Issued: 22 April 2014

WEEKLY INVESTOR RESEARCH

Ashmore

The Fed and the Oracle of Delphi

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Emerging Markets (EM) performance has been relatively resilient in the face of US dollar strength on the back of stronger US data and dovish comments from the Fed. EM fixed income benchmarks ended the week close to flat, currencies posted a mildly negative performance, and EM equities had strong positive performance. In a relatively quiet week, the main focus was the meeting between Russia and Western powers in Geneva over Ukraine, which produced a joint statement pledging to disarm the militias in eastern Ukraine, though pledging is easier than implementation. An unambiguously strong set of economic data in the United States set the tone for markets during a week when US company earnings were also stronger than expected. Into this mix, Fed Chairwoman Janet Yellen added fuel by issuing a very dovish message. These factors helped to revive momentum in the US equity market, taking the S&P 500 up 2.26% over the week, while the US Treasury curve bear flattened. The 5-year Treasury underperformed with yields rising 10 bps to 1.72%. The US dollar index (DXY) advanced 0.64%.

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Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1009		1.03%
MSCI EM Small Cap	1057		1.07%
MSCI FM	664		1.55%
GBI EM GD	6.82%		0.53%
ELMI+	3.66%		0.17%
EMBI GD	5.46%	272 bps	0.25%
EMBI GD IG	4.67%	187 bps	0.10%
EMBI GD HY	7.41%	493 bps	0.53%
CEMBI BD	5.40%	302 bps	-0.04%
CEMBI BD HG	4.49%	210 bps	-0.06%
CEMBI BD HY	7.29%	491 bps	0.00%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1872	2.26%
VIX Index	13.25	-17.75%
5 year UST	1.71%	9 bps
10 year UST	2.70%	7 bps
US HY	5.33%	0.00%
European HY	4.40%	0.05%
EURUSD	1.3803	-0.09%
USDJPY	102.48	0.56%
Brent	109.77	0.91%
Copper	308.41	0.01%
Gold	1290.57	-0.94%

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

Emerging Markets

- **Russia and Ukraine:** Unidentified armed groups occupied key administrative buildings in different cities of eastern Ukraine in a move resembling the occupation of Crimea. Western threats of further sanctions were matched by Russian pledges to 'defend' Russian citizens in Ukraine, leading to volatile markets at the beginning of the week. The meeting in Geneva between the US, EU, Ukraine and Russia produced a joint statement pledging to disarm illegal militias, but tensions on the ground remain high as both sides are already trading accusations of non-compliance. The case of Ukraine illustrates starkly the adverse effect that 'Superpower meddling' can have in smaller EM countries. This serves as a reminder to everyone that the real reason for the dramatic improvements across the EM universe over the last 20 years are mainly due to political changes associated with the end of the Cold War rather than any short-term cyclical issues, such as changes in US monetary policy.

Fortunately, most EM countries are not caught up in Superpower tensions. For the few that are affected by such tensions, including Ukraine, the outlook will depend at least as much on external factors as domestic ones. We don't believe Russia will allow the Western world to dictate the next chapters on Ukraine on their own. Russia's strategy of imposing pain on Ukraine via higher gas prices and supporting pro-Russian elements in Ukraine are geared at keeping the country weak. In part this aims to weaken support for anti-Russian political interests ahead of the election scheduled for May and in part seeks to increase the odds that the country once more turns to Russia for financing. By contrast, the West will want to see the new administration in Ukraine succeed economically. However, this requires strong upfront financial support through what will be a tough economic transition, which could yet undermine support for pro-Western politicians. Behind the scenes, Ukraine's interests are of course not central to either Russia or the West. Both sides ultimately care about their own strategic interests, energy supplies, and Ukraine's gas storage facilities although bothwould be seriously hurt by a descent into more widespread civil unrest and civil war.

Investors are likely to focus on the potential impact of further sanctions on Russian asset prices as US officials warned that more sanctions were planned against Russia, something that President Putin labelled as "unacceptable". So far there is no evidence that sanctions have had much of an economic impact on Russia. Consumption and industrial production indicators remained relatively strong and surprised positively in March,

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Emerging Markets

although wages and investments softened. High and stable oil prices together with a weaker RUB are helping to keep fiscal and external accounts at healthy levels. Indeed, should tensions worsen it is likely that oil prices will rise further, while the RUB weakens further, thus providing a 'put option' on Russia's economy.

Meanwhile, in Kiev the Central Bank raised the benchmark discount rate from 6.5% to 9.5% and the overnight loan rate from 7.5% to 14.5% on Monday as part of the stabilisation program agreed with the IMF. The UAH moved away from its historical lows at 13.50 to 11.30. Industrial production declined 6.8%, down from -3.7% in February.

