Issued: 24 June 2013

WEEKLY INVESTOR RESEARCH

Ashmore

Summary

The policy response in Brazil illustrates the short leash available to policy makers in most Emerging Markets. Strong bottom-up demand for sustained macroeconomic stability tends to produce rapid policy responses when governments lose touch with electorates. Meanwhile, the on-going sell-off in Emerging Markets assets is extremely technical in nature. Pricing is already moving into oversold territory, in our view. While this does not preclude further selling in the near-term the reason why markets turn is ultimately the re-emergence of value.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	881	–	-7.86%
MSCI FM	531	–	-2.63%
GBI-GD	6.58%	–	-5.74%
ELMI+	5.04%	–	-2.26%
EMBI GD	5.90%	334 bps	-4.37%
EMBI IG	4.84%	227 bps	-4.58%
EMBI HY	8.55%	604 bps	-4.01%
CEMBI BD	5.67%	356 bps	-2.96%
CEMBI HG	4.80%	267 bps	-2.56%
CEMBI HY	7.64%	558 bps	-2.43%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,563	-4.62%
VIX Index	20.26	20.60%
5 year UST	1.49%	43 bps
10 year UST	2.59%	41 bps
10 year Bund	1.81%	29 bps
EURUSD	1.3092	-2.09%
USDJPY	97.63	3.21%
Brent	$101	-5.03%
Copper	$310	-5.32%
Gold	$1281	-8.18%

Emerging Markets

The recent political unrest in Brazil illustrates the very limited scope available to most Emerging Market governments in terms of pursuing policies at odds with the wishes of electorates. The policies most highly valued by electorates in poor countries are those which preserve macroeconomic stability and growth.

Unlike populations in rich countries, populations in Emerging Markets are unable to turn to the provisions of the welfare state to ameliorate the effects of business cycles. This increases their sensitivity to macroeconomic volatility. Moreover, greater access to information technology today allows ordinary people in Emerging Markets to express their displeasure more swiftly and more effectively than at any time in the past. The rapid expansion of middle classes in Brazil and other Emerging Markets has also introduced a fresh set of items onto the policy agenda, including better quality public services, an end to corruption, and better environmental policies.

Seen in this light, the recent unrest in Brazil is a very positive development. In a post-Cold War world, where most governments in Emerging Markets are accountable to local populations, rather than foreign powers politicians, must respond to discontent or risk losing power. Protests of the kind we have seen in Turkey and Brazil – and recall just a few years ago in Chile and Thailand – limit the scope for governments to pursue heterodox policies. Protests also help governments define the next generation of reforms, which will be needed to help Emerging Markets to cope with major changes underway in their own economies and in the global economy. While Emerging Markets have largely achieved macroeconomic stability they must now turn to second-generation reforms and supply-side measures in order to continue to grow in a world, which will soon see inflation re-emerge in those countries, which print the most money.[1]

We see strong reasons to be optimistic that most Emerging Markets will be able to make the required adjustments as the global economic environment changes. China is already well ahead of the curve and stubbornly transitioning its economy away from export dependence, despite upfront costs in the form of lower growth and political challenges. India has recently resumed reforms and major fiscal adjustment despite the proximity of elections. Mexico is likely to embark on serious reforms in H2 2013. Colombia has embarked on significant reforms. In Brazil, the government's response has also been relatively swift, once the population began to voice dissent. First, the central bank responded to the gradual rise in inflation by raising policy interest rates by 75bps (with another 75bps now priced in). Second, the government responded to the weaker currency by removing IOF taxation on derivative and fixed income investments by foreigners as well as providing domestic dollar lines. Thirdly, the treasury offered to buy back bonds in order to provide liquidity to traders, thus also anchor the domestic yield curve. Finally, President Dilma Rousseff this weekend announced changes to public service provision in response to the recent protests.

We believe that Brazil is already changing direction. A draconian shift towards more orthodoxy is unlikely ahead of elections, but the direction of travel is nevertheless clear and we see no scope for crisis. Brazil should grow about 3% this year, or three times as fast as last year. It is worth remembering that Brazil's net debt to GDP ratio is less than 35% and still falling. Brazil has just 20% of GDP external debt, including intercompany loans compared to an average of 271% for developed countries.[2] Finally, the central bank manages around $400bn of FX reserves, which means that Brazil entirely controls its own currency. Where BRL goes is where the central bank wants it to go.

Continued overleaf

[1] See *"Convergence, global imbalances, and the role of infrastructure in EM"*, The Emerging View, June 2013.

