A+ to Russia's central bank

By Jan Dehn

Russia's central bank has handled a triple-whammy of shocks without putting a foot wrong. China is forging ahead with reforms despite headwinds. Argentina significantly boosted its Dollar holdings through two successful bond issues. Brazil's Petrobras reported results ahead of a key deadline. Venezuela swaps gold for cash. Mongolia signs MIGA. India permits companies to issue abroad in INR. We discuss Greece, Sarao, US data and oil in the global section.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,064	–	3.03%
MSCI EM Small Cap	1,119	–	1.95%
MSCI FM	602	–	0.24%
GBI EM GD	6.40%	–	0.32%
EM FX spot	–	–	0.53%
ELMI+	4.61%	–	0.65%
EMBI GD	5.33%	339 bps	0.71%
EMBI GD IG	4.10%	210 bps	0.41%
EMBI GD HY	7.56%	575 bps	1.15%
CEMBI BD	5.18%	345 bps	0.25%
CEMBI BD HG	4.09%	234 bps	0.10%
CEMBI BD HY	7.33%	563 bps	0.53%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2118	0.84%
VIX Index	12.29	-7.59%
5 year UST	1.33%	1 bps
7 year UST	1.67%	2 bps
10 year UST	1.91%	2 bps
US HY	6.36%	0.20%
European HY	4.46%	0.08%
EURUSD	1.0837	0.81%
USDJPY	119.30	-0.07%
Brent	64.90	1.45%
Copper	275.70	2.45%
Gold	1182.93	-0.98%

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

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- **Russia:** The Russian central bank deserves an 'A+' for its handling of the Russian economy over the past year. It has literally not put a foot wrong in what can only be described as an extremely trying set of circumstances. Recall that the central bank had to steer the economy through a 'triple-whammy' of mega shocks, including a geopolitical crisis in Ukraine, a collapse in oil prices and the imposition of financial sector sanctions that barred a large number of Russian companies from refinancing in European and US markets.

  In assessing the central bank's performance, marks should first be awarded simply for being well prepared. Russia clearly learnt the lessons of 2008/2009 after which it had adopted a fully flexible exchange rate and converted the OFZ market to Euroclearable settlement. Russia also entered the crisis with a very strong FX reserve position. The next set of marks should be awarded for maintaining focus and discipline. In the face of strong political pressure the central bank allowed the currency to adjust in line with oil prices. This insulated the public finances from the oil price shock. The central bank also earns a bonus point for not introducing capital controls and racks up significant additional credit by decisively hiking interest rates to 17% on the (correct) view that an external shock, such as falling oil prices, requires a decisive adjustment of domestic demand. The central bank then went on to cut rates well ahead of market expectations – a decision that subsequent events proved to be immaculate timing. This decision showed leadership and a willingness to take risks. The central bank showed the same qualities when it then decisively helped to bring Russia's extremely mispriced sovereign spreads down to more rational levels by launching an FX repo facility that allowed locals to buy sovereign bonds. It also understood the temporary nature of such interventions and tightened the facility as spreads and the currency approached more rational levels. Based on professional competence, Russian central bank governor, Elvira Nabiullina, is a contender for central banker of the year.

- **China:** The government is showing no signs of wavering in its efforts to liberalise interest rates and opening the capital market, despite the increasing evidence – inevitably in our view – that such policies will expose weak spots in the credit landscape. Thus, in the past week, Boading Tianwei Group Co., a state-owned enterprise (SOE), became the first such company to be allowed to go bust. The decision to let Tianwei go in effect removes the implicit government guarantees on SOE debt. This is positive and consistent with China's stated objectives of SOE reforms and letting prices play a more important role in resource allocation. Interest rate liberalisation will create uncertainty and therefore contribute to slower growth. It will also make funding more expensive for China's corporates, so default rates are bound to rise, albeit from an artificially low level. But this

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is taking place under the vigilant eye of a strong sovereign with the willingness and ability to manage the process, in our view. Indeed, the government last week announced that it is injecting USD 62bn into its three policy banks (China Development Bank, Exim Bank and Agricultural Development Bank) with a view to raising capital ratios of the policy banks to those of commercial banks (10.5%). China's policy banks occupy a central role in China's bond market with RMB 9.78trn (USD 1.6trn) of bonds outstanding (27% of the total onshore bond market in China). China is forging ahead with these challenging reforms, because it is the right thing to do and will ultimately put China in a far stronger position to grow. The strong performance of the Chinese stock market suggests that (a) investors believe in China's future and (b) they believe downside risks are limited due to the government's strong capacity to support the economy. Ordinary citizens of China are rapidly becoming part of these pro-market reforms. In the week to April 17, for example, no fewer than 3.3 million new trading accounts were opened in China, according to China Securities Depository and Clearing Corporation (CSDCC). CSDCC's data also shows that some 2 million of these accounts were immediately activated (added securities).

- Argentina: The government took a huge step towards strengthening its foreign exchange position when it raised no less than USD 2.9bn from two separate bond issues. First the government issued USD 1.4bn in Bonar 2024 bonds (USD denominated, local law). Demand was USD 1.8bn, which far exceeded the government's stated target of raising just USD 500m. Hence, the auction was a major success. In a second transaction, YPF, a state-owned energy company, issued USD 1.5bn, which was three times as much as the company had expected to issue. The successful bond auctions show that Argentina can borrow in foreign currency despite restrictions placed on market access by a US court and that Argentina should be able to avoid a balance of payments crisis in the final months of President Cristina Kirchner's term. In other news, the provincial elections in the provinces of Santa Fe and Mendoza were won by candidates allied to Mauricio Macri, a market-friendly presidential candidate. The outcomes of the regional elections are particularly important due to the power that provinces wield in Argentina. As for the presidential election, polls continue to show that Peronist candidate Daniel Scioli leads with about 33% of voting intentions followed by Macri with 27% and Sergio Massa with 20%. Voting is compulsory in Argentina. Given the relatively tight race, we think that the candidate, who secures President Cristina Kirchner's approximate 25% share of voting support will have a major advantage. At this stage, Scioli looks most likely candidate to secure this bonus.

