Christmas comes to Cuba

By Jan Dehn

Christmas comes to Cuba as the country finally escapes its tragic status as a museum piece from the Cold War. Brazil raises the long-term policy interest rate as the government takes another gradual step towards restoring fiscal credibility. China's GDP is revised higher with more to come. Colombia passes a tax reform and the FARC rebels declare a unilateral, indefinite ceasefire. Several European leaders are seeking to de-escalate tensions with Russia over Eastern Ukraine. Russia recapitalises its banks after a week of exceptional currency moves and a 650bps hike in policy rates. In the United States, the FOMC blew hot and cold without really changing the outlook for monetary policy relative to what was expected prior to the December meeting.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	954	–	3.31%
MSCI EM Small Cap	981	–	0.50%
MSCI FM	591	–	0.68%
GBI EM GD	6.62%	–	1.13%
EM FX spot	–	–	0.82%
ELMI+	5.39%	–	0.38%
EMBI GD	5.66%	347 bps	2.51%
EMBI GD IG	4.46%	223 bps	2.00%
EMBI GD HY	8.27%	619 bps	3.46%
CEMBI BD	5.60%	358 bps	0.64%
CEMBI BD HG	4.51%	247 bps	0.46%
CEMBI BD HY	8.04%	603 bps	1.02%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2071	4.11%
VIX Index	16.49	-19.25%
5 year UST	1.65%	8 bps
7 year UST	1.98%	8 bps
10 year UST	2.17%	5 bps
US HY	7.20%	1.58%
European HY	5.29%	-0.04%
EURUSD	1.2260	-1.45%
USDJPY	119.82	1.43%
Brent	61.33	2.52%
Copper	294.91	-2.64%
Gold	1197.01	-0.89%

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

Emerging Markets

- **Cuba:** The US government has begun the process of normalising relations with Cuba. One of the last legacies of the Cold War thereby finally looks set to dissipate. During the Cold War, the Russian-sponsored Warsaw Pact and Western powers led by the United States were locked in an ideologically motivated dispute over control of Emerging Markets (EM). The result was a plethora of dictatorships across the Emerging world, whose misrule so impeded development that a lasting impression was created that EM are a bunch of fragile and unstable countries. Cuba was one of the highest profile hotspots of the Cold War, which enabled the country to sell itself as a potent symbol of the alleged abuse by the United States of its power the world over, particularly for its own and other left-wing governments that in turn used this perception to justify their own authoritarian misrule. Cuba, welcome to the 21st Century! Time to restart the currency, bond and stock markets!
- **Brazil:** The government took another important step forward towards restoring fiscal prudence by announcing that the long-term interest rate at which BNDES, a massive state lending institution, finances will be increased by 50bps to 5.5% from 1st January 2015. The Treasury of Brazil, which provides the bulk of financing to BNDES, raises funds at the SELIC policy rate of 11.75%, while BNDES lends at the so-called TJLP plus a spread, thus in most cases providing an enormous implicit subsidy for the economy, which crowds out private sector lending and shows up in the public finances as higher public debt. Further narrowing of the gap between the SELIC and the TJLP is likely next year, in our view. Despite slow growth and a much weaker currency, Brazil continues to run larger current account deficits due to quasi-fiscal imbalances of the type described above.
- **China:** The National Bureau of Statistics has revised the 2013 GDP up by 3.4%, mainly due to increases in the services sector. Further increases are likely as GDP in more distant years are revised when China adopts fully recognised international practices for measuring GDP. GDP numbers in EM tend to be systematically understated, because they are calculated based on censi that quickly become obsolete due to the rapid structural evolution of most EM economies. The lower the per capita GDP the larger the typical revisions. Meanwhile, fresh data from the property market shows that property prices are still slowing albeit at a progressively slower rate. The fastest rate of contraction was observed in July 2014. On current trends, China's property prices look set to return to positive growth rates within the next 6 months. The flash PMI for December fell to 49.5.

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Emerging Markets

- **Colombia:** The parliament passed a tax reform last week which is likely to raise more than USD 20bn in revenues for the government in the next four years. This shows that the government is not neglecting the needs of the economy and the public finances even as President Juan Manuel Santos pushes for a final settlement with the FARC rebel group – a target he has made a centrepiece in his second term as president. The FARC rebel group last week declared an indefinite, unilateral ceasefire with the government. The central bank left rates unchanged at 4.5% and formally dropped a policy that has seen the central bank deliberately weakening the COP by way of regular Dollar purchases. The policy, which has resulted in significant reserve accumulation, has constituted an implicit subsidy on Colombia's exporters. Colombian GDP rose 4.2% yoy in Q3 2014, more or less in line with the 4.3% yoy growth rate recorded in the previous quarter.
- **Russia-Ukraine situation:** Public statements last week suggested that several senior government officials were now looking for opportunities to stabilise or even de-escalate tensions with Russia. French President Francois Hollande, Austrian Chancellor Werner Faymann, Italian Prime Minister Matteo Renzi, Swedish Foreign Minister Margot Wallstroem and Danish Foreign Minister Martin Lidegaard all took public positions against applying further pressures on Russia or went as far as suggesting a reduction in sanctions. The economic incentives for a peace deal have recently increased for most parties involved in the Russia-Ukraine situation, while the political incentives for further escalation have deteriorated. This means that odds of a deal have improved, though it remains to be seen if the political talent – or lack thereof – in Europe, the US, Russia and Ukraine are sufficient to prevent this opportunity from going begging. An exchange of prisoners took place in Eastern Ukraine, but fighting is also continuing.
- **Russia:** After a week of exceptionally volatile currencies and a decision by the central bank to raise interest rates by 650bps to support the RUB the Duma authorised a RUB 1trn capital injection into Russia's banks. The government will issue sovereign bonds that will be exchanged for subordinated bonds issued at yields of 12%-13%. The Russian government has one of the lowest debt to GDP ratios in the world, which means that further support is both possible and likely should the stresses in the Russian market continue, in our view. For a comprehensive view on Russia see Russia: A macroeconomic overview, Market Commentary, December 2014.

