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President Macri's Christmas wish list

By Jan Dehn

The Christmas wish list of Argentina's president-elect has just two items – growth and power. Here is why the political business cycle in Brazil may be turning. Two months of positive growth in Russia, but will sanctions go? South Africa's Lesetja cements his hawkish credentials and is rewarded with a rally in the long end of the curve. India's payrise for central government officials could mark the end of India's recent fiscal retrenchment. PBOC takes China one step closer to full interest management of the economy. Nigeria insists on doing the wrong thing, Rwanda trades institutional integrity for short-term political stability, Panama records a dramatic rise in tourist arrivals and Ukraine secures a Caa3 rating with stable outlook for its new bonds from Moody's. In the US, the Fed prepares to hike in December as base effect loom large.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	2.73%
MSCI EM Small Cap	12.1	–	2.39%
MSCI Frontier	9.2	–	-0.57%
MSCI Asia	11.4	–	1.54%
Shanghai Composite	13.9	–	1.39%
Hong Kong Hang Seng	7.4	–	1.18%
MSCI EMEA	9.9	–	5.72%
MSCI Latam	13.4	–	4.82%
GBI-EM-GD	6.81%	–	1.73%
ELMI+	4.23%	–	0.94%
EM FX spot	–	–	1.23%
EMBI GD	6.01%	373 bps	0.92%
EMBI GD IG	4.80%	246 bps	0.69%
EMBI GD HY	7.94%	579 bps	1.21%
CEMBI BD	6.03%	394 bps	0.22%
CEMBI BD HG	4.61%	252 bps	0.04%
CEMBI BD HY	8.48%	639 bps	0.51%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.2	–	3.34%
1-3 year UST	0.94%	–	-0.14%
3-5 year UST	1.72%	–	-0.08%
7-10 year UST	2.29%	–	0.09%
10+ years UST	3.03%	–	0.61%
US HY	8.47%	686 bps	-0.55%
European HY	4.85%	502 bps	0.40%
Barclays Ag	–	227 bps	0.31%
VIX Index*	15.47	–	-4.61%
DXY Index*	99.85	–	0.41%
EURUSD	1.0619	–	-0.70%
USDJPY	123.21	–	0.02%
CRY Index*	183.73	–	-1.03%
Brent	43.7	–	-1.93%
Gold spot	1069	–	-1.51%

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

Emerging Markets

- **Argentina:** For Argentinians Christmas has come early. Mauricio Macri was elected president with a clear margin over Daniel Scioli and he will take office on 10 December. The election of a modern, market-friendly leader marks a dramatic and positive change from a Kirchner era characterised, in our view, by populism, lost opportunities, inefficiency, unnecessarily divisive politics, alleged corruption, ever-growing macroeconomic imbalances and, occasionally, violence.

Still, Macri will be sending a Christmas wish list of his own. Topping the list will be two ingredients he sorely needs in quick order to be able to effectively change Argentina, namely power and growth. Macri's presidency starts with neither a majority in parliament nor much room to stimulate the already over-stimulated economy. The risk is clearly that Macri becomes to Argentina what former-President Fox was to Mexico, an ineffective breath of fresh air. So what will Macri do?

First, he must establish a base of power by reaching out to provinces and across the political spectrum to build a workable coalition, particularly by tapping into the pool of disaffected and moderate Peronists, including supporters of former Cabinet Chief Sergio Massa. Secondly, he must crush the likely threat of opposition from the hard-line 'Kirchnerista' camp of Peronists. This is probably best achieved through anti-corruption investigations.

The growth challenge is equally serious. Aggregate demand has been over-stimulated for years in Argentina. This means that Macri will have to focus attention on the supply-side of the economy. Investors should therefore expect a greater focus on rule of law, better microeconomic policies as well as policies that encourage FDI, including possibly privatisation of some assets and greater openness in the energy sector. Macri will also have to make greater use of fiscal policy. One of the silver-linings in the Kirchner administration was its stubborn unwillingness to settle with holdout investors, a policy that effectively limited fiscal spending by keeping Argentina out of the debt markets. Since the economy has relatively low levels of debt Macri has some freedom to rely more on fiscal policy to ease the transition to macroeconomic stability. But in order to do so he must find a resolution to the holdout issue as a matter of urgency. Finally, he must attract capital back to

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Emerging Markets

Argentina – official and private, Argentinian and foreign – to help rebuild reserves and reinject dynamism into the private sector, which is in enormous need for new investment.

