too benign with the core consumer prices index (CPI) inflation running at just 0.5% yoy.

Fiscal policy is also likely to be scaled back in 2021, albeit only slowly. Stronger growth rates will give the impression of rapid improvement in fiscal deficit and debt metrics (in % of GDP terms). The main focus of the authorities is likely to be on domestic credit markets, where a careful balancing act is now required as China tries to subject more local governments and SOEs to the discipline of market forces, while at the same time avoiding destabilising the economy. It is likely that the various programmes already in place to help small and medium sized companies to defer loan repayments will remain and only be removed gradually on a case-by-case basis.

As for FX policy, the currency will be allowed to float as far as possible, as befits an aspiring global reserve currency. The global environment looks set to change in ways that are broadly supportive for RMB. The Dollar, having risen strongly due to the cyclical upswing in the US since 2010 is now expensive and becoming increasingly unresponsive to positive news (which is also becoming less frequent). As such, the improving global outlook for 2021 compared to 2020 – including the arrival of vaccines, powerful base effects that lift global growth rates, and a far more predictable and convivial administration in Washington under Joe Biden – should be supportive of RMB. RMB will also benefit from tailwinds arising from growing interest in Chinese assets among foreign investors as index inclusion progresses. In short, this environment does not point to significant changes in Chinese FX policy meaning that China will not stand in the way of currency appreciation provided that it happens at a gradual pace. As always, however, China is sensitive to excessive movements in exchange rates due to the impression of lack of control it conveys, so a Dollar crash could certainly trigger temporary Dollar buying by the Chinese authorities.

The most important policy challenge facing China is how to overcome its bad reputation in the West. Politically motivated attacks on China by the Trump Administration in recent years were accepted rather blindly as the new gospel by many of America's traditional allies in Europe and elsewhere. As a result, the West as a whole has become far more mistrustful of China. Yet, it is hard to escape the observation that the antagonism towards China has grown out of proportion with any actual policy changes in China. Critics mainly point to China's clampdown in Hong Kong as evidence of a more 'dangerous China', but it is questionable if China would have clamped down as hard on Hong Kong had Beijing not feared that Washington would scale up financial and possibly military support for the student uprising.

There is very little China itself can do to repair its tarnished reputation, which will take time to live down. China's approach will be to continue to play by international rules and show support for multilateral institutions, so as to give the impression of an increasingly mature, consensus-seeking leader on key policy issues, including the environment. This is also why China supports the Iran Accord, the Paris Climate Accord, and why the country grants more debt relief to poor countries than the rest of G20 combined. It is the same wish to appear sensible which lies behind China's close cooperation with the IMF and global index providers in the process of capital account liberalisation. China's desire to improve its international reputation is also the reason why China is unlikely to do anything to destabilise the West, such as disrupting the US bond market by dumping US Treasury bonds, even when severely provoked. China understands that it will soon take over reigns of global leadership from the US, so the last thing China wants to do is set a precedent of attacking the hegemon. Above all, China will look at itself and continuously ask what it can do to develop as quickly and as sustainably as possible. In this way, other countries will have no choice but to engage with China as the country becomes ever more influential economically and financially.

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Snippets:

