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The real EM capital outflow story – and why EM investors need to think for themselves

By Jan Dehn and Alexis de Mones

We correct the highly misleading impression of Emerging Markets capital outflows created by an exceptionally poorly researched article published on the front page of the Financial Times last week. We also discuss the wider weakness in global markets, where we see Emerging Markets more as the 'canary in the coal mine' rather than the cause. Indeed, there are major problems in developed markets where the Quantitative Easing trades of the past four years are running out of steam with nothing obvious to replace them. What next? Cue nervousness. Or worse. We also cover events in Argentina, Mexico, Brazil, China, Russia, Kazakhstan and Ecuador.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.6	–	-5.93%
MSCI EM Small Cap	9.9	–	-7.54%
MSCI Frontier	8.6	–	-3.34%
MSCI Asia	9.8	–	-6.22%
China A shares	13.3	–	-7.20%
China H shares	6.9	–	-5.99%
MSCI EMEA	8.7	–	-5.46%
MSCI Latam	11.9	–	-5.32%
GBI-EM-GD	6.96%	–	-2.09%
ELMI+	6.01%	–	-1.41%
EM FX spot	–	–	-1.51%
EMBI GD	6.06%	400 bps	-0.90%
EMBI GD IG	4.72%	260 bps	-0.81%
EMBI GD HY	8.36%	645 bps	-1.03%
CEMBI BD	5.81%	397 bps	-0.77%
CEMBI BD HG	4.58%	273 bps	-0.41%
CEMBI BD HY	8.23%	641 bps	-1.45%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.0	–	-5.71%
2 year UST	0.60%	–	0.18%
5 year UST	1.41%	–	0.66%
10 year UST	2.02%	–	1.32%
30 year UST	2.71%	–	2.06%
US HY	7.77%	643 bps	-0.80%
European HY	4.94%	496 bps	-0.58%
Barclays Ag	–	227 bps	0.40%
VIX Index*	28.03	–	15.20%
DXY Index*	94.23	–	-2.57%
USDJPY	1.1484	–	3.66%
EURUSD	120.38	–	3.31%
CRY Index*	191.34	–	-6.63%
Brent	43.7	–	-10.28%
Gold spot	1156	–	3.32%

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

Emerging Markets

Emerging Markets (EM) have long been a victim of sensationalist headlines and this trend continues with a high profile story referencing a report that EM had suffered USD 1trn in capital outflows over the past year or so.[1]

No wonder this story grabbed the headlines. After all, USD 1trn is a big number, equivalent roughly to 3% of the EM's equity and fixed income markets combined. If that much money had left EM it would indeed have been newsworthy.

In reality, outflows of this size never took place. The actual outflows were much, much less – somewhere between USD 183bn and USD 295bn.[2] It turns out that the report arrived at its headline-grabbing USD 1trn outflow number by committing an extremely basic error in balance of payments accounting, an error so rudimentary as to leave one wondering how the report passed even basic peer review.

In fairness to the report and the Financial Times, it is notoriously difficult to measure capital flows, because they are largely unobservable. Economists therefore solve for capital flows in the well-known relationship between the current account, the capital account and changes in foreign exchange reserves:

A. Capital flow = change in reserves – current account flow

This is the method used by the authors of the report to obtain its USD 1trn capital outflow. Specifically, over 12 months to June 2015 EM racked up a USD 365bn current account surplus. Over the same period, EM FX reserves declined by USD 572bn. Hence, the report concluded, capital outflows must have been USD 937bn, rounded to USD 1trn for effect.

Yet, the equation above is a long-term equilibrium condition, which assumes constant exchange rates. In the short run – such as the last 12 months – one could not have missed that currencies have moved around a considerable amount.

[1] *'Surge in Emerging Markets capital outflows hits growth and currencies'*, Financial Times, 18 August 2015.
[2] See *'The Emerging Markets investment universe'*, The Emerging View, August 2015.

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Emerging Markets

This turns out to be quite important, because stocks of reserves change not just because of inflows and outflows. They also change when exchange rates move. After all, reserves are denominated in many different currencies.

What this means is that if one does not correct for currency valuation effects one may arrive at a completely nonsensical estimate of capital flows. For example, consider a country that has, say, half of its currency reserves denominated in EUR and the other half in USD. If EURUSD drops 10% then the stock of reserves will drop by 5% in USD terms, even if there have been no capital flows at all.