Snippets:

- **Ukraine:** S&P, the ratings agency, lowered Ukraine's sovereign credit rating by one notch to CCC-, with negative outlook. Despite the ratings change, which is taking place after Ukraine's asset prices have already moved a great deal, Ukraine's foreign supporters, including EU, US and the IMF issued supportive statements. The IMF indicated that a major overhaul of the economy is on the cards for 2015, a position that was corroborated by President Poroshenko. The Ukraine government is the most pro-Western administration Ukraine is likely to have, in our view. It has complied fully with the IMF requirements and looks set to shortly approve the 2015 Budget.
- **Panama:** The economy expanded a healthy 6.2% yoy in Q3 following growth rates of 6.3% and 5.8% yoy in Q2 and Q1, respectively. Panama is expected to grow about 6.5% per year in the next two years due to massive infrastructure investments, including an expansion of the Panama Canal.
- **Thailand:** The Bank of Thailand left rates unchanged at 2% in line with expectations, but noted downside risks to growth due to uncertainties in the global outlook and inflation is expected to remain low for some time.
- **Mexico:** Retail sales were stronger than expected in October, up 5.6% yoy versus 4.5% yoy in September (and 4.3% yoy based on the consensus expectation). Sequentially, however, retail sales declined marginally over the month.
- **Pakistan:** The IMF approved a USD 1.05bn disbursement under its USD 6.4bn program with the government following a successful fourth review. The IMF board waived several performance criteria. Due to geopolitical considerations Pakistan receives strong financial support.
- **Ecuador:** Moody's, the ratings agency, raised Ecuador's sovereign credit rating from Caa1 to B3 with a stable outlook reflecting continuing increases in Ecuadorian credit metrics (including stronger growth and lower inflation than its peers), Ecuador's re-engagement with the IMF and markets as well as improving capacity to handle lower oil prices.

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Global backdrop

The Fed's FOMC minutes delivered a dovish message, while Fed Chairwoman Janet Yellen struck a more hawkish note in the subsequent press conference. The Fed is therefore in a position, where it can claim to be right regardless of whether the data improves or softens. As it happens, the data was mixed. Industrial production and manufacturing improved, but US services PMI moderated for the sixth consecutive month, while the Philadelphia Fed manufacturing index, the second most widely observed regional survey after the Chicago Fed's survey, fell below expectations. The December flash PMI softened to 53.7 from 54.8. US housing starts declined 1.6% mom versus an expectation of a rise of 3.1% mom. Permits also fell more than expected. US CPI inflation also declined more than expected, hitting 1.3% yoy in November compared to 1.7% in October. The FOMC correctly discounted the fall in inflation as driven mainly by temporary changes in oil prices. One area to watch going forward is the employment statistics: 40% of new jobs created in the US since 2009 were created in Texas. This may now change due to the fall in oil prices, although what is bad for Texas could be good for oil consuming states.

In Europe, the Greek government lost a vote to elect a new President, but this was not unexpected: three rounds of voting are scheduled and only on the last vote on 29 December does the threshold for passage decline to a level, where the government has a chance of winning. Failure to elect a President could trigger fresh parliamentary elections that would see the pro-bailout Syriza party make significant gains. Like US inflation, Euro-area inflation declined due to oil prices. Headline inflation declined to just 0.3% yoy in November, while core inflation declined to 0.66% yoy from 0.73% yoy in October. European flash PMIs rose to 51.7 in December from 51.1 previously.

The Bank of Japan left its monetary policy stance unchanged.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-4.9%	-3.4%	-2.0%	5.0%	2.7%
MSCI EM Small Cap	-4.4%	-1.0%	1.3%	8.5%	3.8%
MSCI FM	-7.3%	-0.1%	0.5%	11.2%	6.0%
S&P 500	0.28%	14.27%	16.78%	22.34%	15.83%
GBI EM GD	-5.62%	-5.41%	-5.73%	0.31%	3.01%
ELMI+	-2.91%	-7.25%	-7.16%	-0.74%	-0.26%
EM spot FX	-3.96%	-12.10%	-12.38%	NA	NA
EMBI GD	-2.59%	7.13%	7.11%	6.22%	7.49%
EMBI GD IG	-1.43%	9.29%	9.20%	5.18%	6.60%
EMBI GD HY	-4.65%	3.38%	3.53%	7.87%	8.77%
5 year UST	-0.68%	3.27%	2.71%	0.86%	3.32%
7 year UST	-0.39%	6.84%	6.19%	1.54%	5.04%
10 year UST	0.30%	12.24%	11.59%	2.70%	6.51%
CEMBI BD	-2.26%	4.60%	4.59%	6.27%	6.66%
CEMBI BD HG	-1.23%	6.85%	6.73%	6.08%	6.66%
CEMBI BD HY	-4.38%	0.01%	0.23%	7.08%	6.96%
US HY	-2.29%	1.54%	1.88%	8.62%	9.40%
European HY	-0.53%	5.25%	5.78%	15.39%	12.14%
Barclays Agg	-0.57%	0.70%	0.75%	0.92%	2.47%

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

Saudi Arabia
T: +966 11 486 8470

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

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