- Brazil: Turning points in political business cycles are not often easy to spot, but it helps to know what to look out for. As is well known, President Dilma Rousseff's approval rating has been declining dramatically over the past year and a half. It has now fallen so far that, barring actual impeachment, it can hardly drop any further. Ironically, herein lies a silver lining for Dilma, because further humiliation of the president by the opposition could begin to backfire.

Consider for example what would happen if the opposition took further measures to erode the public finances in Brazil in order to attack Dilma. The consequences for the Brazilian economy could obviously be severe, but the blame would increasingly begin to fall on politicians in general rather than just Dilma and the PT party. This would happen not just because Dilma's approval rating can hardly fall much further, but also because voters would perceive politicians in general as failing. This increases the risk that parliamentarians right across the political spectrum, not just Dilma and the PT party, end up paying at the next election for their perceived political failures.

In economic language, one would say that the marginal political cost of additional misery is now rising faster for the opposition than for Dilma herself (it is already about as high as it can get).

Last week produced at least three developments that suggest that a political turning point of sorts may indeed be taking place in Brazil.

- President of the Chamber of Deputies, Eduardo Cunha, an ardent opponent of Dilma, said his decision whether to push ahead with the process of impeaching Dilma has now been pushed to 2016. The reality is that Cunha himself is now under severe pressure.
- Parliament ratified Dilma's vetoes on a number of extremely dangerous economic measures that, had the vetoes not been upheld, could have seriously destabilised the economy.
- Dilma publicly rejected a proposal to replace Finance Minister Joaquim Levy with former central bank governor Henrique Meirelles.

Whether Dilma continues to support her finance minister is, in our view, purely down to political expediency. Levy and Meirrelles would both pursue the same sensible policies; the only difference between them is their effectiveness in implementing these policies. Levy's ability to implement reforms has been disappointing, because the erosion of Dilma's political capital has rendered him impotent with respect to parliament. Meirelles has more political clout. He has the backing of former President Lula and therefore the PT party, so the key question is now whether Meirelles can 'deliver' the support of the PMDB party (without whose support Meirelles's policies would be as ineffective as Levy's).

If Meirelles can secure the support of PMDB for Dilma then the job is his, in our view. However, he will likely have to demonstrate this support upfront. With the support of PMDB and the PT party, Dilma would quickly pass the reforms required to bring Brazil out of its cyclical malaise, perhaps even avoid a second downgrade to sub-investment grade.

There is not much time to avoid this, however. The economy continues to deteriorate. The most recent evidence of distress was a rise in the rate of unemployment to 7.9% in October from 7.6% in September, while inflation broke through the 10% level. If the political chill arising from this sorry state of affairs is now spreading out more widely across the political landscape, however, then PMDB and other opposition parties may just be considering how they should respond – and Meirelles for one will be watching their deliberations more keenly than most. So should investors.

- Russia: Russia recorded its second consecutive month of positive economic activity in October, suggesting that the worst of the adjustment to last year's dramatic fall in oil prices is over. Investment and industrial production beat expectations, but retail sales, real wages and unemployment were worse than expected. This is consistent with the pattern of adjustment one would expect for Russia. Currency weakness and rate hikes have helped to bring down domestic demand to a level consistent with lower national income due to lower oil prices. By reducing domestic costs and increasing competitiveness versus the rest of the world these policies are also helping the supply side of the economy.

