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Ashmore

The road less travelled

By Jan Dehn

Global politics is becoming more confrontational with significant potential implications for investors in Emerging Markets as developed countries are pursuing policies that serve their own self-interest. Further developments in the Argentinean bond saga were announced last week and Argentina now stands at an important cross roads. Political announcements make the news in Turkey. Russia and Ukraine see continued tensions but these are now accompanied by noteworthy diplomatic efforts. Softer data in China should not be a cause for concern. Brazilian election news gets interesting after a recent poll and South Africa's financial system shows resilience.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,085	–	0.10%
MSCI EM Small Cap	1,108	–	0.51%
MSCI FM	695	–	-0.85%
GBI EM GD	6.56%	–	-0.53%
ELMI+	3.15%	–	-0.29%
EMBI GD	5.14%	273 bps	-0.07%
EMBI GD IG	4.31%	185 bps	0.32%
EMBI GD HY	7.05%	483 bps	-0.80%
CEMBI BD	5.10%	293 bps	0.16%
CEMBI BD HG	4.26%	207 bps	0.16%
CEMBI BD HY	6.96%	483 bps	0.17%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1998	0.85%
VIX Index	11.70	-4.18%
5 year UST	1.65%	8 bps
10 year UST	2.38%	-2 bps
US HY	5.55%	0.20%
European HY	4.70%	0.27%
EURUSD	1.3195	-0.93%
USDJPY	103.89	0.97%
Brent	100.81	1.29%
Copper	328.43	2.53%
Gold	1288.11	-0.61%

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

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The transformation of finance, economic policy and global politics that was sparked by the economic crisis in developed countries in 2008/2009 is far from over, in our view. Global politics is becoming more confrontational and investors in Emerging Markets need to pay particular attention, because the direction of travel being mapped out largely by developed countries is serving their own self-interest.

One of the early political responses was to identify scapegoats. This resulted in the total vilification of banks, which, so the story goes, not only caused the crisis, but also had to be bailed out at considerable cost to the taxpayer. This vilification continues to this day in the shape of near-daily billion Dollar fines dished out to banks as punishment for a plethora of alleged past misadventures. In fairness, most banks merely exploited, as one would expect them to, an extremely permissive regulatory regime deliberately designed to stimulate credit markets by the very same politicians who are now baying for bankers' blood. One of the consequences of the constant attacks on banks is that their capacity to make markets has been much reduced, hurting especially the liquidity in smaller markets, such as Emerging Markets.

Politicians then went a lot further. The widespread perception of immorality at the heart of the financial sector presented an opportunity that was not lost on a political establishment desperate to win back to the state some of the many powers ceded to the market over the past few decades. The result was the most draconian overhaul of the global regulatory system since the Great Depression. But, needless to say, the overhaul was not done without a keen eye on the potential political benefits. Thus, rather than fixing the flawed fiscal and monetary policies that had contributed the most to the crisis, regulators now turned their guns on entirely innocent bystanders, namely Emerging Markets.

The new regulatory system dramatically increased the risk weightings for bonds issued by countries with a lot of poor people, while keeping them at zero in countries with a lot of rich people. The result was a powerful first wave of financial repression without which the descent into full-on Keynesian policies and big government in Western economies would simply not have been possible. Central banks in both Developed and Emerging Markets also helped a great deal by pushing interest rates to all-time lows and buying or promising to buy lots of bonds in developed countries in exchange for freshly minted currency.

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Indeed, the only area where governments had more or less managed to keep pace with the private sector over the past few decades was in the area of debt accumulation. Despite generally smaller governments, states had nevertheless managed to accumulate unprecedented amounts of debt largely due to unsustainable tax cuts, military adventures abroad and the desire to minimise voters' exposure to income volatility by wrapping them up in the cotton wool of benefits. This is why the zero risk rating for developed market debt was so fortuitous; as everyone knows when debt is risk free there is no limit to how much can be issued.