[2] Credit Suisse, *Brazil Economics Digest*, 7 May 2013.

Ashmore

Global backdrop

Last week the Fed signalled the commencement of tapering of Quantitative Easing (QE) later this year and the conclusion of the process by the middle of next year. A market dominated by a binary risk-on/risk-off mentality took this to mean higher rates. Real yields have moved from -50bps to +60bps in short order, triggering a massive technical sell-off in multiple markets. This begs the question why the Fed moved so decisively so soon. US PCE inflation is running at just over 1%. Growth is tracking less than 2% in Q2. Perhaps the Fed's intention was to ease the handover to the next Fed Chairman. Perhaps the Fed believed it could successfully convince the market of the difference between scaling back QE and hiking rates. Perhaps the Fed is simply bullish on growth. If so, the Fed is at odds with the US stock market, whose performance suggests that confidence in the underlying growth story is perhaps less than robust.

The selling has also impacted Emerging Markets, despite little change in fundamentals. The sell-off has been mainly technical in nature. Technical sell-offs can be violent, but the silver-lining is that they tend to produce overshoots and hence give rise to significant value opportunities, which can pay off for months or even years.

Why has Emerging Markets been hit in this sell-off? The answer is that the technical position was particularly exposed. First, positioning in Emerging Markets, particularly in local markets, increased sharply in Q1 2013 on the back of very strong inflows motivated by the strong performance over the preceding 15 months. Many investors entered the market near the top, leaving it vulnerable as existing holders were long and the number of new buyers was falling. Second, significant leverage was added to the market during the month of March, when hedge funds and other leveraged investors began to front-run an anticipated inflow into local currency bonds from Japanese institutional investors. The speculation was that Japanese institutions would move money in Emerging Markets as JGB yields rose. The idea was strongly punted by investment banks. But the Japanese flow never materialized. Indeed, some Japanese investors opted to take out of Emerging Markets to invest in stocks at home. The leveraged speculative buying further worsened the technical. Thirdly, the intensification of the Fed's rhetoric about tapering triggered rapid reduction liquidity as market makers reducing book sizes for market makers. This made it difficult for the market to deleverage. The result was exaggerated price action.

The technical nature of the sell-off is illustrated by the fact that it has been the 'most owned' and 'most leveraged' positions which have taken the biggest hits. By contrast, a number of higher beta markets, which typically get beaten up in sell-offs have done comparatively better. Frontier Market equities have outperformed the United States S&P500 Index. Argentinean FX has outperformed other currencies in Emerging Markets. High Yield corporate bonds have been the best performing fixed income asset class in Emerging Markets.

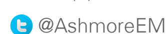
The sell-off has also illustrated the inefficiency of pricing in Emerging Markets, a feature which arises due to the behaviour of banks, hedge funds, and cross-over investors. Liquidity has once again proved to be pro-cyclical, causing prices to move far more than underlying risk. The asset class is once again being treated as an amorphous mass rather than a universe of 65 readily investable countries and the market is now approaching over-sold territory, in our view. The US swap curve is pricing in more than100bps of hikes by June 2015, while local bond markets are pricing multiple times more hikes. We think these are extremely unlikely to materialize. FX has already moved significantly. While this does not prevent further selling in the near-term on the back of momentum trading we believe value has already been realized. It is always value that turns flows, and hence markets.

Contact

Head Office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000


@AshmoreEM

www.ashmoregroup.com

Other Locations

Beijing
T: +86 10 5764 2601

Bogota
T: +57 1 347 0649

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Melbourne
T: +61 0 3 9653 9524

Moscow
T: +74 9566 04258

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Sao Paulo
T: +55 11 3556 8900

Shanghai
T: +86 21 3855 6766

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

Bloomberg Page
Ashmore <GO>

Fund Prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2013.

Important information: This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised and regulated by the Financial Conduct Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. This document does not constitute an offer to sell, purchase, subscribe for or otherwise invest in Units of any Fund referred to above and is not intended to provide advice on the merits of investing in any particular Fund. The value of the Units may fall as well as rise and investors may not get back the amount originally invested. With the exception of the SICAV fund, Ashmore's public Funds are only available to persons defined as Professional Clients and Eligible Counterparties under the rules of the Financial Conduct Authority of the United Kingdom. Prospective investors should obtain and review the Scheme Particulars or other offering documents relating to the Units or Shares of any Fund, including the description of risk factors/investment considerations contained in the Scheme Particulars or other offering documents, prior to making any decision to invest in such Units or Shares. The Funds are offshore and not regulated in the United Kingdom.