A spike in vol in the summer lull

By Alexis de Mones

Headlines are habitually assigned excessive importance in Emerging Markets (EM), not least during the summer lull, and geopolitics-related headlines particularly so. While the tragic loss of a Malaysian airliner over Eastern Ukraine and severe violence in Gaza are newsworthy, their impact on *sentiment* is likely to be much greater than their impact on the *economic* reality in Emerging Markets. We think that the market generally got it right this time and the increase in price volatility (a measure of sentiment) has been much greater than actual price movements except in the very specific case of Russian assets. This reflects the broadly supportive global economic backdrop painted by the economic data reported over the past week, and the soothing tune of developed markets policy makers.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,063	–	0.11%
MSCI EM Small Cap	1,097	–	0.24%
MSCI FM	709	–	0.04%
GBI EM GD	6.48%	–	-0.12%
ELMI+	3.40%	–	-0.49%
EMBI GD	5.09%	259 bps	0.07%
EMBI GD IG	4.39%	183 bps	0.15%
EMBI GD HY	6.73%	444 bps	-0.08%
CEMBI BD	5.07%	284 bps	-0.14%
CEMBI BD HG	4.28%	205 bps	-0.05%
CEMBI BD HY	6.74%	455 bps	-0.34%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1978	0.08%
VIX Index	12.06	2.03%
5 year UST	1.67%	0 bps
10 year UST	2.48%	-7 bps
US HY	5.56%	-0.52%
European HY	4.61%	0.01%
EURUSD	1.3522	-0.67%
USDJPY	101.29	-0.31%
Brent	106.32	0.00%
Copper	325.82	-1.95%
Gold	1314.86	0.67%

Additional benchmark performance data is provided at the end of this document.

Emerging Markets

- **Russia:** Last Wednesday, the US government unilaterally announced deeper sanctions against Russian entities in response to the perceived influence of the Russian government over political instability in Eastern Ukraine. The Office of Foreign Assets Control (OFAC) expanded the list of Russian companies subject to restrictions on transactions with US persons to include eight firms from the military procurement sector and four large companies: Gazprombank, Vnesheconombank, Rosneft and Novatek. EU leaders, meeting in Brussels the next day, did not replicate these sanctions but threatened to announce new sanctions by the end of the month. US persons are now prohibited transacting in, providing financing for, or otherwise dealing in "new debt" (over 90 days to maturity) or "new equity" issued by these companies. Interestingly, as a result of these sanctions new debt issued by the four companies will not be eligible for inclusion into the J.P. Morgan suite of indices due to investors' inability to replicate the benchmark. This answers the question we raised in a previous weekly – whether index providers would remain neutral or be swayed by the interests of one particular stakeholder group (see Weekly 28 April 2014).

Given the limitations of the sanctions, their main impact is likely to be to increase at the margin funding costs of the companies affected, possibly forcing them to modify their funding profile and possibly their capex plans. The sanctions do not freeze these companies' assets in the US, nor shut them out of the international payment system, nor force US persons to sell their current bonds and equity holdings. The sanctions will have little impact on the country's sovereign credit, in our view. The companies targeted by the sanctions have manageable funding profiles, or, in the case of Rosneft, significant cash in hand to meet short-term external debt repayments. Though not explicitly guaranteed by the government, these companies all have strategic importance for segments of the Russian economy and would most likely by supported by the authorities. Russia is in a position to help owing to its strong credit position – having very little external debt (USD 38bn) and very large external reserves (approximately USD 450bn), which provide a sizeable buffer against potential pressure on the balance of payments. Russia also has other reserve assets (Reserve Fund and National Wealth Fund) and has made progress in securing funding and establishing credit lines with new economic partners including China. Meanwhile the Russian economy has done better than feared since the stand-off over Ukraine started six months ago, and the economy has avoided a recession owing to firm domestic demand and a better external balance. Exports were up 2.1% over the first six months of 2014, while imports shrunk 5.2% over the same period. Fiscal revenues have also benefitted from the weaker RUB and the fiscal surplus has increased.