Macroeconomic policy also changed beyond all recognition. Financial asset price inflation (aka bubbles) hitherto considered a risk to be avoided became – literally – the central pillar of monetary policy across the Western world. The associated risk of inflation, so long seen as a foe, was quickly dismissed as insignificant. Meanwhile, the economic case is for higher inflation is slowly being made and it should not be a tough sell: inflation is wonderful in indebted countries because it reduces real rates, erodes the real debt stock and weakens currencies to enable countries to export at the expense of other countries, while they deal with sluggish growth at home due to deleveraging challenges. As for the once-touted economic evils of inflation, such as its deterrent effect on investment those are easy to dismiss: There is no investment in the first place. The political benefits of inflation are also obvious. Inflation hurts future generations by robbing them of savings, while the currency weakness that accompanies inflation will pass the cost of adjustment onto mainly Emerging Market central banks as holders of 80% of the world's FX reserves.

In addition the vilification of banks, financial repression via the regulatory system and beggar-thy-neighbour macroeconomic policies, there was also a huge change in conventional politics. Wanting to divert attention away from their impotence in the face of sluggish growth and enormous income inequality at home, politicians in developed countries have increasingly turned to foreign policy. This is of course the oldest trick in the book – to deal with domestic malaise get tough on immigrants, minorities, wave the flag, and pick fights with poorer countries so you are sure you can win – read up on European politics in the 1930s if you need a refresher course.

The West is now making great strides forward in the realm of aggressive foreign policy, but it took them some time to catch on. At the beginning, just after 2008/2009, the West was actually forced by economic necessity to abandon some of its less strategically important partnerships with dictators in North Africa, thus spawning the Arab Spring. Soon the unrest spread from North Africa to the very heart of the Middle East, Syria. Alarm bells must have rung when Western governments failed to act against Bashar al-Assad following mounting evidence of chemical attacks on civilians. Unopposed by Western military might, al-Assad's military secured victory.

There is no doubt that the humiliation of the West in Syria emboldened Russia's President Putin, al-Assad's backer. Not long afterwards Putin decided to grab Crimea, prompted by the fall of his ally in Kiev, Victor Yanukovich.

Finally, the West woke up to the fact that it needs to be far more aggressive in order to secure those all-important foreign policy victories to keep the home fires burning. Soon Putin was painted as a rogue leader with Hitler-like lebensraum ambitions. Russia's perspective, understandably, is somewhat different. Moscow has viewed the West as a threat dating all the way back to Napoleon. Maybe they have a point. At no time in history has the military might of the West been so unrivalled. The West regularly deploys its forces in military adventures all over the globe, sometimes without prior UN approval, sometimes after lying to the UN. Russia, feeling beset on all sides, saw its national interest fundamentally threatened by the potential loss of its strategically essential Black Sea port of Sebastopol after Yanukovich's fall.

This time the West was ready. The annexation of Crimea drew immediate and fierce Western condemnation and recrimination. Diplomatic necessity then triggered mutual rounds of sanctions culminating in a proper old-fashioned Cold War style localised 'hot war' in Eastern Ukraine. By now, it should be clear that global politics really has changed. The flash points are likely to be the familiar ones from the Cold War of old, namely the Middle East, the Russian periphery and in the far East as China increasingly challenges Japan (and therefore the West) for dominance there.

In short, global politics has come full circle. From global political excess during the Cold War through the near-extinction of international politics in an orgy of economic excess during the Greenspan Bubble, we are now back once more to a miniature version of the Cold War. 'Miniature' because no country today can muster the economic resources required to restore the global political hegemony of the Superpowers of old. But nevertheless a marginal negative for those unfortunate Emerging Markets, which, like Ukraine, find themselves caught in these new geopolitical forces. The good news is that the majority of Emerging Markets countries are unlikely to become pawns in this game; controlling more than 50% of global GDP with vastly better macroeconomic fundamentals than developed countries they are simply too strong to be dominated.

But the rise of aggressive self-serving foreign policy in the West should make Emerging Market issuers and investors sit up and pay attention. Where will the West strike next? One area that has so far been relatively free from political interference is law. But that may be about to change. Emerging Markets countries still rely heavily on New York and English Law for issuance of bonds (though mainly for foreign currency denominated paper, which is about 14% of total EM debt). Should EM issuers and investors worry that New York and English Law become instruments of foreign policy?