- China: China's GDP growth slowed from 7.7% yoy in Q4 2013 to 7.4% yoy in Q1 2014, which was slightly better than the 7.3% yoy consensus expectation. Industrial production and retail sales improved in March compared to January-February levels, but Fixed Asset Investment slowed very marginally to 17.6% yoy from 17.9% yoy during the previous two months. Credit growth also slowed with the biggest downside surprise being the deceleration of M2 growth to a historical low of 12.1% yoy, which is below the PBoC's annual target of 13% yoy. China's modest slowdown is due to aggressive restructuring of the economy. This restructuring, which is likely to help China sustain strong growth rates over the medium term, will likely be accompanied by various measures to aid growth during the transition. In the past week, China announced measures to develop rural financial services and new tax benefits for small business to help promote employment.

- Brazil: A new poll released by IBOPE during the weekend showed President Dilma Rousseff losing support. If an election was held today with participation of only the three leading candidates, Dilma would receive 39% of the vote (down from 43%), followed by Aécio Neves with 16% (up from 15%) and Eduardo Campos with 8% (up from 7%). Campos officially announced his candidature this week with Marina Silva as his running mate. Meanwhile, unemployment declined further in March to 5%, but mainly due to contraction of the labour force. Real wages remained soft, rising only 0.1% in March. Perishable food inflation declined more than expected to help lower the mid-April CPI reading, which in turn increases the odds that the Central Bank will not hike rates further.

- Argentina: The central bank purchased USD 635m in the week ending on 11 April, resulting in a net increase in international reserves of USD 530m. Year-to-date, the central bank has purchased USD 1.4bn of foreign currency, while reserves have dropped USD 2.9bn – mainly as a result of debt payments and capital flight.

Global backdrop

In Ancient Greece, the Oracle of Delphi predicted the future inspired by the gods, attracting legions of followers in search of clear answers in uncertain times. Unable to actually predict anything at all, the Oracle of Delphi issued ambiguously worded forecasts so as to cover any and all possible outcomes.

As monetary policy has gained enormous importance for the behaviour of financial asset prices amidst unprecedented economic tidings since the 2008 crisis the US Fed has similarly attained a somewhat similar status to the Oracle of Delphi.

Thus, last week saw the release of generally strong US data. The Beige Book for the April FOMC meeting suggested stronger economic activity. Retail sales, jobless claims, and inflation also pointed to a better economic outlook. The more hawkish minutes of the March FOMC meeting released on 9 April also showed a committee biased towards normalising monetary policy sooner rather than later.

Yet, at this very juncture of stronger data Fed Chairwoman, Janet Yellen, chose to issue a decidedly dovish message in a speech at the Economic Club of New York last Wednesday. Yellen spoke of significant slack in the US labour market, soft inflation, and downside risks to the economic recovery. She added that "unemployment is 1% above the 5.2% - 5.6% central tendency of longer run normal rate and 'slack' will take 2 years to close in the Fed's assessment". She reminded markets that the Fed's economic forecasts were also disrupted in 2010-2012 by downside surprises. Taken as a whole, the Fed's position now appears as ambiguous as any position adopted by the Oracle of Delphi.

This makes sense, of course the Fed cannot predict the future. It also has a strong incentive to maintain its credibility for as long as possible, especially on account of extremely large, longer-term inflation risks. The Fed understands that the economy has 'headwinds' – a euphemism for the large stocks of debt still present across all sectors of the US economy – that remain a major risk to growth in the event of interest rate shocks such as the one seen in 2013. Finally, the Fed will generally want to appear hawkish during periods of weaker data, because this means that it can be less hawkish during periods of stronger data.

We note in passing that investors hungrily snapped up bonds when Greece successfully returned to the market for the first time since its dramatic default in 2011. The fact that appetite for Greece's new bonds is so strong – despite the country's 175% debt to GDP ratio – indicates that many investors still believe firmly in Oracles.

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.7%	1.3%	2.8%	-3.0%	13.1%
MSCI EM Small Cap	1.8%	5.3%	2.8%	-2.0%	17.0%
MSCI FM	6.2%	13.6%	31.1%	8.7%	13.9%
S&P 500	0.07%	1.87%	22.91%	14.30%	19.60%
GBI EM GD	0.78%	2.69%	-8.81%	0.28%	8.84%
ELMI+	0.21%	0.74%	-2.29%	-1.69%	3.83%
EMBI GD	1.02%	4.79%	-0.58%	7.19%	11.03%
EMBI GD IG	0.92%	4.61%	-3.05%	5.96%	8.74%
EMBI GD HY	1.21%	5.15%	3.99%	9.46%	14.34%
5 year UST	0.20%	1.02%	-2.29%	2.90%	2.99%
7 year UST	0.27%	2.33%	-4.19%	4.29%	3.96%
10 year UST	0.65%	5.00%	-4.43%	6.57%	4.45%
CEMBI BD	0.56%	3.36%	1.13%	5.69%	11.31%
CEMBI BD HG	0.61%	3.65%	0.91%	6.22%	9.83%
CEMBI BD HY	0.45%	2.75%	1.63%	4.99%	16.37%
US HY	0.39%	3.65%	7.98%	9.60%	17.49%
European HY	0.57%	3.97%	12.50%	13.13%	20.82%
Barclays Ag	0.68%	3.10%	2.26%	2.37%	5.30%

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