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WEEKLY INVESTOR RESEARCH

Ashmore

Karibu Kenya!

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We welcome Kenya as the 62nd member of the Emerging Markets (EM) external debt asset class. We put the recent upside economic surprises in Colombia and Mexico into the context of future tighter global financial conditions. We report the latest poll numbers in Brazil ahead of the October election. We also discuss Argentina, where a resolution to the decade long stand-off between holdout investors and the Argentinean government appears to be drawing nearer. All sides have skin in the game so expect the complex, fluid situation to persist for some time. Finally, we think Fed Chairwoman Janet Yellen's dismissal of inflation as "noise" should be taken at face value – they want inflation.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,043		-0.24%
MSCI EM Small Cap	1,070		-0.78%
MSCI FM	686		-0.72%
GBI EM GD	6.58%		-0.12%
ELMI+	3.17%		0.00%
EMBI GD	5.17%	253 bps	0.21%
EMBI GD IG	4.46%	176 bps	-0.21%
EMBI GD HY	6.82%	442 bps	1.00%
CEMBI BD	5.09%	279 bps	0.14%
CEMBI BD HG	4.29%	197 bps	0.12%
CEMBI BD HY	6.75%	447 bps	0.19%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1963	1.31%
VIX Index	10.85	-14.23%
5 year UST	1.68%	-1 bps
10 year UST	2.60%	0 bps
US HY	5.12%	0.31%
European HY	4.13%	0.27%
EURUSD	1.3590	0.15%
USDJPY	101.85	0.00%
Brent	114.47	1.41%
Copper	313.18	0.86%
Gold	1312.08	2.82%

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

Emerging Markets

Karibu (Welcome) Kenya! In the past week Kenya's government formally joined the global capital markets by issuing two benchmark sovereign dollar denominated bonds with 2019 and 2024 maturities and yields of 5.44% and 6.5% respectively. Kenya will most likely enter the JP Morgan benchmark index within the next couple of months to become the 62nd member of the index. There were 26 EM sovereign bond issuers 10 years ago. There are now about three times more EM issuers of sovereign bonds than there are developed economies in the world. The EM fixed income asset class offers exposure to a very diverse set of issuers that on average have less than half the level of debt of developed economies and much higher yields. We expect the number of EM issuers to continue to rise, especially from frontier economies. In other issuance news, **Ecuador** returned to the market with a USD 2bn 10-year benchmark bonds priced at 7.95% yield. Ecuador is already an index member on account of its 2015 benchmark bond.

EM fundamentals have improved over the last two decades, but they have also become more homogenous – homogenously stronger.[1] As we look ahead, we see the homogeneity giving way to greater diversification across countries due to the unwinding of the global imbalances and tighter financial conditions. The good news is that EM countries as a group and individually are far, far better placed to cope with these changes than developed economies. Fundamentals are strong and EM asset prices have also not been inflated to the unsustainable levels of those in developed economies. EM's lack of addiction to the cheap money provided by QE is particularly reassuring at this stage.[2]

Even so, the many differences between EM countries will become more pronounced and one of the most important determinants of future success will prove to be past reforms. **Colombia** today offers a good example of what the winners of tomorrow may look like. This past week Colombia released first quarter GDP numbers that showed the country growing 6.4% yoy, well beyond the consensus expectation of 5.2% yoy. Newly re-elected President, Juan Manuel Santos, implemented sweeping economic reforms in his first term. The effect of these reforms has been to raise the rate at which Colombia can grow without bumping into supply-side constraints, that is, the sustainable trend growth rate has risen. Even so, Colombia's central bank sensibly (and in line with expectations) raised benchmark interest rates by 25bps to 4% last week. Many other countries in EM have, like the Colombians, understood that the key to sustainable growth going forward is to improve productivity. We believe they could be the winners of tomorrow.

Continued overleaf

[1] See *'The High Income Trap'*, Emerging View, June 2014.
[2] See *'Financial Divergence: How ready are Emerging Markets for Global Financial Tightening?'*, Emerging View, May 2014.

