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Taper tantrum two and the dumbing down of EM

By Jan Dehn

An unprecedented spike in correlations between US real rates and Emerging Markets (EM) spreads reflects the current taper tantrum and a general dumbing down in the way the market trades EM. We explain in detail why an impending possible default in a Chinese trust product loan poses no major risk to China. We discuss Turkey and Argentina. The situation in Argentina is ultimately of little relevance to the wider EM, because Argentina is so atypical of other countries. Turkey is more widely owned, and therefore more relevant but it too is ultimately a Turkey specific problem rather than reflective of conditions in EM more widely.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	934		-3.64%
MSCI FM	606		-0.71%
GBI-GD	7.01%		-2.17%
ELMI+	5.05%		-1.18%
EMBI GD	5.97%	343 bps	-1.03%
EMBI GD IG	5.01%	231 bps	-0.62%
EMBI GD HY	8.21%	597 bps	-1.86%
CEMBI BD	5.64%	332 bps	-0.31%
CEMBI BD HG	4.76%	244 bps	-0.03%
CEMBI BD HY	7.48%	521 bps	-0.71%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,790	-2.61%
VIX Index	18.14	45.82%
5 year UST	1.56%	-7 bps
10 year UST	2.73%	-9 bps
10 year Bund	1.66%	-8 bps
EURUSD	1.3697	1.00%
USDJPY	102.35	-1.75%
Brent	$109	1.66%
Copper	$336	-1.34%
Gold	$1268	1.02%

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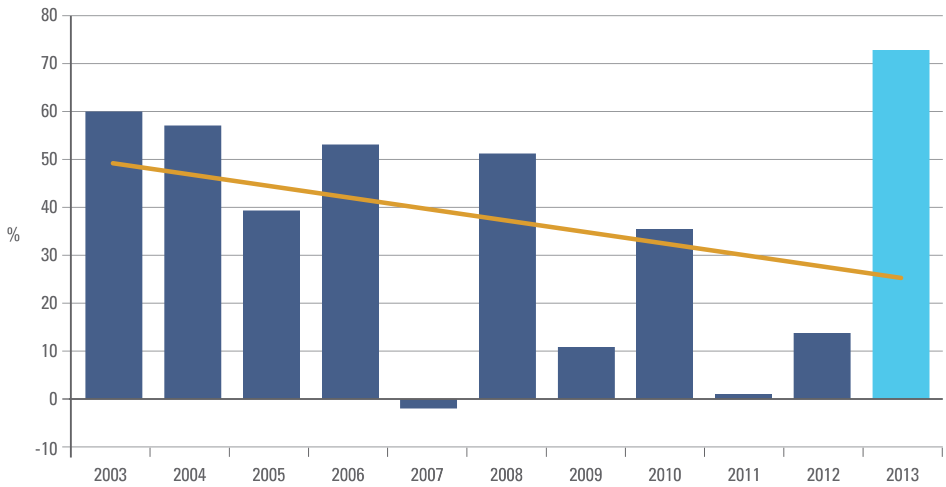
Last week's sell-off in Emerging Market is ultimately about how EM will manage in a world of tighter global liquidity, that is, a world of higher real interest rates. This led a perceptive client to ask about the relationship between **real yields and EM sovereign external debt spreads**. It turns out that in 2013 the correlation between real yields and EM spreads rose to a completely unprecedented 74%. Not only is this the highest correlation ever recorded; the correlation is also twice as high as the average correlation for the whole of the 2003-2013 period.

Fig 1: **Correlations between EM sovereign debt spreads and real US treasury yields (2003-2013)[1]**



Source: from JP Morgan's EMBI GD index.

We think EM markets are over reacting to Fed tapering and that the reaction has been far too indiscriminate. Or put differently, there is some serious dumbing down going on in financial markets right now when it comes to EM. EM debt levels (especially external debt), EM's general reliance on external markets, and EM's reserve holdings have all improved beyond all recognition over the past ten years. Also, the number of countries in JP Morgan's EMBI GD index has more than doubled over the period, so the external debt asset class as a whole is today far more diversified than at any time in the past.

[1] Annual averages of 3-month rolling correlations between real US treasury yields and spreads on Emerging Market sovereign dollar bonds (based on weekly data from JP Morgan's EMBI GD index).

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On the one hand, this dumbing down is quite disappointing, because it shows that many participants in EM markets plus the media still haven't learnt much from the past. We know that markets are still extremely bad at valuing the EM assets class during periods of general policy uncertainty. We know that asset price volatility sometimes spikes far in excess of what is justified by fundamentals in EM. On the other hand, we believe this means that there is great opportunity now. Indeed, all big generalised EM sell-offs have proven to be excellent buying opportunities. Correlations tend to temporarily increase sharply only to collapse later and in retrospect such spikes have always proven lucrative for value investors in EM.