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Emerging Markets

Since last Wednesday, RUB has dropped 3% and local equities are down 6%, while external debt and local bonds are 30-40 basis points wider. This only partly reverses the Q2 rally, and the market seems to recognise that the main risks are not so much macroeconomic or political – Russia looks solid on both – but rather how other investors behave, mainly in response to a further escalation of economic sanctions. Thus President Putin's response to the Malaysian airline disaster is an important barometer to this precise risk.

- **China:** Rumours of China's hard landing have once again proven exaggerated. China's 2Q14 GDP ticked up to 7.5% yoy from 7.4% in 1Q, helped by a rebound in investments to 4.1% (contribution to total) from 3.1% in Q1. Net exports also turned to a positive contribution of 1.0% from -1.2% the previous quarter. The contribution from final consumption halved, however (2.3% in Q2 from 5.7% in Q1), owing to the anti-corruption campaign and housing price weakness. The strength in investments is consistent with the rebound in total social financing and in M2 growth observed in June. Strong net exports have also led to a sizeable increase in FX reserves by USD 42bn to USD 3.99trn. We expect China's FX reserves to exceed USD 4trn over the course of the summer.

- **Argentina:** Discussions between representatives of the Argentinean government and the court-appointed mediator, Daniel Pollack, adjourned without agreement. Government officials made a request to Judge Griesa to reinstate a temporary suspension of his ruling (that Argentina must pay holdout investors) – a hearing was set for 22 July. The deadline for coupon payment on the 2033 Discount bonds is 30 July. Meanwhile, a local newspaper reported that China had offered to give Argentina up to USD 12bn in emergency credit lines in case of a currency crisis.

- **India:** Both consumer price index and wholesale price index inflation data for June came below expectations at 7.3% (vs. 7.8% expected) and 5.4% (vs. 5.8% expected), respectively. Despite better actual data, the market remains concerned about the impact of poor rainfall on future harvests. Current rainfall stands 35-40% below long-term averages and further lack of rain in July could put upward pressure on prices and limit the central bank's ability to cut interest rates. Other economic data was also positive on balance: industrial production for May exceeded expectations at 4.7% yoy, and the 12-month trade balance was in line with expectations at -USD 11.8bn after a 10.2% yoy rise in exports.

- **Brazil:** Brazil's Monetary Policy Committee (COPOM) kept the short term interest rate (SELIC) overnight rate unchanged at 11.0%, in line with market expectations. The central bank repeated the neutral statement used at the previous meeting. Retail sales for May were slightly better than anticipated, but are expected to reverse after the World Cup, while the broader economic backdrop remains tepid. Politics loom large and the latest Datafolha poll this week saw voting intentions in favour of President Dilma Roussef decline by 2% to 36%. While Dilma is still well ahead of the opposition, simulations now suggest that in the event of a second round run-off against Aecio Neves her lead would drop to just 4% (from 7% in late June). This is within the error margin for such polls and would make the election too close to call for the first time since polling for October's election started.

- **Turkey:** The central bank cut its one-week repo rate (the main refinancing rate) by 50bps to 8.25% but left the overnight lending rate (ceiling) unchanged at 12%, as a small concession to the hawks. This brings the total rate cuts delivered since May to 125bps, reversing a little less than half the emergency rate hikes delivered in January at the height of the latest bout of hysteria about Turkey. Inflation is still close to 8%, which is well above the 6% top-end of the target range, but the central bank is basing its decision on better market conditions and a stronger TRY since last March, thus taking advantage of a window of opportunity to follow a more pro-growth agenda. In turn, this short-term focus of the central bank is related to the political business cycle – the first round of presidential elections is now less than a month away.

- **South Africa:** The South African Reserve Bank (SARB) hiked rates by 25bp to 5.75%. This was in line with market expectations. The SARB remains committed to a small hiking cycle, balancing marginally higher inflation against weak growth momentum. Alongside the policy rate change, the SARB revised its CPI forecast up for this year (to 6.3% from 6.2%) and next, and revised its growth forecast down for this year (to 1.7% from 2.1%) and next year as well. In addition to the impact of the weaker ZAR on inflation dynamics, the SARB is explicitly concerned about the impact of the mining sector strikes on future wage negotiations. The ANC won recent elections, but shows little inclination to tackle South Africa's deeper structural challenges.

