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WEEKLY INVESTOR RESEARCH

Ashmore

Summary

The past week saw a number of Emerging Markets announce fresh initiatives to boost infrastructure investment, doubtless prompted by the prospect of tougher financial conditions. This is exactly the right response, in our view. Mexico pushed forward the timeline for energy reform. China took another step towards interest rate liberalisation. Meanwhile, the global backdrop improved on the back of dovish comments from the US Fed, better manufacturing data, and hopes of reform in Japan following this weekend's senate election.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	952		0.01%
MSCI FM	557		2.00%
GBI-GD	6.36%		1.10%
ELMI+	4.38%		0.44%
EMBI GD	5.50%	297 bps	1.75%
EMBI GD IG	4.57%	200 bps	1.73%
EMBI GD HY	8.87%	654 bps	1.79%
CEMBI BD	5.47%	341 bps	1.15%
CEMBI BD HG	4.61%	252 bps	0.97%
CEMBI BD HY	7.41%	540 bps	1.00%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,692	0.60%
VIX Index	12.54	-9.06%
5 year UST	1.29%	-9 bps
10 year UST	2.47%	-7 bps
10 year Bund	1.52%	-6 bps
EURUSD	1.3181	0.99%
USDJPY	99.94	0.00%
Brent	$109	0.00%
Copper	$322	0.40%
Gold	$1317	2.47%

Emerging Markets

The Fed has barely taken its first tentative steps towards a normalisation of monetary policy, but a number of Emerging Markets are already responding. Hikes in the Fed funds rate are still far into the future and tapering of Quantitative Easing (QE) has yet to commence. Still, yields in US treasury market have already re-priced higher and global financial conditions have tightened. The US economy has slowed steadily this year due to sequestration and higher real rates. In short, the world has been served a little taster of the tougher demand-side conditions, which will prevail as monetary policy and fiscal policies turn more restrictive over the coming years. As far as Emerging Markets are concerned, higher US treasury yields are only half of the story. We think there are also currency adjustments in the pipeline, because countries that print the most money will incur the highest inflation, and in turn their currencies will underperform. In other words, Emerging Markets will eventually also face stronger currencies in addition to a higher rate environment.

Stronger currencies and higher global interest rates will inflict drags on Emerging Markets growth, which they will feel primarily through weaker external demand for their exports. Voters in Emerging Markets will not be particularly tolerant of slower growth, so policy-makers will be tasked to identify alternative drivers of growth to replace the lost impetus from exports. The most important alternative driver of growth will be domestic demand. But it is not possible to simply stimulate domestic demand, say by fiscal or monetary means or by fighting FX appreciation, because in the absence of measures to stimulate the supply-side of the economy higher domestic demand will simply translate into higher inflation and wider current account deficits. Neither of which are sustainable, although many Emerging Markets would do well to import more capital on account of their investment needs.

What supply-side measures will be required in order to sustainably rotate Emerging Markets economies away from exports towards domestic demand? Firstly, economies need to be flexible, so capital and labour can move relatively smoothly from one sector to the other. Secondly, private sector productivity has to increase, and the best way to ensure this happens is to put in place measures that enable firms to finance the most productivity enhancing investments, which tend to be longer-term bigger ticket investments. In other words, governments need to help facilitate the establishment of local corporate bond markets. Finally, governments need to provide the key public infrastructure investments, which complement private sector investment. For example, a company may successfully increase its productivity by investing in training its labour force, but if the cost of transporting goods to market is prohibitive due to poor road infrastructure such training will never occur.

It is therefore noteworthy that the past week saw a plethora of announcements of infrastructure investments across Emerging Markets. Of course, many countries in Emerging Markets have been aware for some time of the need to focus on domestic productivity enhancement, Colombia and Peru being two cases in point. But the timing of this week's announcements is undoubtedly related to the recent talk of tapering of QE, which has suddenly increased the sense of urgency. This week Ivory Coast announced plans to implement infrastructure investments worth $10bn financing with subsidised credit from China over the next 6 years. The funding will go into ports, railways, and power plants. Mexico's government launched its National Infrastructure Program (NIP) worth $312bn of which one third is targeted at roads, ports, airports and rail, and about two thirds are energy-related

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Emerging Markets

investments. The NIP should lift the country's annual spending on infrastructure to more than 5.3% of GDP. Mexico also pushed forward the expected timeline for reforms in the energy sector. On 12 July, China's Premier Li Keqiang announced a series of new initiatives to upgrade China's energy-consuming infrastructure and measures to upgrade the IT infrastructure. This follows recent initiatives to expand the public housing, railways, and urban infrastructure. And in the Philippines the government of President Aquino presented a broad set of legislative measures aimed at further boosting public private partnerships in the infrastructure area. The measures tackle legal and other bottlenecks, which have discouraged both private and public investment. Aquino's proposals are likely to result in a doubling of infrastructure spending as a share of GDP by 2015.

Infrastructure investment flies beneath the radar in global markets and rarely makes it to the mainstream media. However, in a world slowly exiting enormous global imbalances infrastructure investment and other supply-side measures are absolutely essential to sustaining growth in Emerging Markets.

In another noteworthy development this past week, China took a further step towards interest rate liberalisation by lifting restrictions on lending rates by banks and announcing that banks now have to set those limits themselves. This move is best understood in the broader context of China's on-going structural transformation from an export-led to a consumption-led economy. An economy where consumption plays the dominant part, particularly in an economy as large and relatively closed as China, is best managed using interest rates and their transmission through the economy via rates for bank loans, student financing, mortgage rates, and of course local government bond yields. Our view is that China's deliberate efforts to transition to a consumption-led economy, while costly in the near-term, are essential to sustaining China's growth over the medium term.

Global backdrop

Global sentiment was broadly positive in the past week as S&P500 set new highs and US treasury yields ended the week back down below 2.5%. The buoyant mood was due to a dovish set of pronouncements from Federal Reserve Chairman Ben Bernanke, who is slowly beginning to get his message through to the market that tapering QE is not the same as hiking rates. While we firmly share this view, we do not believe that the market will do so on a consistent basis, and we expect a generally more volatile environment for rates over the next several years that we have seen in the past few years. Also helping sentiment was marginally better US data, notably initial claims for unemployment and Philadelphia Fed manufacturing. The claims numbers should be discounted on account of technical factors, but the stronger manufacturing number is worth noting. Manufacturing is a global supply chain. After several months of considerable weakness, the odds now favour a pickup in the pace of manufacturing, which should also show up in better Emerging Markets prints. Finally, sentiment was aided by prospects of a resounding victory for Prime Minister Shinzo Abe in the senate election this past weekend. The election result itself is secondary in importance; the key is whether Abe will expend his political capital on the deep structural reforms required in the Japanese economy, or seek to preserve his capital by skirting the structural challenges in favour of more populist objectives, such as a more assertive foreign policy.

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