More sophisticated investors recognise this. They prefer to buy when things are cheap. However, investors should resist the temptation to buy into the current weakness in a simplistic contrarian fashion. After all, not all credits are alike. Some EM credits are very weak and in some cases the decline in their asset prices is entirely justified. Yet, the weakest credits can also sometimes be the very best buys. Identifying value is a complex exercise. Turning points are hard to identify. Decide how much you want to buy. Divide your purchases into little bite sized pieces and begin to nibble. Keep your engagement active with a strong credit focus.

Turning from the general market to China, much attention is being paid to an alleged imminent default on a so-called investment trust product offered by ICBC, a Chinese bank. We have no comment on the specific product or the bank, but we do believe that the significance of the investment trust issue is being blown out of proportion, probably due to widespread ignorance about the nature of the trust sector in China. So let us provide some context.

When ordinary people put money in the bank in China they have a choice. Either they can opt to get paid the regular deposit rate of 3% or thereabouts, or they can opt to put their money into higher yielding 'wealth management products' (WMP) or 'investment trusts' that pay about 200-500 bps more in interest. Traditional WMPs have a wide investor base, while investment trust products are placed with a narrower set of wealthy individuals or corporates. They are not trusts in the conventional sense of the word. Rather they are mainly passive, unleveraged, and regulated loans made from depositors to borrowers in the public or private corporate sector in China.

These trust products are unambiguously more risky than ordinary deposits or traditional WMPs. Trust assets are exposed directly to more risky sectors and there are duration mismatches. It is the trust's investors, not the banks placing the product that face these risks. Unlike regular deposits that appear on the balance sheet of banks, trust product loans are kept off the balance sheets of the banks, meaning that they are not a bank liability. The bank merely acts as a broker or intermediary between the depositor and the end-user of the funds.

What, then is the broader significance of a potential default on the ICBC trust loan? The most critical thing to watch is whether ICBC opts to bail out its depositors for the losses on the loan in question. Even though the trust product loan is not legally a direct liability of the bank wider social and political pressures could force the bank to compensate trust investors. If so, it would be reasonable to consider trust loans de facto liabilities of the banks.

Suppose that ICBC is forced to bail out its trust products' clients. What would be the wider macroeconomic implications in a worst case scenario?

First, let us put the size of the problem in context. Total deposits in China are roughly CNY 100trn, or 160% of GDP, and trust products are about CNY 10trn, or 16% of GDP. This means that in an extremely unlikely scenario where: (a) every single trust product loan in China went bust; (b) recovery value on every single loan was zero; (c) banks were forced to bail out every trust loan; and (d) the government bailed out every single bank for every single loss on every single trust loan the cost to the government would be 16% of GDP.

A loss of this size would take total public sector debt in China from 56% of GDP today to 72% of GDP. While this would be a big one-off increase in public debt it would still not make China's debt burden unsustainable (for example the US public debt level is already substantially larger against a much lower trend growth rate). In other words, we believe that the trust loan sector poses no systemic risk.

In reality, the risk posed by trust products is quite low, in our view. They are generally simple structures with a good track record. NPLs are running at about 1.5% and banks have provisions for these loans amounting to about 300% of the current NPL rate, despite the fact that trust loans are not a legal liability of the banks. Besides, we believe there are plans afoot to move the modest NPLs to the mutual fund industry. Trust loans are also included in broad monetary aggregates, such as M1, M2, and Total Social Financing, and subject to reserve requirements.

The other reason why we are not concerned is that the Chinese government is entirely aware of the issue and has already launched a number of reform measures aimed at changing the investment trust sector dramatically over the next few years. The government is actively promoting the mutual fund business to remove the trust

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products business from banks. The process of interest rate liberalisation will further reduce demand for trust products as the interest paid on other savings instruments rises. And the bond market is being promoted heavily and will soon be the basis of a very active asset management business in China. Eventually, the asset management industry will take over the bulk of direct term lending to corporates from the banks in China.

Turkey grabbed headlines this week when the central bank offered one tenth of its FX reserves in a single day of FX intervention with little effect on the currency. The intervention followed a tightening of liquidity conditions in the domestic market (but a reluctance to raise actual interest rates).

The real source of Turkey's current vulnerability is not its external deficit, but an excessive and sustained over-extension of domestic credit over the past few years. The domestic construction sector is now extremely sensitive to higher interest rates, which severely constrains the central bank in terms of rates policy. Moreover, the Erdogan administration is putting explicit public pressure on the central bank to keep rates low. As a result, the way Turkey has preferred to adjust is through weakening of its currency. The currency can weaken gradually if external conditions are stable, but when the Fed is tapering and investors are panicking then TRY becomes vulnerable to much greater moves. And those in turn could force the central bank into ultimately abandoning its policy of keeping rates unchanged with negative consequences for the domestic economy and the political outlook alike. Like Brazil but unlike almost any other country in the entire EM universe Turkey openly embarked on a clearly heterodox policy experiment at the onset of the global crisis. It is now paying the price for its adventure. For more details on Turkey's specific economic predicament see our report on the country (the Emerging View, October 2013 'Turkey base case: Slow adjustment, not crisis.').