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Global backdrop

Last week's most notable development on the global stage was the return of equity market volatility. After hovering around its lowest level in the last decade, the VIX index (a volatility index that provides a barometer of market sentiment) jumped by almost a third to 14.5% in one day on Thursday – the biggest jump in 15 months. The rebound of the VIX, which was partly reversed on the following day and was not accompanied by a broad-based sell-off in asset prices, ended a period of several weeks during which the VIX came down to close to 10%, a level not sustained since 2007. Volatility has been low due mainly to soothing words from global central bankers.

The brief jump in the VIX was the result of the dramatic shooting down of a Malaysia Airways civilian flight over the border between Eastern Ukraine and Russia, causing an increase in the level of market nervousness. The worsening war between Israel and Hamas also garnered attention.

US macro data was generally positive over the week, although not unambiguously so. 'Core' retail sales for June rose 0.6% and the previous two months were revised higher. This brightens the picture for the Q2 GDP growth print, although the US economy is going to struggle to reach 2% growth this year due to the extremely weak print in Q1. The Empire Manufacturing index rose to +25.6, its highest level since April 2010, and the Philadelphia Fed survey also rose to +23.9 vs. +16 expected, the strongest reading since March 2011. The details of the surveys also surprised positively, with strong increases in new orders and shipments components to reach multi-year highs. The disappointment came from the housing-related data. Housing starts were down 9.3% mom to 893K in June with negative revisions to prior data. Permits were also softer. Consumer confidence declined and industrial production slowed.

Fed chair Janet Yellen's testimony in front of the House of Representatives and the Senate were eagerly awaited and confirmed her reputation as a dove. She repeated her mantra that a significant amount of slack remains in the US economy, which therefore needs on-going monetary policy stimulus. Yellen repeated that extended conditions in the US high yield and leveraged loan markets are an issue for financial regulators and that using broader monetary policy tools to deal with bubbles simply damages financial stability without serving the Fed's dual mandate. Yellen also appeared somewhat less convinced that employment participation rates would increase, which would suggest that the first Fed Funds hike is marginally closer. All in all, the front-end of the US Treasury curve sold-off 3 basis points on the week, while the 10-year yield was down 2 basis points to 2.48% on geo-political fears. Nothing to see here. Move along please.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.7%	8.0%	14.3%	1.2%	9.3%
MSCI EM Small Cap	1.3%	10.1%	13.2%	1.3%	11.3%
MSCI FM	2.4%	22.6%	32.2%	13.9%	11.4%
S&P 500	1.02%	8.22%	19.55%	17.37%	18.48%
GBI EM GD	0.32%	6.34%	2.95%	1.56%	7.18%
ELMI+	-0.40%	1.90%	1.50%	-0.63%	2.47%
EMBI GD	0.47%	9.18%	9.35%	7.50%	10.18%
EMBI GD IG	0.23%	8.31%	7.28%	5.93%	8.34%
EMBI GD HY	0.93%	10.89%	13.65%	10.37%	13.01%
5 year UST	-0.13%	2.03%	1.27%	1.80%	3.67%
7 year UST	0.10%	4.28%	2.63%	3.21%	5.19%
10 year UST	0.51%	7.62%	4.86%	5.60%	6.14%
CEMBI BD	0.17%	6.52%	8.38%	6.24%	9.41%
CEMBI BD HG	0.18%	6.45%	7.77%	6.27%	8.48%
CEMBI BD HY	0.14%	6.60%	9.67%	6.50%	12.30%
US HY	-0.55%	5.14%	9.10%	9.71%	14.27%
European HY	-0.28%	5.72%	13.22%	13.78%	16.65%
Barclays Agg	-0.20%	4.72%	6.56%	2.51%	4.34%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

Ashmore

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Beijing
T: +86 10 5764 2601

Bogota
T: +57 1 347 0649

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Sao Paulo
T: +55 11 3556 8900

Singapore
T: +65 6580 8288

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