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Ashmore

Sanusi's large shoes

By Jan Dehn

Lamido Sanusi takes a bow as he leaves Nigeria's Central Bank, Argentina formally links its new CPI index to inflation-linked bonds, China shakes up currency speculators and starts SOE reform, Brazil addresses a fiscal challenge head on, and Ukraine takes a huge step forward towards a solution to its political crisis. Away from EM, the US data continues to disappoint, but still no one appears to care.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	955		-0.93%
MSCI EM Small Cap	1,008		-0.29%
MSCI FM	609		-0.90%
GBI-GD	7.01%		-0.25%
ELMI+	3.52%		-0.32%
EMBI GD	5.87%	333 bps	0.43%
EMBI GD IG	4.86%	215 bps	0.36%
EMBI GD HY	8.24%	602 bps	0.57%
CEMBI BD	5.54%	325 bps	0.30%
CEMBI BD HG	4.64%	235 bps	0.33%
CEMBI BD HY	7.46%	516 bps	0.40%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1836	-0.08%
VIX Index	14.68	8.18%
5 year UST	1.52%	0 bps
10 year UST	2.72%	-2 bps
DAX	9657	0.00%
10 year Bund	1.66%	-2 bps
EURUSD	1.3743	0.26%
USDJPY	102.24	0.31%
Brent	109.85	0.81%
Copper	334.30	0.02%
Gold	1327.49	-0.10%

Emerging Markets

- **Nigeria:** Zenith Bank's Managing Director Godwin Emefiele replaced Lamido Sanusi as Central Bank governor. Lamido Sanusi's stint at the CBN was remarkable, if not legendary. Sanusi left a job as head of risk management at First Bank of Nigeria (Nigeria's oldest bank founded in 1894) to run the central bank at the height of a banking crisis. He wasted no time in pursuing wrongdoers within the Nigerian banking system, sending several to jail. He set up a 'bad bank' (to ring fence impaired debt assets) and brought the banks back to health. He restored credibility to the currency and overall macroeconomic management in Nigeria.

Government bonds became eligible for inclusion in JP Morgan's GBI index during his tenure. He was named Central Banker of the Year in 2010. Sanusi was also outspoken about corruption in the oil sector. This was ultimately what led to his dismissal as Nigeria drifts towards elections amidst a growing number of defections from the ranks of supporters of President Jonathan. Yet, except for the timing, Sanusi's exit was no surprise because it was already known that he would leave by June. Emefiele will be challenged to match his predecessor's credibility; Sanusi's shoes were far larger than his slight physique would suggest. Even so, it is a measure of Sanusi's stature than he leaves Nigeria's macroeconomy in a far stronger state than how he found it, even if he never managed to end the microeconomic food fight over oil revenues that ultimately swallowed him.

- **Argentina:** The government of Argentina this week took another small step towards more sensible policies when it agreed to tie payments on its inflation-linked bonds (called CER bonds) to the new CPI index. The government has in the past 'saved' billions of dollars by linking payments on the CER bonds to the old manipulated CPI index. The decision to link CER bond payments to the new CPI index is therefore an encouraging development, which follows recent decisions to devalue, raise interest rates, and adopt the new credible inflation index. Are CER bonds now a buy? Investors can trade CER bonds either onshore or offshore. Onshore investing still carries considerable risk of capital controls, in our view. Offshore exposure requires FX trading via the blue-chip swap market, which is highly inefficient. Besides, the government has yet to implement the comprehensive macroeconomic adjustment required to stabilise the currency (which still trades with a significant premium between the official and parallel exchange rates). Still, the direction of travel is encouraging, especially if they are followed up with further macroeconomic measures.

Meanwhile, the government this week filed a request to the US Supreme Court to review a ruling by New York's Second District Court that financial intermediaries must divert payments on performing Argentine Dollar bonds issued under New York law to holders of defaulted bonds. The holdout investors now have 30 days to respond to Argentina's request and the Supreme Court then has up to a month to decide whether to hear the case. If

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Emerging Markets

the court refuses to hear the case then coupon payments could be diverted to holdouts by early July, potentially triggering a technical default unless the Argentine government comes up with a solution (for example by offering to swap New York law bonds into local law). On the other hand, the US Supreme Court could also ask for opinions of outside parties, such as the US government that has previously expressed an interest in the decision (because the 2nd District Court's ruling potentially sets a negative precedent for all bonds issued under New York Law). If so, the Supreme Court decision could be significantly delayed.