A word on Argentina. "Peeing in your pants to keep warm" is Danish expression to describe short-term measures that provide temporary comfort, but ultimately leave you worse off than if you had not taken the measures at all. Last week, the government of Argentina peed in its pants to keep warm by allowing its currency to weaken sharply and introducing small measures to ease capital controls. But the government did not sufficiently address the underlying excess demand problem.

The devaluation of the peso in both the official and parallel markets became almost inevitable after an announcement of higher fiscal subsidies by President Cristina Kirchner. Higher public spending right now is about as close as one can get to pouring gasoline on the fire, because higher public spending only worsens Argentina's excess demand problem and dollar shortage.

Recall the context. After inheriting a wide output gap from the default in 2001 successive Kirchner administrations continued to pursue aggressive stimulatory policies even after the output gap was closed. At the same time the government increasingly intervened in the supply side of the economy to deal with the symptoms of excess stimulus (mainly inflation and capital flight and falling demand for government bonds), thereby undermining the capacity of the economy to deliver output. The combination of rising demand and declining production capacity contributed to a massive build-up of imbalances to the point where the country is now in danger of running out of reserves.

The devaluation now underway will only provide temporary relief unless the administration addresses the underlying problem of excess demand and declining supply. This seems unlikely under this administration. We think that the problem will therefore simply reappear in short order.

Finally, we note a few other developments in EM in the past week:

- Poland: Better than expected economic data. Polish retail sales for the month of December picked up strongly from November, rising at a pace of 5.8% yoy versus 3.8% yoy the month before. The retail sales data is consistent with a general upswing in the economy that began last year and which should take real GDP growth in Poland from around 1% in 2013 to about 2.5% in 2014. Unemployment also surprised to the positive side at 13.4% versus 13.5% expected.
- Mexico: Retail sales in Mexico firmed strongly in November after a strong print in October. In seasonally adjusted terms retail sales rose 3.1% mom in November. Like Poland, Mexico is experiencing an economic upswing and the country may grow three times as fast in 2014 as last year. The Mexican upswing has three important drivers: Strong reforms undertaken last year, a Mexico specific cyclical upswing, and a marginally faster US growth rate in 2014 compared to last year.
- Singapore: Industrial Production picked up sharply in December at 6.2% yoy versus the market's expectation of a decline of 1.4% yoy. Like Poland and Mexico, Singapore's economy is also heading higher and the market is now likely to have to revise growth expectations higher.

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- **Russia:** The business cycle in Russia appears to be turning after having lagged the rest of EM in H2 2013. Industrial production rose 4.3% mom sa in December. We do not think Russia's economy is about to take off in a dramatic fashion, but a gentle cyclical upswing in 2014 should allow Russia's growth rate to double to 3.0% in 2014 from last year's sluggish 1.5%.
- **Brazil:** The need to raise productivity in Brazil is becoming more and more obvious. It manifests itself in various ways, such as relatively elevated inflation rates in spite of slow real GDP growth. Another manifestation is that the current account deficit is widening despite a weaker currency and modest domestic growth. In the past week, Brazil released its December current account data, which showed that Brazil's current account deficit widened to USD 81.4bn, or 3.7% of GDP, in 2013. This compares to a deficit of USD 54.2bn in 2012 (2.4% of GDP). The silver-lining is that FDI flows have been stable at close to USD 65bn in 2013. Besides, Brazil has huge foreign exchange reserves, which means that the country is not in danger of a balance of payments crisis. But at a time of slowing growth and a weaker currency the external accounts should be improving, not deteriorating. Business investment is simply far too low, and this is entirely a self-inflicted problem attributable to low quality economic policies.
- **Thailand:** The Bank of Thailand left rates unchanged citing the need to preserve financial stability amidst Thailand's ongoing standoff between supporters and opponents of the government. This past week the government invoked emergency decree powers. An snap election is scheduled for 2 February but the opposition says it will boycott the poll. We do not see immediate prospects for reconciliation. Thailand's political challenges are 100% specific to Thailand.

Global backdrop

Global sentiment deteriorated sharply last week. One of the obvious risks going into 2014 was a broader correction in the US equity market following a very strong rally in 2013. This risk now appears to be unfolding. It is now going to be important to see how sensitive the US Federal Reserve will be to weakening sentiment. The other thing we noticed was that the global manufacturing outlook now looks to be turning again.

After some six months of general upturn in manufacturing the data from last week was distinctly more mixed. While some countries are still experiencing strong expansion others are now beginning to disappoint relative to expectations. Among the latest to disappoint were the United States and China whose PMI reports both undershot expectations. Of course, the market chose illogically to pay far more attention to China because it is an EM country. On the other hand, PMIs were strong in Europe, while industrial production rose sharply in countries such as Russia and Singapore.

At the end of the day, we do not assign too much importance to PMI numbers. They matter more as drivers of short-term sentiment than as predictors of growth over the cycle. Besides, PMI cycles have reflected temporary demand shocks and resulting inventory adjustments far more than capex spending intentions since 2008/2009.

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

Sao Paulo
T: +55 11 3556 8900

Singapore
T: +65 6580 8288

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