Brazil's pain and Argentina's gain

By Jan Dehn

The news from Brazil – a second sovereign downgrade, a change of finance minister and a likely delay to the impeachment of President Dilma Rousseff – is unambiguously poor, although it has the merit of hardly surprising anyone anymore. By contrast, the news out of Argentina – including a rapid return to a market determined exchange rate – was unexpectedly positive. Other notable positives included the once-in-180-years event of Ecuador repaying a bond and Putin giving strong backing for his economic team and signalling that pension reform is back on the agenda. Mexico hiked rates and successfully auctioned off a few oil fields to private investors. In the United States, the Fed finally hiked rates. The euphoria was short-lived as manufacturing, industrial and services data continue to deteriorate among increasingly poor liquidity conditions going into the holiday season.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.9	–	2.13%
MSCI EM Small Cap	12.1	–	2.74%
MSCI Frontier	8.6	–	-1.04%
MSCI Asia	11.4	–	1.33%
Shanghai Composite	14.2	–	4.21%
Hong Kong Hang Seng	7.2	–	3.51%
MSCI EMEA	9.1	–	6.48%
MSCI Latam	12.7	–	0.46%
GBI-EM-GD	7.05%	–	1.78%
ELMI+	4.79%	–	0.28%
EM FX spot	–	–	0.86%
EMBI GD	6.38%	417 bps	-0.10%
EMBI GD IG	5.03%	276 bps	0.14%
EMBI GD HY	8.51%	641 bps	-0.42%
CEMBI BD	6.42%	437 bps	-0.11%
CEMBI BD IG	4.78%	273 bps	-0.02%
CEMBI BD Non-IG	9.37%	731 bps	-0.26%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.7	–	-0.31%
1-3 year UST	0.96%	–	-0.21%
3-5 year UST	1.68%	–	-0.46%
7-10 year UST	2.20%	–	-0.64%
10+ years UST	2.91%	–	-0.75%
US HY	9.41%	776 bps	-1.19%
European HY	5.59%	569 bps	-0.16%
Barclays Ag	–	226 bps	-0.46%
VIX Index*	20.70	–	-3.69%
DXY Index*	98.77	–	1.17%
EURUSD	1.0867	–	-1.14%
USDJPY	121.39	–	0.30%
CRY Index*	172.16	–	-2.70%
Brent	36.1	–	-4.72%
Gold spot	1071	–	1.01%

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

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- **Brazil:** The news from Brazil was poor, but perhaps not quite as bad as the headlines would suggest. After all, very little of what transpired last week had not already been priced in by the market. Here are the most important developments.

Firstly, Finance Minister Joaquim Levy stepped down and was replaced by Nelson Barbosa, formerly Minister of Planning. Barbosa is less orthodox than Levy, but Levy had been rendered completely impotent due to President Dilma Rousseff's lame duck status in parliament. Should investors fear a wholesale descent into economic populism now? The answer is no. The most likely outcome is that Barbosa maintains the current fiscal stance, which, in net terms, is restrictive. President Dilma Rousseff is in no position to change policies meaningfully without risking major backlashes, in our view.

Secondly, Fitch became the second ratings agency to downgrade Brazil's sovereign credit rating to sub-investment grade following S&P's downgrade earlier this year. Moody's still has Brazil rated one notch into IG territory. Petrobras's credit rating was also cut to junk by Fitch with negative outlook, which was no surprise following Fitch's downgrade of the sovereign. Fitch's decision means that Brazil's sovereign bonds will now be classified as non-IG in most indices and mandates. Only the IG sub-indices of the EMBI and GBI-EM are impacted; Brazil will remain in the main EMBI and GBI-EM indices. Brazil will exit the EMBI IG indices at the 29 January, 2016 index rebalancing. Brazil's weight in this index is 5.48%. Only very few investors follow this index. On the corporate side, Brazil only represents 2.94% of the CEMBI BD IG index. Many Brazilian companies were downgraded in recent months and only a few are still included in the index, including companies that are 'supported' by the sovereign (like BNDES, Banco do Brasil, Caixa) and exporters that can 'pierce' the sovereign ceiling. The former will likely drop out of the IG indices in the coming weeks, while the latter may be able to stay in the index. On the local currency side, Brazil is currently the largest country in the GBI-EM GD IG with a weighting of 15.5%. Brazil will exit this index at the 29 February, 2016