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The answer is yes. A new and nasty development in the politicisation of finance aimed, it seems, at Emerging Markets may soon be upon us. Debt sanctions have not yet been adopted into English or New York Law, but the idea is gaining influence and finding willing backers in the context of the Russia-Ukraine conflict. The central idea of debt sanctions is to deny enforcement of contracts for political reasons, including contracts governing bonds. Debt sanctions are being pushed in connection with USD 3bn of financing under English Law extended to Ukraine by Russia in the dying days of the Yanukovich regime. Debt sanctions would annul Russia's remedy – i.e. Russia's right to seek redress in English courts in the event of non-repayment by Ukraine. While proponents of debt sanctions argue that such measures should only be applied in a limited and narrowly targeted manner (with sunset clauses), it is our view that debt sanctions could quickly become a widely used instrument of foreign policy, of course, each time only applied in a limited and targeted way.

Investors should be mindful that there are at least two precedents where creditor rights have been suspended for political reasons for Emerging Markets financial instruments issued under English or New York law. In 2003, Western allies adopted into their legal systems UN Security Council Resolution 1483, which specifically shielded Iraq from its financial obligations. The result was an 80% haircut on creditors. In 2010, the UK Debt Relief Act blocked private creditors from receiving full payment on obligations issued under English Law by Zambia and Liberia. This law was imposed retroactively. Both sets of cases were politically motivated.

- Argentina: The case of the Republic of Argentina versus holdout investors at least does not appear overtly politically motivated. Still, a US court did push 93% of creditors into default in order to uphold the rights of the remaining 7%. So far, New York Law has not been a happy experience for either party.

The latest significant development in the Argentinean saga is that the government last week announced its intention to pass legislation that enables holders of New York law bonds to swap them into local law bonds. A vote on the 'swap law' is scheduled for 4 September 2014. The current payment agent for the bonds – Bank of New York (BoNY) – would also be replaced by a local government banking institution, Banco de la Nacion, located a stone's throw from Casa Rosada, the presidential palace in Buenos Aires.

A New York law to local law swap would in principle address the specific constraint that has prevented Argentina from servicing the exchange bonds, namely Judge Griesa of the New York Southern District Court's ruling that BoNY must not forward Argentina's payment to exchange bond holders without Argentina simultaneously paying holders of bonds from the 2001 default (so-called 'holdouts') in full (or settling with them). Argentina refused and the exchange bonds went into default in July with the funds stuck at BoNY (in Argentina).

Argentina now stands at an important cross roads: The path of the swap is very much the road less travelled. It promises not only to delink Argentina from the US legal system, but also to sever Argentina's ties to the standard payment, clearing, custody, and settlement systems used across the world. Payment of coupons, clearing of trades, custody of bonds and registration of new securities tend to be undertaken by large international financial institutions with considerable operations in the US, a fact that places them within the jurisdiction of the US legal system. Argentina might therefore have to divorce itself entirely from these systems in order to implement a swap. Will investors follow? This local law swap would also not solve the holdout issue; Argentina would merely be turning its back and walking away. All holders of New York law bonds except those that enter the swap could in theory become holdout investors, assuming Argentina found a way to overcome the logistical challenges.

The market is hoping that Argentina will take the more well-trodden path of settling with the holdouts within the confines of New York law. Or if a settlement is not possible at least that Argentina next year, possibly under a new government, resolves the problem through a big restructuring that involves all holdouts (via CACs), a modest haircut and the promise of a clean start for Argentina.

Which of these two paths will Argentina take? The road to riches in Argentina is paved with the corpses of those who believed in fairy tales. To imagine that Argentina will do the pragmatic thing is to be a romantic at best, reckless at worst. It is still possible that Argentina takes the clean way out, but the messy difficult path has been their way. The local swap fits the profile perfectly. If Argentina ventures down this difficult road into isolation the risk is that economic and political conditions may continue to deteriorate, possibly to the point, where even a clean post-election resolution with a modest haircut is no longer feasible. Still, hope springs eternal. A group of exchange bondholders are rumoured to be planning to solicit consent to eliminate the RUFO clause, potentially providing a way to strike a deal with holdout investors. By now, exchange bond holders can only gain from such a development, but whether Cristina and Co. in Buenos Aires will want to deal with the 'vultures' remains to be seen.