S&P, a ratings agency, last week said that better relations between Russia and the West could boost Russia's sovereign debt rating. The argument is that Russia's support in the fight against Islamic State in Syria could be rewarded with the removal of Western sanctions against Russia over Ukraine. There is no doubt that Russia's standing has now improved with respect to the West. With immaculate timing, Russia inserted itself into the Islamic State situation in Syria just weeks before the recent Paris attack. The demand for action against Islamic State in the West is now so strong that Russia's support has clearly helped to raise the country's standing in the eyes of the West. However, sanctions relief is unlikely to be imminent. Trust overall is low. The sanctions are explicitly linked to finding a political solution in Eastern Ukraine and Crimea. Finally, the West and Russia have still not managed to agree on the role of President Assad in a new Syria. Still, if the current pace of détente with Russia continues it is quite conceivable that the West will eventually drop sanctions on Russian financial institutions. Ultimately, both sides are keen for this to happen due to strong mutual economic interests, including energy and trade in general.

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Emerging Markets

- **South Africa:** The South African Reserve Bank (SARB) surprised the markets by hiking the repo rate by 25bps to 6.25%. It was immediately rewarded with a rally in the long end of the curve. The rate hike was a direct response to a recent rise in long-term breakeven inflation following public sector wage increases and expectations of more government bond issuance following the announcement of the Budget recently. SARB Governor Kganyago Lesetja, a former senior treasury official, is extremely well equipped to evaluate the inflationary impact of fiscal policy and his reputation as a hawk has been reinforced by this decision. Meanwhile, core inflation actually moderated slightly from 5.3% yoy in September to 5.2% yoy in October.

- **India:** It does not take much of a memory to remember the root causes of the growth slump that India found itself in just a few years ago. It was fiscal policy. Years of excessive public spending combined with inadequate attention to the supply-side of the economy pushed up costs, forcing the central bank to hike rates. The economy slowed and the currency began to fall. Sure, it was only a cyclical problem that the Modi administration and Reserve Bank of India (RBI) governor Raghuram Rajan were to remedy. That is why investors should not ignore the 23.5% pay rise recommended by the pay commission last week. The fiscal cost of this measure will be around 0.7% of GDP, which means that India's fiscal adjustment is now at an end. In turn, this increases the odds that (a) RBI does not cut rates any time soon and (b) that the room for further cuts now depends on further supply-side measures. Meanwhile, the trade deficit shrank again to USD 9.8bn in October from USD 10.1bn in September. The result was much better than expected (a deficit of USD 11.1bn).

- **China:** The People's Bank of China (PBOC) reduced the rates on its Standing Lending Facility (SLF) from 4.5% to 2.75% for the overnight rate and from 5.5% to 3.25% for the 7-day rate. The SLF is a short-term facility that was created a few years ago to help banks manage liquidity so as to avoid excessive spikes in short term interest rates, for example when there are sudden events that change liquidity in the banking system. The ability to manage short-term rates within a well-defined range is becoming increasingly important in China as the country turns to consumption-led growth and interest rate management of the economy. The adjustment to the SLF rates (a) brings them in line with policy rates that have recently declined, (b) cheapen short-term funding ahead of an expected re-opening of the IPO market this week (can impact liquidity in the banking system), and (c) furthers the aim of developing an interest rate corridor around the policy rate. In other news, China announced last week that it intends to merge its regulation of bank, insurance and capital markets into one single powerful regulator. This is all consistent with China's transformation into a modern market economy.

- **Nigeria:** Nigeria's government continues to insist on doing the wrong thing. Last week it announced that access to US dollars will be further restricted, while spending will rise by 10% to pay mainly for domestic energy subsidies. These policies serve to postpone the necessary adjustment to lower oil prices, but will ultimately extract a larger cost for the economy. In the near-term, however, the data has been improving marginally. The economy expanded 2.8% yoy in Q3, which was an improvement from the 2.4% rate achieved in Q2. Inflation also declined marginally from 9.4% yoy in September to 9.3% in October.

- **Rwanda:** The Senate has agreed to extend term limits for the president. This means that President Kagame could serve at least one more term in office. The decision sacrifices institutional integrity in favour of short-term stability (stability has returned to Rwanda under Kagame's time in office). We expect that Rwandans will support him in a referendum for the proposed constitutional change in favour of extending term limits ahead of the next presidential election in 2017.

- **Panama:** Panama is on fire. Tourist arrivals this year between January and September are up 13% yoy with tourism-related revenues up 15% on a year ago. This is very important for Panama, because tourism is 17.5% of GDP, while more than 17% of the labour force are employed in the tourism industry. The fiscal deficit from January to September was 1.8% of GDP, a dramatic improvement from the situation at the same time last year (a deficit of 4.6% of GDP).