- China: The PBOC surprised currency markets by allowing the Chinese currency to weaken from 6.09 to 6.11 versus the Dollar. This move is both very modest and it is not the first time that the PBOC has intervened to upset comfortable long positions in the CNH market. Why is China doing this? Three reasons: First, China has in the past sought to weaken the currency whenever it has anticipated fewer official Dollar sales, the idea being that by weakening CNH it encourages non-official inflows from value investors that thereby offset lower official Dollar sales. Secondly, China wants to remind investors that CNH is a two-way risk (always a healthy thing). Recall, that China is moving towards a more flexible exchange rate. The PBOC wants the market to get accustomed to more volatility in the currency. We do not expect China's policy of gradually strengthening its currency to change.

China understands that the Dollar will be much, much weaker versus CNH in the future, and that the economy is best off by gradually getting used to this fact. This is why China is moving away from the exchange rate as the main anchor for macroeconomic policy towards inflation targeting and using interest rates to control the temperature of the economy.

In a far more important development, SINOPEC, the Chinese oil refiner, announced the sale of 30% of its retail operations to private investors, including gas stations and pipelines. This is the start of an extremely important new set of reforms to China's state owned enterprises. China's largest corporates are quasi sovereign companies, owned variously by the national or local governments. The Third Plenum recently decided to introduce more private involvement in the SOE sector. This process will be gradual, but will ultimately be recognised for what it is: A Big Bang event. We expect that China's SOEs will see massive efficiency improvements, stock markets will stand to make very large gains, and that the privatisation of China's enormous SOE sector will be hugely positive for China's public finances.

- Ukraine: The political situation in Ukraine changed dramatically over the weekend as the Rada voted to oust President Yanukovich. Yanukovich's ouster followed an earlier agreement between the government and the country's opposition to end the political crisis. The agreement involved the restoration of the 2004 Constitution (which gives less power to the executive and more power to parliament), the release of the former Prime Minister Yulia Tymoshenko, an interim government that looks set to be led by Parliament Speaker Oleksandr Turchynov, and fresh elections, provisionally slated for 25 May 2014. However, the ink had hardly dried before Yanukovich's position became untenable, probably due to alleged killings of protesters by security forces last week plus a number of other grievances. Parliamentarians who had defected to Yanukovich at the start of his term now switched sides again and Yanukovich has now fled to Eastern Ukraine. The political situation in Ukraine remains extremely fluid, but the formation of a new government is a major positive, in our view. After all, the only sustainable solution in Ukraine is one that involves the establishment of a new and stable government; only a stable government can stabilise the public finances and the economy, and thereby also begin to wrest back control of the country's affairs from special interest groups, domestic and foreign.

Ukraine's political crisis is so complex largely because of the sovereign's weakness; it is this weakness that lures so many interested parties to try to influence events in the country. Externally, EU/US and Russia are both vying for influence over Ukraine because of the country's strategic location and its gas storage facilities. Domestically, the population itself is split into pro-Western and pro-Russian factions. The opposition is divided and oligarchs remain a powerful independent source of influence. Years of economic mismanagement have eroded the government's freedom to act independently in the face of all these competing interests. Financial resources are tight and divisions will not be healed easily or quickly. As Ukraine now moves forward towards a new political constellation the focus will increasingly shift to the public finances.

Our view is that Ukraine's resources are sufficient to last for some time and that none of the major competing interest groups want to see Ukraine descend into complete lawlessness. This means that the most likely outcome is that Ukraine muddles through.