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rebalancing. What will be the likely impact on flows? Since the main holders of Brazil are Emerging Markets (EM) dedicated funds for whom ratings only have limited relevance, this group is unlikely to exit on ratings grounds alone. But Brazil is also held by IG-only crossover investors, including Brazil's presence within the mammoth Global Aggregate and US Aggregate indices. According to Barclays, an investment bank, IG crossover investors could sell as much as USD 5.2bn if they are market weight. This selling would be off-set by forced buying by Global HY funds resulting in net selling of just under USD 4bn. Given that many investors are underweight, however, net selling could be much lower. In general, this second downgrade of Brazil to sub-IG is one of the most anticipated and predictable downgrades in recent EM history. As such, it offers an important lesson why investors should be active (as opposed to passive) in the EM space. By now, IG-only passive funds have literally taken all the losses associated with Brazil's macroeconomic demise over the last few years. They are now being forced to sell and therefore crystallise their losses, that is, make them permanent. Yet, it is extremely likely that Brazil will not default nor have a balance of payments crisis nor even have to turn to the IMF for support. So while the recovery will be slow and painful the big perspective says that investors should take advantage of technical selling events, such as ratings downgrades. The passive investor's loss is likely to be the active manager's gain.

Thirdly, President Dilma Rousseff managed to win some time in the ongoing impeachment process as the Brazilian Supreme Court clarified two matters of direct relevance to the process. First, the Supreme Court ruled that a single committee consisting of members appointed by party leaders in the Lower House is the relevant institution to evaluate the validity of impeachment allegations. This rulings is an improvement on previous practice, where multiple ad hoc committees were put forward by various factions in the Lower House, which risked that the entire impeachment process could be hijacked by a narrow segment (for example, those with superior knowledge of the technical steps involved, such as speaker Cunha). The Supreme Court also ruled that the President can remain in office until after the Senate has voted on the question of impeachment. Before, the President would be suspended immediately after the Lower House vote (which comes before the Senate vote). The net effects of these two Supreme Court rulings are that (a) important weaknesses in the impeachment process have been eliminated and (b) the hurdle for impeachment itself has been raised. This is negative for short-term market sentiment, but good for the quality of institutions in Brazil.

Finally, the economic data continues to be weak. Mid-month inflation was higher than expected in December (1.18% versus 1.13% expected). On the other hand, fewer than expected jobs (130K vs 175K) were lost according to the latest payroll statistics, while retail sales rose 0.6% on the month, the first increase in more than half a year. Importantly, real wages are now down 8.8% yoy. The reduction in domestic demand and labour costs plus the weaker BRL will bring Brazil's current account into balance in 2016, in our view.

- Argentina: It is almost inevitable that financial markets will fall in love with Argentina. The new economic team is certainly doing its best to ensure that outcome. Last week the Central Bank successfully lifted all controls on the currency, which was much sooner than expected. The official exchange rate devalued to 13.76. This was inside the parallel exchange rate (14 handle), which can only be described as a success. Theoretically, the parallel exchange rate ought to trade wider than the freely determined interest rate on account of liquidity and other premia, but there is always the risk of overshooting. The fact that the overshoot did not happen is testament to the preparations made by the new economic team ahead of the float of the currency. In particular, they had put in place a number of supportive measures ahead of setting the currency free, including commitments by farmers to sell Dollars, credit lines with banks and authorisation from China for Argentina to sell some of its stock of RMB for Dollars. The early achievement of a market determined exchange is clearly confidence inspiring. The next big issue will be to fix the holdout issue. This will prove more challenging, because it involves negotiation. Still, we think the government will likely outperform expectations in this area too. Utility prices will be raised on 1st January, according to officials. Utility subsidies are close to 5% of GDP.

- Ecuador: Who said that leopards do not change their spots? President Rafael Correa, once a defaulter, took an important step to redeem his past financial sins by becoming the first President in Ecuador in more than 180 years to repay a bond. This notable milestone was reached, when Correa repaid in full the government's USD 650m 2015 sovereign bond. President Correa defaulted on the 2012 and 2030 Global bonds in his first term, but continued to service the 2015 bond, which he had himself issued during an earlier spells as Finance Minister. It remains to be seen if Ecuador's leaders can go on to repay bonds issued by others than themselves. Ecuador is the most default prone nation on planet Earth, after Spain.

- Russia: President Putin has given strong support for his economic team. This should be viewed with great satisfaction by bond holders, because it shows that there is political support all the way to the top in Russia in favour of keeping the government's spending within the available means. Besides, with oil prices still struggling to find a floor the macroeconomic adjustment in Russia is not yet over. President Putin also specifically mentioned the need to raise the pension age, which is a clear signal that a much needed pension reform may be on its way.