Emerging Markets

- Mexico: Another country destined for success is Mexico. Like Colombia, Mexico recently undertook deep economic reforms. Despite an initially sluggish response of the economy to the reforms, there are now signs that the Mexican economy is beginning to expand (as we reported in last week's research). This week Mexico's retail sales numbers significantly beat expectations. The consensus was for a seasonally adjusted contraction of 1.3% mom, but instead there was an expansion of 1.3% mom. The turnaround in retail sales began last month. Mexico's economy has considerable slack, partly due to a protracted cyclical downturn, but most importantly because the recent reforms will enable the economy to grow even faster without running into supply-side constraints. This bodes well for Mexico – the combination of stronger growth and well-contained inflation is an attractive one.

- Brazil: In Brazil, the latest polls ahead of October's presidential election show President Dilma Rousseff's approval rating stabilising. The CNI/Ibope poll shows that 44% of Brazilians approve of Dilma's government and that 39% of potential voters would support her. This compares to 21% for Aecio Neves, her nearest challenger. These ratings imply that Dilma has gained 2% against Neves compared to the previous poll.

- Argentina: Turning to Argentina, the US Supreme Court last week refused to review a ruling by the New York 2nd District Court that requires Argentina to pay holdout investors from the 2001 default before servicing performing bonds issued under New York Law.

Shortly afterwards the 2nd District Court lifted a stay on its ruling, which has been in place pending the decision by the Supreme Court. This means that the ruling has now taken effect, potentially putting in jeopardy coupon payments on the 2033 Discount Bonds that fall due on 30 June and, by implication, all debt issued by Argentina subject to the ruling. Under the terms of the bond prospectus, there is a 30 day grace period for payment, so the critical deadline is end-July.

In terms of cold cash, the ruling means that Argentina could face a near-term liability of up to USD 15bn because, although the Court's ruling only applies to the plaintiffs in the case, it is widely expected that the ruling could quickly be extended to all holdout investors, whose total claims amount to about USD 15bn (about 3% of Argentina's GDP).

A liability of this size presents a problem for Argentina, which has just short of USD 30bn in foreign exchange reserves. Hence, even under the unlikely scenario where Argentina was willing to pay the full claim upfront it would likely not be able to do so unless it secured sizeable fresh money from some third party.

So far, the government has said that it wants to continue to service performing debt. Over the weekend, President Cristina Kirchner said that her government wants to negotiate with holdout investors.

The government, holders of performing debt, and holdout investors all have 'skin in the game'. As such, what are the likely scenarios going forward?

First, holdouts and the government could negotiate a smaller settlement, payment in instalments, or payment in bonds, so as not to destabilise Argentina's balance of payments. Both sides have now expressed willingness to negotiate.

Secondly, Finance Minister, Axel Kicillof, reiterated last week that the government plans to offer holders of performing New York law bonds (which are affected by the ruling) a swap into local law bonds (which are not).

Thirdly, the government could opt to default on all performing New York law bonds if, for example, it felt unable to prevent payments going to holdout investors.

Finally, there may be additional scenarios that are either not yet being considered or not yet discussed in public. The situation is therefore complex, likely to remain fluid for some time, and requires close monitoring.

In our view, Argentina's case is unique within EM as no other countries find themselves in a similar predicament with the New York courts. As such, the outcome of this case should not have direct implications for other EM countries.

The main indirect implication, however, could be that EM issuers become less inclined to issue under New York law. After all, the 2nd District Court's ruling implies that small numbers of holdout investors can potentially derail workouts in the event of restructurings. Avoiding issuing under New York law would only accelerate an already strong existing trend within EM. Nearly 90% of all EM fixed income is already under local law and the percentage is only likely to rise further in our view.