- Brazil: The government announced the budget for 2014. The budget introduced fresh fiscal measures intended to deliver a 1.9% of GDP primary surplus. The budget also introduced more realist growth assumptions (2.5%) and inflation forecasts (5.3%), and should stabilise public debt levels. The fiscal adjustment implied in the budget follows significant tightening of monetary policy by the central bank, a devaluation of the currency, and removal of capital controls. Under normal circumstances, such measures would trigger a strong investment

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Emerging Markets

response. After all, it is obvious that Brazil is not heading for a crisis and that the government is willing to do whatever it takes to avoid one, even in an election year. Also, these measures will go a long way towards avoiding a downgrade of Brazil's sovereign rating by ratings agencies. Sadly, we do not expect the strong investment response because the market has zero confidence in the heterodox policies of Finance Minister Guido Mantega.

In other EM developments:

- South Africa: South Africa's power company ESKOM declared an emergency due to power shortages that epitomise the failings of the ANC administration in dealing with the country's underlying structural challenges.

- Venezuela: the government arrested opposition leader Leopoldo Lopez as it cracked down on a population increasingly disgruntled with the government's ruinous economic policies. However, in a positive development for their ability to pay, the government launched a fresh mechanism for selling Dollars, effectively devaluing the currency.

- Singapore: GDP growth in Q4 2013 was revised sharply higher to +6.1% yoy versus 2.0% yoy expected, taking 2013 GDP growth to 4.1%. Like most other EM countries, Singapore experienced soft growth in H1 2013 due to a downturn in global manufacturing, but then recovered in H2 2013. Singapore's fiscal results were also stronger than expected as the government delivered a surplus in 2013 of 1.1% of GDP (about 2/3 larger than budgeted).

- Poland: the economy also continued to accelerate as Industrial Production beat expectations by rising 6.3% yoy in January compared to 5.2% yoy in December.

- Russia: Russia's FX reserves rose marginally last week to USD 492.5bn. Still, they remain lower than the USD 510bn reached prior to January's bout of RUB weakness. But Russia's reserve volatility has dropped significantly compared to previous bouts of anti-EM sentiment. This is because the government has increased the flexibility of the currency, which insulates the public finances from oil price volatility and reserves from FX volatility. The challenge for Russia going forward is how to grow. As Russia adopts inflation targeting and interest rate management growth it will require a greater focus on the supply side of the economy. Last week's data releases were good reminders of this very fact: Retail sales in January came at 2.4% versus 3.7% yoy expected, down from 3.8% in December, while investment fell 7.0% yoy in January from +0.3% yoy in December.

Global backdrop

When the members of the FOMC met at the end of January they still felt good about the US economy and mostly believed that there was a high hurdle for changing the pace of tapering, according to the FOMC minutes. The US treasury market did not respond significantly to this news. After all, only last week Fed Chairwoman Janet Yellen hinted strongly that rate guidance would be amended. This rather than tapering is now the focus of the market. In general, we think the Fed is pleased to be able to taper without causing a big sell-off in the US treasury market. But this is only possible because of the continuing deterioration in the US data. This past week only one data release out of ten beat expectations:

- US Philly Fed manufacturing came at -6.3 for the month of February versus +8.0 expected
- US Empire manufacturing came at 4.5 versus 8.5
- NAHB housing sentiment came at 46 versus 56 expected
- Core PPI was 1.3% versus 1.4% expected
- Housing starts dropped to 880K versus 950K expected
- Building permits were 937K versus 975K expected
- Core CPI hit 1.6%, in line with expectations, but down from 1.7% in December
- Initial claims were marginally higher than expected at 336K
- Existing home sales fell -5.1% yoy in January versus -4.1% yoy expected
- Only the preliminary read of Markit's PMI was stronger than expected at 56.7 versus 53.6 expected

Most analysts continue to blame the weather. We think there is also an inventory correction at play after significant inventory accumulation in both Q3 and Q4 2013. Elsewhere, real exports in Japan dropped 3.2% in January, while a rush of imports ahead of April's consumption tax hike caused the external deficit to widen to a record JPY 1.82trn. In the Eurozone, PMIs declined marginally to 52.7 in January from 52.9 in December. Germany's manufacturing sector got stronger, but France's weakened. Overall this shows that growth in Europe is okay, but that countries with structural challenges are less able to take part in upswings, probably because they have more sluggish investment responses.

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