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- **Mexico:** The Mexican economy's gradual acceleration continues. Aggregate demand accelerated at a pace of 4.3% yoy in Q3, up from 3.5% yoy in Q2. The acceleration was reflected mainly in exports, consumption and investment, while government spending detracted from total demand. As widely expected, the Mexican Central Bank raised interest rates by 25bps following the Fed. In other news, Mexico successfully auctioned off oil fields. Eventually these fields will attract USD 1.1bn in new investment and increase oil output by about 3%. There will be more auctions in the future. The introduction of private capital into the oil sector was made possible due to reforms undertaken soon after President Enrique Peña Nieto took office.

- **Venezuela:** The small Caribbean nation of St. Kitts is allegedly in talks with Venezuela to buy back the debt it owes Venezuela. Similar buybacks have proven lucrative to Venezuela's obligors. Venezuela's desperation for cash upfront is now so great that the Maduro administration is willing to discount the principal to be repaid by countries such as St. Kitts by as much as 50%. Sadly, this is very much a case of diminishing returns. Having already tapped this source of upfront cash among the larger obligors, this particular deal is likely only to raise about USD 40m for the sovereign.

Snippets:

- **Azerbaijan:** The Central Bank devalued the Manat from 1.05 versus the US dollar to 1.55 in response to lower oil prices: this is sensible policy. When an oil producer's national income drops by more than 50% the correct response is to reduce domestic demand and to devalue the currency. Before throwing in the towel, Azerbaijan managed to lose half of its foreign exchange reserves trying to defend the currency.
- **Chile:** Bank of Chile hiked interest rates by 25bps in response to the Fed's hike.
- **China:** Property prices rose at a pace of 1.3% yoy in November, up from +0.4% yoy in October.
- **Colombia:** Retail sales rose a mere 0.1% yoy in October versus 1.7% yoy expected. Colombia still faces a challenging period ahead to bring down domestic demand in response to lower national income due to falling oil prices. The Central Bank hiked interest rates by 25bps to 5.75%.
- **India:** The trade deficit of USD 9.8bn in November was lower than expected (USD 10.2bn). Current activity indicators for India show that the economy slowed to 6.4% yoy in October from 7.4% yoy in September.
- **Indonesia:** Bank Indonesia left rates unchanged. The rhetoric from BI remains dovish. The trade balance was a small negative USD 0.3bn in November.
- **Iran:** The Central Bank devalued the Dinar.
- **Panama:** The economy expanded 5.8% in the first three quarters of 2015 compared to the same period last year. This constitutes an acceleration compared to the 4.8% yoy growth rate achieved over the same three quarters last year.
- **Peru:** The real GDP growth rate stabilised in October at 3.0% yoy, roughly unchanged from September's yoy rate.
- **Poland:** Labour markets strengthened with wage growth picking up to 4.0% yoy (3.9% yoy expected) and employment growth rising to 1.2% (1.1% expected). Even so, CPI inflation was low at -0.6% yoy (versus -0.7% yoy expected).
- **South Korea:** The Central Bank ditched its old inflation target rate of 2.5-3.5% in favour of a simpler 2% target with a band of +/- 0.5% on either side. Failure to remain within the target range for more than six months triggers an escalating series of remedial steps. Early indications point to sharply lower exports in December.
- **Taiwan:** The Central Bank cut rates to 1.625%.
- **Turkey:** The government recommenced membership talks with the EU after a hiatus to two years. We do not expect dramatic and rapid progress.
- **Ukraine:** As expected, Ukraine did not repay its USD 3bn bond to Russia on 20 December. The bond is now in default and Russia may pursue its claim in an English court.

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Global backdrop

The Fed hiked rates by 25bps leaving most investors asking themselves what all the fuss was about. Fundamentally, 25bps has no effect, especially since headline inflation is due to rise sharply in the US in the next few months. For trading purposes, however, banks had enormous incentives to exaggerate the importance of the first Fed hike, because the more unnecessary churning of portfolios they can induce, the more they can make on the bid-offer spread.

The US yield curve is anchored in time, which is a good thing, in our view. Still, the initial bounce in risk appetite following the Fed's rate hike was short-lived, however. Investors are loath to have big directional positions on going into the illiquid holiday period. But the US data is also becoming a greater worry. Following bad ISM and PMI numbers it was the turn of services PMI last week, which came at 53.7 vs 55.9 expected (down from 56.1 in the previous month). Industrial production was also soft as were the regional manufacturing indices and the US current account deficit widened to USD 124bn in Q3 from USD 109bn in Q2. It seems that much of America's manufacturing sector is hurting from the strong Dollar. The lifting of the US oil export ban may help beleaguered shale producers, although oil prices continue to seek firmer footing.