- **Abu Dhabi:** The government announced the discovery of 22bn barrels of new oil reserves.
- **Belarus:** President Alexander Lukashenko said last week that he will leave office after the approval of a new constitution, according to Belta, the Belarussian news agency. The precise timing of his retirement is unclear at this stage.
- **Brazil:** The 12 months rolling current account deficit narrowed to USD 15.3bn, or about 1.0% of GDP from USD 24.9bn in September. CPI inflation jumped to 4.22% on yoy basis in mid-November from 3.52% yoy in mid-October. Employment rose 0.5% in September. Loan growth accelerated at a yoy rate of 14.5%, led by market-based lending which expanded at a rate of 16.3% yoy. State-directed credit was up 12.3% yoy.
- **Colombia:** Banco de la Republica left the policy rate unchanged at 1.75%.
- **Ecuador:** The government reached staff-level agreement with the IMF on the first review of Extended Fund Facility program, paving the way for further disbursements.
- **Ghana:** Bank of Ghana left the policy rate unchanged at 14.5%.
- **India:** The yoy rate of growth recovered sharply from -23.9% in Q2 2020 to -7.5% in Q3 2020. The market had expected a contraction in Q3 2020 of 8.2% yoy. On the other hand, the number of coronavirus cases rose following the Diwali holidays during which families frolic together.
- **Malaysia:** The yoy rate of CPI inflation declined to -1.5% in October from -1.4% yoy in September.
- **Mexico:** Real GDP was 12.1% higher in Q3 2020, which is the best quarterly growth rate since 1990. Retail sales expanded 2.7% in September, unchanged from August. The yoy rate of inflation in mid-November declined to 3.43% from 4.09% yoy in the second half of October.
- **Peru:** Economic activity rebounded strongly in Q3 2020, according to the INEI index of economic activity. The index was up 29.9% in the quarter, although this follows a contraction of 31.3% over the previous two quarters combined.
- **Poland:** Official data showed that industrial output grew 1.0% on a yoy basis in October versus 0.6% yoy expected.
- **Romania:** The country's constitutional court delayed a judgement on a 42% pension hike proposed by the opposition. The delay means that there may not be enough time to include the pension hike in next year's budget, which is positive for the fiscal balance.
- **Russia:** The pace of contraction in retail sales slowed to 2.4% yoy in October from 3.0% yoy in September, which was better than expected (-3.6% yoy as per the Bloomberg consensus expectation). Real wages were also 2.2% higher on a yoy basis in September, although industrial production declined somewhat in October.
- **Serbia:** The government issued a benchmark sized 10-year Dollar-denominated bond, which will likely be eligible for inclusion in the EMBI GD. As such, membership of EMBI GD could rise to 74 countries.
- **Singapore:** Headline CPI inflation declined to -0.2% on a yoy basis in October from 0.0% yoy in September. The real GDP growth rate for Q3 2020 was revised up to 9.2% qoq sa. Industrial production on the other hand disappointed due to weaker pharma output.
- **South Africa:** Ratings agencies Fitch and Moody's both downgraded South Africa's sovereign credit rating by one notch to BB- and Ba2, respectively. Both agencies maintained their negative outlooks for the sovereign credit rating. The yoy rate of headline CPI inflation rose to 3.3% in October from 3.0% in September. Core CPI inflation rose to 3.4% yoy from 3.3% yoy.
- **South Korea:** The yoy pace of exports in the first 20 days of October surged to 11.1% from -5.8% yoy in the first 20 days of September. Bank of Korea left the policy rate unchanged at 0.5%. The government introduced new stricter social distancing rules following a rise in coronavirus cases.
- **Sri Lanka:** Fitch downgraded the sovereign credit rating to CCC from B-.
- **Taiwan:** Export orders were 9.1% higher in yoy terms in October following 9.9% yoy in September. Industrial output expanded at a 7.1% yoy pace in October following high output growth in September as well.
- **Thailand:** Trade was weaker than expected in October with exports down 6.7% and imports down 14.3%, both on yoy basis. The trade surplus of USD 2.0bn was in line with expectations.
- **Turkey:** Regulators abandoned an asset ratio rule, which was used to force Turkish banks to lend more to the real economy. The abandonment of this rule should enable banks to offer higher interest rates on TRY deposits and thus tighten financial conditions. The economy expanded 6.7% on a yoy basis in Q3 2020 versus 4.8% yoy expected.
- **Ukraine:** The government has reached agreement on the main budget parameters for 2021, which bodes well for relations with the IMF.

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Global backdrop

In the US, the General Services Administration acknowledged Joe Biden as winner of the presidential election. To air its general displeasure, the outgoing Trump Administration slapped bans on US technology exports to another 89 Chinese companies. Meanwhile, the minutes of the November Federal Reserve meeting focused on asset purchases, but revealed less urgency about additional monetary stimulus than markets had hoped for. Initial jobless claims climbed again, but lower frequency economic data releases have not yet started to reflect the renewed slowdown due to the ongoing second wave of the coronavirus outbreak. In a positive development, former Federal Reserve Chairwoman Janet Yellen was appointed to be Joe Biden's Treasury Secretary. Her appointment should ease tensions between the Treasury and the Federal Reserve, which she used to run.