- Turkey: In Turkey, current prime minister and president-elect, Recep Tayyip Erdogan, said that foreign minister Ahmet Davutoglu would be Turkey's next prime minister. The focus now turns to whether the Deputy Prime Minister of Turkey with responsibility for the Economy, Ali Babacan, will remain in place. We think the odds are good that Babacan will keep his job. In our view, this would be very positive, because Babacan's presence at a

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senior level in the administration is an important anchor for the credibility of economic policy more broadly. In particular, we think Babacan would strongly oppose forces within the administration more inclined to push for far more interventionist policies such as capital controls. As for Davutoglu, we believe he will pursue policies closely aligned to those of Erdogan. In Erdogan's first term, Davutoglu won considerable respect for his policy of "zero enemies among the neighbours" policy, which aimed to place Turkey in a powerful position as mediator in Middle East conflicts. During the early phases of this policy, Turkey's influence in the Middle East thus expanded sharply. However, a combination of domestic political difficulties and a different vision of Turkey's role in the region on the part of Prime Minister Erdogan soon forced Turkey away from this path, into greater partisanship, and ultimately into relative foreign policy obscurity. It is, in our view, a good indicator of Davutoglu's loyalty to Erdogan that he chose to remain in his post as foreign minister even as his boss gutted his very successful policy.

- Ukraine and Russia: Tensions between Ukraine and Russia remain high, but now accompanied by noteworthy diplomatic efforts. During most of last week the market was focused on the delivery of Russian aid to Luhansk, but the fact that this convoy took place at all is a step forward. Senior representatives of both Ukrainian President Poroshenko and President Putin spoke in person to diffuse tensions arising from the convoy. These talks may give rise to open peace talks this week when Poroshenko, Putin and Chancellor Merkel may meet face to face. The timing is right – things get a great deal more complicated once winter begins and heating needs increase the demand for Russian gas. Still, progress can easily be foiled by unforeseen events on the ground as the downing of the Malaysian airliner showed. But if the coming week results in a break-through then it will likely be followed within months by the dismantling of sanctions (all of which have sunset clauses).

The solution is in principle easy to define. It would have four basic components: First, the parties would agree to disagree on Crimea, thus removing this thorny issue from peace talks. Second, peacekeepers would be brought into Eastern Ukraine to prevent a flare-up of tensions. Third, Ukraine would commit not to join NATO (but EU talks can continue). Finally, Russia and Western Europe would reach agreement on a new framework for the supply of Russian energy to Europe. This solution would allow both sides to claim victory. Russia gets to keep Crimea and obtains the commitment on the part of Ukraine not to join NATO. The West can claim to have stood up to Russia, prevented an invasion of Eastern Ukraine, and turned Ukraine into a prospective new EU member state with strong pro-Western sympathies.

President Petro Poroshenko last night called a much expected parliamentary election for October. The proximity of this event will charge the political environment in Ukraine, which, at the margin, is negative for chances of a peace settlement, though we think the more relevant factor deciding whether conditions improve or worsen are developments in Berlin and Moscow.

- Asia: In Asia, the economic data in China is once again softening. Manufacturing numbers, while still signalling expansion, point to a slower pace of expansion than in the past few months. Other macroeconomic data have also been weaker than expected recently. We do not think investors should be overly concerned. The economic cycle, particularly when it comes to manufacturing, is volatile in all countries, including China. Fluctuations in the manufacturing cycle does not reveal much about the underlying trend growth rate, which we think remains on track to deliver between 7% and 8% real GDP growth in China this year, or about four times faster growth than the United States. China's growth has slowed in recent years due to aggressive structural reforms, including interest rate liberalisation, motivated by a desire on the part of China to wean itself off a growth model predicated on currency manipulation and endless debt fuelled consumption in the West. In the future China will depend more on domestic demand led growth, which in turn requires greater use of interest rates to manage the economy. This is why China's domestic bond market – a USD 4trn market that transmits PBOC's interest rate policy into the wider economy – is absolutely central to everything that is happening in China today.

- Brazil: The Brazilian election has suddenly become very exciting after a poll showed that Marina Silva, presidential candidate for the PSB party, would defeat President Dilma Rousseff in the second round of the upcoming presidential election. Fernando Henrique Cardoso, former president and an influential member of the centre-right PSDB party, said that PSDB should not fight Marina in the first round and that the party would be willing to support Marina in a run-off against Dilma (i.e. in a second round). Despite this support, which could mean a very business friendly new government in Brazil, the election outcome is now likely to boil down to three or four variables: Campaign funding; Marina's relationship with PSB; TV time; and social media. Of these, funding is the most critical, in our view. If Marina manages to convince business that she will get along with PSB and do a good job on the economy so that Brazilian business can once again flourish, then she can secure more money and thereby overcome the major deficit she faces versus Dilma when it comes to TV time (Marina only has 2 minutes per day compared to Dilma's 10 minutes per day). Marina is widely regarded as a better user of social media than Dilma. Marina's main economic adviser says that Marina would support central bank independence. PMDB, an important swing party, would go with her if they think she can win, in our view.