In other developments, the Bank of Japan surprised the market with further easing, extending the maturity of bond purchases, increasing REITS investments and initiating an ETF stock purchase program targeting specific companies. Mirroring the pattern observed in other developed economies, policy makers in Japan have been far more enthusiastic about printing money and buying financial assets than undertaking deep economic reforms. The new stimulus immediately sparked speculation about fresh elections in Japan. In Europe, Spain became the latest casualty of voter discontent when, at the weekend, voters failed to award a majority to any single block in parliament, mainly due to the rise of populist alternatives to the mainstream parties. Oil prices continued to fall, reaching the lowest levels since 2004.

Last thought: After four years of stellar performance, the bonds and stocks in developed markets performed poorly in 2015 despite still record-low interest rates and strong support via asset purchase programs (the ECB taking over where the Fed left off). As developed markets no longer respond to policy support the big question for 2016 will be this: where will the next 10% return come from? In our view, it is time to take profits in the QE markets and to rotate into the non-QE markets, which, due to lack of central bank sponsorship, have lagged far behind developed markets for some time now. The risk to this strategy comes mainly from US credit markets. A blow up in US credit could trigger a recession and be negative for risk appetite. On the other hand, the Fed would respond by quickly reversing the recent 25bps rate hike and possibly even move to negative rates. This would be bad for the US dollar, but positive for EM FX and therefore local currency government bonds.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.95%	-15.33%	-13.18%	-6.40%	-4.01%
MSCI EM Small Cap	-2.07%	-8.71%	-6.30%	-1.49%	-2.88%
MSCI Frontier	-2.34%	-16.41%	-10.16%	4.05%	0.23%
MSCI Asia	-1.62%	-10.06%	-7.29%	-0.53%	0.44%
Shanghai Composite	3.89%	12.40%	18.92%	21.44%	6.93%
Hong Kong Hang Seng	-1.60%	-17.14%	-12.34%	-1.53%	-1.56%
MSCI EMEA	-7.67%	-20.12%	-19.66%	-12.91%	-7.99%
MSCI Latam	-2.69%	-29.76%	-28.12%	-18.48%	-13.19%
GBI EM GD	-1.75%	-14.50%	-14.49%	-9.66%	-3.01%
ELMI+	-0.91%	-7.42%	-7.00%	-5.50%	-2.69%
EM FX Spot	-1.07%	-17.24%	-17.81%	-12.98%	-9.08%
EMBI GD	-1.61%	0.96%	1.91%	1.06%	5.47%
EMBI GD IG	-1.32%	-1.15%	-0.13%	0.17%	4.81%
EMBI GD HY	-2.00%	3.82%	4.61%	2.33%	6.49%
CEMBI BD	-1.30%	1.23%	1.82%	2.00%	4.51%
CEMBI BD IG	-0.49%	1.41%	1.83%	2.45%	5.02%
CEMBI BD Non-IG	-2.69%	0.80%	1.76%	1.14%	3.65%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-3.49%	-0.58%	-0.65%	13.85%	12.37%
1-3 year UST	-0.05%	0.40%	0.39%	0.36%	0.61%
3-5 year UST	-0.07%	1.71%	1.90%	1.23%	1.95%
7-10 year UST	0.04%	2.48%	2.83%	1.81%	5.06%
10+ years UST	1.35%	0.54%	1.82%	3.66%	9.22%
US HY	-3.89%	-5.89%	-4.96%	1.38%	5.34%
European HY	-1.57%	2.01%	2.34%	6.81%	9.58%
Barclays Ag	-0.43%	0.02%	0.51%	2.72%	4.72%
VIX Index*	28.33%	7.81%	25.53%	16.03%	25.53%
DXY Index*	-1.40%	9.42%	10.24%	24.06%	22.37%
CRY Index*	-5.69%	-25.14%	-28.36%	-41.47%	-47.32%
EURUSD	2.86%	-10.18%	-11.14%	-17.60%	-17.05%
USDJPY	-1.40%	1.34%	1.12%	44.10%	44.94%
Brent	-19.01%	-36.98%	-41.14%	-66.84%	-61.23%
Gold spot	0.54%	-9.61%	-9.00%	-35.40%	-22.74%

*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

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

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

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