- **Ukraine:** Moody's, a ratings agency, rated nine new bonds created in the recent exchange at Caa3 and with a stable outlook. In other notable news, industrial production rose 7.3% mom. Finally, Ukraine took receipt of a proposal from Russia to restructure repayments of its USD 3bn Russian obligation from a bullet repayment in December this year to three equal repayments in 2016, 2017 and 2018.

Snippets:

- **Chile:** GDP expanded 0.4% qoq in Q3, which was stronger than expected (0.3% qoq).
- **Ghana:** The central bank lifted policy rates again, this time by 100bps, taking the policy rate to 26%.
- **Indonesia:** Bank Indonesia left policy rates unchanged, but eased reserve ratios marginally to 7.5%.
- **Malaysia:** CPI inflation was 0.1% mom in October, in line with expectations.
- **Mexico:** Growth continues to improve sequentially in Mexico. Q3 GDP was 3% higher than in Q2. On a yoy basis, growth rates also rose. Q3's yoy expansion was 2.6% compared to 2.3% yoy in Q2. Markets had only expected growth to rise at a rate of 2.4% yoy.
- **Namibia:** Fitch, the ratings agency, affirmed Namibia's sovereign debt rating at BBB- with a stable outlook.
- **Philippines:** Remittances from foreign workers was up 4.3% yoy in October versus -0.4% yoy expected.

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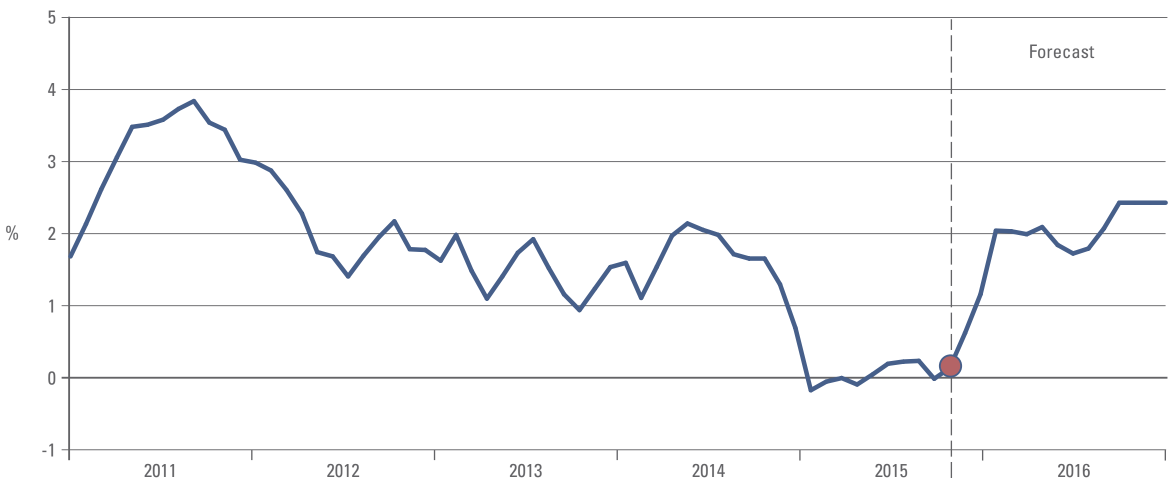
- **Singapore:** Non-oil domestic exports rose 1.1% yoy in October versus -2.7% yoy expected. CPI inflation declined 0.4% in the month of October. Core inflation was 0.3% yoy (0.6% yoy expected).
- **Thailand:** The central bank's FX reserves rose by USD 1bn to USD 157bn last week from USD 156bn the week before.

Global backdrop

Fed officials continue to insist on lifting rates in December. Both US stock markets and EM FX markets appear to have priced in the event. One important reason why the Fed might want to consider a rate hike now is that the US economy is about to experience a sharp rise in headline inflation due to base effects.