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Meanwhile, Guido Mantega, finance minister, announced last week new measures to stimulate housing. What does Brazil look like after the election? Answer: Likely better, regardless of who wins. If Dilma is re-elected, she will be returned to power with a much diminished mandate. She will have to move to the centre in order to govern. This will require her to change her economic team and undertake a fiscal adjustment, which is precisely what Brazil needs, so the market should be pleased. If Marina wins, the outlook will be even brighter. Of course, there is considerable uncertainty about Marina's ability to govern, but one thing that sets her apart from Dilma is that she is a politician, while Dilma was an administrator. Dilma's administrator skills have proven ineffective in the political setting in Brazil. Perhaps the political machine that is Marina stands a better chance of governing in the arena of horse trading that is Brazilian politics.

- South Africa: South Africa's financial system has successfully weathered a significant storm over the past few weeks, proving that it is strong and robust. African Bank, a commercial lender directing credit to low income segments of the population, was restructured and will be divided into a good and a bad bank. The South African Reserve Bank (SARB) will inject ZAR 7bn and take over ZAR 17bn of African Bank's bad assets. The good bank will continue to operate. South Africa's other banks will inject fresh capital to the good bank, and corporate depositors, money market creditors and senior bond holders will take a 10% haircut (bail in). Ordinary depositors and suppliers will be paid in full. SARB may eventually make money on the bad assets.

Global backdrop

Developed markets signalled yet more easing, this time from President Mario Draghi at the ECB. Earlier in the week, the FOMC minutes were perceived as marginally hawkish, pushing US 10-year yields sharply higher, but then the market remembered that the minutes often fail to distinguish adequately between the weighty and the less weighty members of the committee. Over the course of the subsequent days US treasury yields declined and by the time of writing – after the dust settled from Fed Chairwoman Janet Yellen's presentation at Jackson Hole – Treasuries had settled around 2.40%, unchanged from a fortnight ago. USDJPY rallied above 104, while EURUSD dropped to a 1.31 handle after Haruhiko Kuroda sounded dovish at Jackson Hole and Draghi signalled QE to begin later this year. US stocks welcomed the additional liquidity and liked better housing and manufacturing data, pushing the S&P 500 to new highs marginally above the previous top that preceded a mini-selloff in early August. The price/earnings ratio of the index is now about 18 (versus less than 14 in MSCI EM).

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.0%	10.4%	19.7%	6.7%	7.7%
MSCI EM Small Cap	1.9%	11.8%	19.7%	6.7%	9.4%
MSCI FM	-1.3%	20.5%	27.9%	16.0%	9.2%
S&P 500	3.67%	9.54%	22.60%	22.50%	16.63%
GBI EM GD	-0.06%	4.81%	6.11%	0.77%	5.89%
ELMI+	-0.05%	1.30%	2.41%	-0.55%	1.77%
EMBI GD	0.37%	9.51%	13.67%	7.14%	9.34%
EMBI GD IG	1.17%	9.60%	13.37%	5.66%	8.01%
EMBI GD HY	-1.11%	9.38%	14.37%	9.69%	11.42%
5 year UST	0.51%	2.20%	2.64%	1.03%	3.57%
7 year UST	1.11%	4.94%	5.06%	1.89%	5.07%
10 year UST	1.92%	8.93%	8.05%	3.39%	5.92%
CEMBI BD	0.57%	6.92%	10.64%	6.62%	8.42%
CEMBI BD HG	0.87%	7.29%	10.73%	6.26%	7.77%
CEMBI BD HY	-0.06%	6.10%	10.44%	7.71%	10.45%
US HY	1.37%	5.84%	11.15%	11.45%	12.95%
European HY	0.49%	6.15%	12.56%	16.38%	14.99%
Barclays Agg	0.18%	4.17%	5.70%	1.33%	3.73%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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