This simple fact – that reserves can change even if there are no flows – underlines how critical it is to take account of currency valuation effects before concluding that changes in reserves can give meaningful insight about capital flows.

In mathematical terms, equation [A] must be augmented as follows:

B. Capital flow = change in reserves – current account flow – FX valuation effects

FX valuation effects had a huge impact over the past year. To illustrate just how large, we estimated the impact of currency movements on EM reserves between June 2014 and June 2015. This is not entirely a straight-forward exercise. For example, some countries do not disclose full details of the currency composition of their reserves. Another complication is that IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) data on the currency composition of foreign exchange reserves is published with a considerable lag (latest available data is March 2015).

These constraints led us to make two separate calculations of FX valuation effects, one based on the COFER database and another using bottom-up FX reserve numbers published individually by 114 EM countries. To calculate FX valuation changes we used the weights of individual currencies in the COFER database, applying those weights to the undisclosed reserves held by countries such as China and Saudi Arabia. We found that FX valuation changes were enormous, accounting for between USD 642bn and USD 754bn in the overall change in reserves in EM over the past 12 months (see Figure 1).

Fig 1: **Emerging Markets capital flows (June 2014-2015)**

	USD bn	% of total EM tradable debt and equity
EM current account	365	–
EM foreign exchange reserves (bottom-up)	-573	–
FX valuation effect (top down)	-642	–
FX valuation effect (bottom up)	-754	–
Capital outflow (top down)	295	0.9%
Capital outflow (bottom up)	184	0.6%
EM fixed income and equity	32,200	100%

Source: Bloomberg, JP Morgan, IMF.

Given the scale of the FX valuation effects it is clear that estimates of capital outflows from EM that do not take them into account will be hopelessly wrong. Our estimates of EM capital outflows – after controlling for FX valuations effects – turn out to be between 3 and 5 times smaller than the estimate in the report.

At between USD 183bn and USD 295bn, depending on the methodology used, EM capital outflows are still large, but they are by no means catastrophic. They measure between 0.6% and 0.9% of total tradable debt and equity in EM. Alternatively, rather than being more than twice the size of outflows recorded during 2008/2009 – a point laboured by the Financial Times – the outflows are in fact significantly smaller, perhaps as low as half that size.

Our estimates of the scale of outflows also have the merit of being far more consistent with the price action. In 2008/2009, sovereign debt spreads in EM blew out to 800bps. Today, spreads are around 400bps. Local bond yields in EM blew out to more than 9.5% in 2008. Today, yields are about 7% and still below levels seen during the Taper Tantrum.

Last week the Institute of International Finance (IIF) published an outflow number of just under USD 300bn, based on data for the last four quarters. This estimate is very close to our own. The IIF concluded, "Don't panic! EM capital flows have weakened, but NOT collapsed".

Ignorance and prejudice about EM are rife. When combined they can become dangerous. When they fuel misleading, sensationalist media headlines they remind us that there is no substitute for independent thinking when it comes to EM.

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Emerging Markets

- **Argentina:** June's economic activity index pointed to 3.8% yoy growth versus 2.1% yoy growth expected. Unfortunately, considerable uncertainty surrounds official data releases in Argentina. We think the economy requires major adjustment, but remain confident that such adjustment can be undertaken in an orderly fashion under the next administration that takes office early next year.

- **Mexico:** Retail sales in June rose 1.1% after season adjustment. This was significantly better than expected (0.4% mom sa). On a yoy basis, retail sales are now up 5.4% (versus 4.6% yoy expected). In June the economy expanded by 3.11% yoy compared to 2.5% yoy expected. Mexico announced last week that it has locked in a USD 49 per barrel oil price for the 2016 budget through its forward oil sales program. In effect, this means that spot prices will not matter for Mexico for the next year, though of course prices do matter for 2017 onwards.

- **Brazil:** Mid-month consumer price inflation points to decelerating inflation. The IPCA-15 indicators showed that inflation had declined to 0.43% in August from 0.59% in mid-July and 0.62% in July as a whole. Brazil is going through a serious recession, which is pushing up unemployment (7.5% in July versus 7.0% expected) and is now putting serious downward pressures on wages and other services related costs. This is positive, in our view, though the economy is taking a heavy toll (real GDP declined 0.6% in June versus 0.5% mom expected). Also positive is that the Senate last week passed new tax laws that will increase revenues by BRL 10bn per year. The measure has already passed in the lower house and will now become law. More importantly, Finance Minister Joaquim Levy is taking steps to move the public finances to a medium-term expenditure framework (MTEF). MTEF's are four-year rolling programs that reduce the discretionary element in the public finances. Such frameworks have become standard practice in many EM countries and tend to be associated with better public sector management.