Continued overleaf

Global backdrop

US economic data improved over the past week. The Philadelphia Fed manufacturing survey rose from 15.4 in May to 17.8 in July. Claims for unemployment also fell marginally. Following a shockingly soft Q1, the US economy will yet again record a lacklustre 2% growth rate for the year. Even so the US publishes its GDP data on a quarter-on-quarter basis, so it is almost a mathematical certainty that the headline data will look stronger in Q2 than in Q1. Currently Q2 GDP is tracking 2.9% following weaker than expected housing data published last week. Yet, the high frequency data is improving and it is in this stream that Fed Chairwoman, Janet Yellen, last week characterised an observed recent rise in US inflation as "noise". Yellen is right that inflation data can be volatile and airfares did play a special part in the latest CPI print. Still, Yellen's dismissal of recent higher core inflation numbers in the US should not be ignored. It is consistent with comments from other Fed officials that have also tended to discount inflation as a concern.

Why are they doing this? Basically for the same reason that the ECB recently got a lot more dovish. Monetary officials in all the heavily indebted developed countries understand that their economies are still far too weak to handle a material rise in real rates, mainly due to huge debt levels. The Fed is therefore downplaying inflation risks because they don't see inflation as a risk, rather as part of the solution. Inflation in the US would be a salvation, because inflation would erode the debt, help keep real interest rates low, and increase the competitiveness of the Dollar. The cost of inflation – in terms of lower investment – would probably be fairly low, because as long as there is too much debt investment rates will likely stay low anyway. Inflation would materially help to restore equilibrium and mostly be at the expense of future generations and foreigners, so the domestic political cost is relatively low. This is why we think inflation is coming: the real challenge facing policy makers and the markets today is therefore mainly psychological; after nearly 40 years where inflation was labelled a 'no-no' it will take some time before a heavily indebted United States understands the fact that inflation is now its friend.

So how far are we away from inflation? A couple of years, in our view. Consider the link between money supply and inflation, which is encapsulated in the Quantity Theory of Money: MV=PY, where M is the money supply, V is velocity of circulation, P is prices, and Y is growth. Empirically, there is an extremely strong relationship between money supply and inflation in the long-run, but in the short-run the relationship depends crucially on velocity. Velocity is of course strongly related to the demand for money. And the demand for money is currently depressed due to deleveraging. US household deleveraging is about 75% complete. Deleveraging has recently slowed somewhat, which suggests that households may now no longer get back to full spending power until late in 2016 or even 2017.[3] Still, inflation is already migrating from financial asset prices into real investments, such as house prices, so the risk of an expectations-led rise in inflation is already growing. In this context, the decision by FOMC members last week to move the terminal fed funds rate lower rather than higher seems consistent with a strategy to inflate America out of its debt.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.8%	5.3%	17.9%	1.2%	9.8%
MSCI EM Small Cap	0.3%	7.9%	13.3%	2.0%	11.9%
MSCI FM	-1.2%	18.6%	30.9%	12.0%	9.4%
S&P 500	2.16%	7.24%	26.19%	17.89%	18.79%
GBI EM GD	-0.10%	4.84%	4.36%	1.13%	7.57%
ELMI+	-0.15%	1.60%	2.66%	-0.94%	2.73%
EMBI GD	-0.19%	8.07%	11.13%	7.39%	10.51%
EMBI GD IG	-0.88%	7.26%	8.50%	5.72%	8.62%
EMBI GD HY	1.14%	9.67%	16.58%	10.39%	13.39%
5 year UST	-0.70%	1.68%	1.02%	1.94%	3.95%
7 year UST	-0.80%	3.49%	1.26%	3.15%	5.40%
10 year UST	-1.13%	6.10%	2.02%	5.31%	6.16%
CEMBI BD	0.25%	5.92%	8.74%	6.28%	9.77%
CEMBI BD HG	-0.04%	5.87%	8.36%	6.24%	8.79%
CEMBI BD HY	0.82%	5.98%	9.51%	6.66%	12.88%
US HY	0.79%	5.75%	12.08%	10.51%	14.81%
European HY	1.06%	6.44%	15.72%	13.98%	17.67%
Barclays Ag	-0.22%	3.95%	5.46%	2.22%	4.63%

[3] *'Has Godot arrived in Mexico?'*, Weekly Research, 16 June 2014.

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