The chart below shows how yoy inflation in the US will evolve over the next 12 months based on mechanical projections of stable monthly inflation of 0.2% every month in 2016. The red dot in the chart denotes the latest data point. Clearly, yoy inflation is set to shoot up meaningfully next year starting immediately in Q1 2016.

Fig 1: **US CPI projections based on 0.2% mom inflation throughout 2016**



Source: Ashmore, Bloomberg.

This base effect should be put into the context of the US business cycle. If the US economy achieves full employment and consumers start to spend a bit next year – both of which are entirely consistent with the latest labour force data and evidence of declining household debt-to-income ratios and declining negative housing equity rates – then inflation could obviously rise even further.

One particularly nasty challenge facing the Fed is that it will be tough to soak up, all the money that has been printed under its QE program over the past few years in a hurry. This means that, barring a recession, there is a non-trivial risk that inflation expectations respond more than anticipated to rising headline inflation.

Meanwhile, bond yields and swap spreads continue to drift lower. German two-year bond yields set a new record low of -0.389% last week. Three-years swap spreads turned negative in the US too after 30 year, 10 year, 7 year and 5 year swap spreads had already turned negative. ECB President Mario Draghi maintained an extremely dovish line in public commentary, basing his position on low long-term inflation expectations for the Eurozone. The US data was mixed. Empire manufacturing, industrial production and new home sales disappointed relative to expectations, while the Philadelphia Fed survey of manufacturers was better than expected.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.47%	-9.65%	-12.44%	-2.21%	-2.68%
MSCI EM Small Cap	-0.74%	-5.02%	-7.51%	1.40%	-1.87%
MSCI Frontier	-0.82%	-11.18%	-14.82%	7.48%	1.74%
MSCI Asia	-1.11%	-6.42%	-6.12%	2.92%	1.25%
Shanghai Composite	7.34%	14.01%	50.37%	25.04%	7.27%
Hong Kong Hang Seng	-0.91%	-11.39%	2.33%	4.11%	-1.32%
MSCI EMEA	-0.59%	-8.34%	-18.04%	-6.60%	-5.07%
MSCI Latam	3.46%	-22.05%	-29.01%	-13.84%	-11.62%
GBI EM GD	-0.04%	-11.09%	-16.63%	-7.64%	-2.71%
ELMI+	-0.52%	-5.76%	-8.94%	-4.55%	-2.71%
EM FX Spot	-0.50%	-14.76%	-19.63%	-11.70%	-8.82%
EMBI GD	0.23%	2.91%	1.12%	2.11%	5.31%
EMBI GD IG	-0.03%	0.40%	0.14%	0.92%	4.56%
EMBI GD HY	0.57%	6.33%	1.69%	3.83%	6.43%
CEMBI BD	-0.18%	2.91%	1.24%	2.95%	4.76%
CEMBI BD HG	-0.46%	2.08%	1.48%	2.89%	4.95%
CEMBI BD HY	0.28%	4.25%	0.34%	3.14%	4.45%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.67%	3.40%	3.93%	17.04%	14.11%
1-3 year UST	-0.39%	0.38%	0.24%	0.36%	0.61%
3-5 year UST	-0.58%	1.56%	1.68%	1.15%	1.69%
7-10 year UST	-0.83%	1.94%	3.34%	1.32%	4.24%
10+ years UST	-1.72%	-1.78%	3.87%	1.85%	8.08%
US HY	-2.31%	-2.12%	-3.49%	3.50%	6.19%
European HY	0.78%	3.85%	4.16%	8.48%	9.95%
Barclays Ag	-0.09%	0.24%	1.33%	2.80%	4.50%
VIX Index*	2.65%	-19.43%	19.92%	2.18%	-25.01%
DXY Index*	3.00%	10.62%	13.07%	24.52%	25.32%
CRY Index*	-6.07%	-20.10%	-31.72%	-38.57%	-38.28%
EURUSD	-3.52%	-12.24%	-14.55%	-18.16%	-20.71%
USDJPY	2.15%	2.81%	4.05%	49.53%	48.73%
Brent	-11.82%	-23.77%	-45.62%	-60.76%	-47.51%
Gold spot	-6.41%	-10.03%	-10.71%	-39.03%	-22.55%

*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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