- **China:** The August flash reading of the Caixin China manufacturing index declined to 47.1 from 47.8 in July. Significant volatility in both stock markets and currency markets, combined with deep and broad reforms of the economy, is causing economic agents to delay spending decisions. The slowdown should therefore not surprise, but it should also not cause too much alarm, because China is slowing for all the right reasons. In other news, the IMF announced that the current Special Drawing Rights ('SDR') basket will be extended for another 9 months. This does not change the scheduled review of the SDR basket in November, where we expect the IMF to decide to include the RMB in the SDR basket with effect from late 2016 once a number of technical obstacles have been overcome. For a view of what is going on in China today see *"China Roadmap",* Market Commentary, June 2015.

- **Russia:** Retail sales rose 0.5% in the month of July. This is the first time retail sales have risen this year following a major devaluation of the RUB and interest rate increases last year designed to bring domestic demand in line with lower levels of national income due to falling oil prices. Russia's adjustment to lower oil prices has been decisive and prompt. RUB deposits are now rising, while FX deposits are declining, according to the latest data from the Russian central bank.

- **Kazakhstan:** The government last week moved the KZT to a floating rate. The currency immediately spiked from 197 to 250 versus the USD. This is good news. Oil dependent countries have experienced a major external shock due to falling oil prices. It is prudent to treat such shocks as permanent and to respond to them accordingly. The correct policy response is to adjust the external accounts using the currency and to also reduce domestic demand using fiscal and/or monetary policy measures. The devaluations in oil countries such as Russia, Nigeria and Kazakhstan have been labelled a 'race to the bottom' by a number of bank analysts; but this is lazy analysis on two counts. First, oil countries are right to devalue as part of a sensible adjustment process. Second, EM countries are generally averse to devaluing just for the sake of it for the simple reason that the resulting pass-through to inflation could be very politically destabilising.

- **Ecuador:** The government announced spending cuts of 2.2% of GDP and will base the 2016 budget on an oil price of USD 40 per barrel. Unlike Russia and Kazakhstan, Ecuador uses the USD as its official currency. Hence, it does not have the option of using the currency to rebalance the economy. The spending cuts will hurt the economy's growth rate. For this reason, there is often worry among Ecuadorean analysts that the government may abandon the USD in favour of printing its own currency. On that account, the government reiterated its commitment to retaining the USD as its currency.

- **EM trading volumes:** Newly released data from the Emerging Markets Traders' Association (EMTA) shows that EM debt trading volumes declined to USD 1.2trn in Q2, down 27% from Q2 2014 and 1% lower than in Q1 2015. A major factor impacting trading volumes appears to be the 'Volcker Rule', which came into effect in July this year. The 'Volcker Rule' forms part of broader set of financial repression measures that bias fixed income markets in favour of developed economies.

Snippets:

- **Indonesia:** The central bank left rates unchanged at 7.5%. At USD 1.3bn, the July trade surplus was much larger than expected (USD 0.6bn).
- **Iraq:** The government has hired three investment banks to undertake up to USD 6bn of sovereign debt bond issues.
- **Turkey:** The central bank left rates unchanged at 7.5%. Unsurprisingly, coalition talks with opposition parties Nationalist Movement Party ('MHP') and Republican People's Party ('CHP') broke down as Turkey moved a step closer to fresh elections.

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Global backdrop

One could be forgiven for thinking that EM issues are driving negative global sentiment. After all, there are some juicy credit stories in EM right now, including economic and political challenges in Brazil, volatile markets and slower growth in China and unrest in Turkey. Commodity prices are also falling and oil producers are adjusting to lower export prices, including, in some cases, undertaking major devaluations.

But it would be wrong to conclude that EM events are the only factors affecting global market sentiment, or even the main ones. EM may comprise 57% of global GDP, but EM accounts for less than 15% of tradable debt. Moreover, EM central banks – which hold enormous stocks of developed market bonds and currencies – have, if anything, added to their exposures to developed market assets in response to recent global risk aversion.