In Germany, growth bounced back strongly in Q3 2020 ahead of new government lockdowns to counter a renewed surge in coronavirus cases. In Japan, the yoy pace of core CPI inflation hit -0.7% in November from -0.5% yoy in October. In the UK, the government announced massive new fiscal spending, while at the same time warning of a deepening economic crisis. The UK government also cut international aid, which will not help Britain to make friends after Brexit. As far as aid-dependent EM countries are concerned, they should pay heed: developed countries in general are becoming far more fiscally challenged, so many more will cut their aid budgets, in our view. EM countries can reduce their vulnerability to aid cuts by accessing international markets and developing their own domestic bond markets.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	11.58%	13.89%	12.84%	19.84%	5.29%	11.27%
MSCI EM Small Cap	14.70%	14.07%	11.54%	18.12%	1.70%	6.79%
MSCI Frontier	5.26%	6.37%	-2.82%	1.93%	-0.26%	5.08%
MSCI Asia	10.45%	13.55%	19.94%	25.86%	7.09%	12.61%
Shanghai Composite	5.71%	5.95%	14.36%	20.16%	3.29%	2.11%
Hong Kong Hang Seng	10.55%	14.86%	0.43%	5.63%	0.97%	5.93%
MSCI EMEA	15.89%	11.15%	-10.84%	-4.80%	-2.31%	3.93%
MSCI Latam	24.20%	22.80%	-21.33%	-12.47%	-4.16%	5.52%
GBI EM GD	5.73%	6.18%	-0.53%	3.81%	2.54%	5.42%
ELMI+	3.57%	4.01%	-0.15%	2.26%	0.77%	2.95%
EM FX Spot	4.55%	4.63%	-7.06%	-3.89%	-4.95%	-2.35%
EMBI GD	4.00%	3.97%	3.44%	5.47%	4.63%	6.37%
EMBI GD IG	2.12%	2.21%	8.13%	8.85%	7.21%	7.21%
EMBI GD HY	6.34%	6.15%	-2.13%	1.31%	1.68%	5.32%
CEMBI BD	2.55%	2.81%	5.46%	6.50%	5.54%	6.47%
CEMBI BD IG	1.54%	1.80%	6.49%	7.02%	6.08%	5.89%
CEMBI BD Non-IG	3.97%	4.24%	3.97%	5.69%	4.82%	7.45%

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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	11.44%	8.48%	14.52%	17.52%	14.00%	13.96%
1-3yr UST	0.01%	-0.03%	3.08%	3.35%	2.71%	1.87%
3-5yr UST	0.06%	-0.20%	6.01%	6.08%	4.12%	2.93%
7-10yr UST	0.26%	-1.05%	10.27%	9.38%	6.32%	4.48%
10yr+ UST	1.16%	-1.88%	19.06%	15.55%	10.51%	8.08%
10yr+ Germany	-0.74%	1.23%	8.67%	4.97%	7.65%	5.56%
10yr+ Japan	0.19%	-0.09%	-1.95%	-2.63%	1.66%	2.91%
US HY	3.88%	4.41%	5.06%	7.19%	5.67%	7.64%
European HY	4.32%	4.57%	1.00%	2.30%	2.49%	4.18%
Barclays Ag	1.81%	1.91%	7.74%	8.39%	4.40%	4.59%
VIX Index*	-45.19%	-20.97%	51.23%	65.13%	84.75%	29.20%
DXY Index*	-2.49%	-2.34%	-4.87%	-6.70%	-1.46%	-8.46%
CRY Index*	11.22%	8.39%	-13.36%	-8.88%	-14.91%	-11.82%
EURUSD	2.71%	2.06%	6.68%	7.98%	0.50%	13.23%
USDJPY	-0.67%	-1.44%	-4.28%	-4.61%	-7.62%	-15.55%
Brent	25.20%	14.53%	-28.94%	-24.88%	-26.22%	5.13%
Gold spot	-5.53%	-5.88%	16.98%	21.37%	39.22%	66.70%

*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
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