Instead, we think EM is more akin to the 'canary in the coal mine', i.e. a symptom of something far bigger and far worse. All the big trades in developed markets of the last four years that did so well on the back of enormous QE programs in the US, Europe, Japan and the UK – US stocks, USD and core European government bonds – have struggled this year. Yet positioning in these trades is simply enormous. US stocks are now down for the year. The broad USD index – DXY – is down sharply since March. And European core bond markets have seen huge losses since April.

The reasons why these trades are losing steam are obvious. In the US, the USD is now so strong that it is clearly hurting the US economy and impacting the decision-making process at the Fed. US stock markets have little upside if there is no growth. And who wants to buy long-dated European government bonds that pay negative or zero yields out to 30 years?

Simply put, the thing that no one ever imagined could come to pass, namely that there would be limits to what hyper-easy monetary policies can achieve has happened. If the drugs no longer work, what is next? Where to go?

The markets have not yet found an answer to this question and herein originate the roots of the current global nervousness. Moreover, what would happen if developed economies actually experienced a major slowdown at this point? Would further QE in the US really achieve anything? Would more issuance of debt in connection with a new fiscal stimulus make any difference?

The past four years were great for developed market assets but, unfortunately, policy makers squandered the good times by not undertaking sufficient reforms or deleveraging, in our view. Now we are stuck with overvalued asset prices, weak, unproductive and heavily indebted economies and no obvious way forward.

These huge uncertainties cloud the outlook for returns in developed markets and, as per normal, adversely affects sentiment towards EM. But at the end of the day it is developed markets, not EM, that are over-indebted, slow growing, money printing and unable to reform. They are also the more expensive markets, by far.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-9.76%	-13.39%	-22.85%	-3.29%	-1.11%
MSCI EM Small Cap	-9.40%	-9.45%	-17.39%	0.89%	-0.27%
MSCI Frontier	-3.57%	-9.63%	-20.64%	9.32%	4.39%
MSCI Asia	-9.69%	-10.70%	-15.53%	2.30%	2.82%
China A shares	0.19%	14.99%	64.05%	22.40%	8.31%
China H shares	-6.27%	-9.22%	-1.07%	7.15%	1.72%
MSCI EMEA	-9.34%	-10.02%	-25.57%	-7.56%	-2.46%
MSCI Latam	-11.47%	-23.93%	-41.28%	-15.17%	-9.94%
GBI EM GD	-4.49%	-11.48%	-20.57%	-6.92%	-1.86%
ELMI+	-3.41%	-6.97%	-14.72%	-4.44%	-2.00%
EM FX Spot	-3.71%	-13.38%	-23.80%	-11.38%	-7.89%
EMBI GD	-1.48%	0.66%	-1.22%	2.62%	4.98%
EMBI GD IG	-1.16%	-0.24%	0.10%	1.76%	4.26%
EMBI GD HY	-1.92%	1.80%	-4.04%	3.95%	6.04%
CEMBI BD	-1.16%	2.46%	0.67%	3.81%	4.99%
CEMBI BD HG	-0.49%	2.07%	2.04%	3.84%	5.11%
CEMBI BD HY	-2.41%	3.16%	-2.23%	3.96%	4.92%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-6.14%	-2.99%	0.97%	14.11%	15.35%
2 year UST	0.07%	0.66%	0.75%	0.51%	0.70%
5 year UST	0.41%	2.15%	2.98%	1.52%	1.91%
10 year UST	1.21%	2.95%	5.56%	2.25%	4.33%
30 year UST	3.45%	2.31%	11.47%	4.07%	7.13%
US HY	-2.22%	-0.26%	-3.67%	4.97%	7.63%
European HY	-0.96%	2.57%	2.44%	9.87%	10.44%
Barclays Ag	0.19%	0.29%	1.79%	3.79%	4.45%
VIX Index*	131.27%	45.99%	144.38%	84.65%	2.08%
DXY Index*	-3.19%	4.39%	14.45%	15.49%	13.33%
CRY Index*	-5.54%	-16.79%	-33.72%	-37.48%	-27.10%
EURUSD	4.55%	-5.09%	-12.99%	-8.22%	-9.38%
USDJPY	2.92%	-0.45%	-13.64%	-34.65%	-30.14%
Brent	-16.24%	-23.72%	-57.25%	-61.50%	-39.58%
Gold spot	5.52%	-2.66%	-9.53%	-30.78%	-6.00%

*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

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