- Brazil: Petrobras published its financials with a sign-off from independent auditors before the 30 April deadline. This removes the risk of covenant breach on Petrobras bonds. The company reported USD 2.1bn in graft related losses, well below expectations. Fitch, the ratings agency, affirmed the company's BBB- rating with negative outlook. The firm was not downgraded because it published its results and raised new financing. Credit growth in Brazil firmed up slightly, albeit driven by public bank lending. Net payroll creation in March was stronger than expected but for the quarter as a whole the labour market was very soft. In general, we expect a weak economy this year due to fiscal adjustment. Business confidence has also been weak in April.The current account deficit is still wide, indicating how much pain the economy still needs to take before the excess demand is squeezed out of the system. Brazil's problem is self-inflicted by bad governance under the previous economic team. Despite the current challenges, we are bullish on Brazil's willingness and ability to right the wrongs done under the previous administration.

- Venezuela: Local media reported that Venezuela has swapped USD 1bn of gold for cash. About 75% of Venezuela's reserves are gold; using the yellow metal as collateral can help to boost cash reserves, though clearly this is not a sustainable solution. We estimate that Venezuela can avoid default at USD 60 per barrel if it takes some basic adjustment measures.

- Mongolia: The government and the World Bank have signed a Multilateral Investment Guarantee Agency (MIGA) agreement, which should free up some USD 1bn in bank credit lines to help restart Oyu Tolgoi, a major mining operation. Another USD 1.4bn and USD 0.4bn are expected to come from the International Finance Corporation and the European Bank for Reconstruction and Development, respectively. Another big project, Tavan Tolgoi, is currently caught up in the quagmire of Mongolia's parliament.

- India: The Reserve Bank of India (RBI) has allowed domestic institutions to issue INR denominated bonds overseas. According to local media, Indian Railways Finance Corporation, a parastatal, may become the first institution in India to take advantage of the decision. This marks a small but positive step towards greater capital account liberalisation in India. On the other hand, the government seems in no hurry to move forward on opening the fixed income markets for inflows.

Continued overleaf

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Snippets:

- Egypt: Former President Morsi of Egypt has been sentenced to 20 years in jail.
- Chile: Central Bank President Rodrigo Vergara signalled that rate hikes are likely towards the end of the year as the economic cycle has been picking up.
- Hungary: The central bank cut rates by 15bps to 1.8% in line with expectations.
- South Africa: Headline CPI came at 4.0% yoy versus a consensus expectation of 4.1% yoy, while the core inflation rate was 5.7% yoy versus 5.8% yoy expected.
- Malaysia: Inflation in line at 0.9% yoy. This was a pick-up from February's low print of 0.1% yoy. The increase was due to higher transportation costs, which were expected given what had happened to fuel prices in the previous month. Inflation remains within the comfort zone.
- Turkey: The central bank left rates, weekly repo rates and the band for short term funding rates unchanged.
- Mexico: Retail sales picked up sharply in February, rising to a 5.6% yoy rate from 4.7% yoy in January. Inflation fell by 45bps in the first half of April. This means that headline is running at 3.03% yoy and core at 2.23% yoy. These are very comfortable inflation rates that suggest that Banxico is not about to hike.

Global backdrop

Emerging Markets (EM) investors should carefully monitor the Greek situation. It has the potential to increase the level of risk aversion and therefore create an excellent entry point into EM fixed income. The last time Greece blew up – in Q3 2011 – EM went on to produce outsize returns in the subsequent six quarters. By Q1 2013, EM sovereign bond spreads had rallied 230bps, corporate HY bond spreads had narrowed by 590bps and local bond yields had fallen by 1.9%. The reason why a Greek 'blow-up' could present an interesting entry point is that the Greece situation may affect market sentiment, but does not pose any serious fundamental risk to EM countries, in our view. Meanwhile, in Greece itself the government has now had to seize all cash held in accounts of government institutions, state owned enterprises and government pension funds in a bid to continue to pay its bills. According to officials, they expect that they can raise some EUR1.5bn to enable the government to keep going until May.

In other interesting global news, US prosecutors acting on orders of the Commodity Future Trading Commission and US Department of Justice allege that Navinder Singh Sarao, a lone trader operating from his home in Hounslow, a suburb of West London, was responsible for the 2010 'flash crash'. Assuming that Mr Sarao did what he is alleged to have done, it does raise concerns about the integrity of the world's deepest stock market. More generally, the prosecution of Sarao suggests that US authorities now view 'spoofing' as market manipulation.

US data continues to soften. Most analysts now predict Q1 qoq annualised growth of less than 1%. Remember this is the annualised number – the actual growth in Q1 is actually only about a quarter of that – i.e. very close to zero. Q2 data is also being revised lower due to the inventory build, the effects of the strong Dollar on an unproductive economy and a poor investment outlook. The consensus for the Fed's first rate hike has moved to September, but the risk surely is that the hike gets moved even further out. As we made clear in a recent report*, QE has failed as a policy of healing. Instead, it has created bubbles that are so sensitive to hikes at the margin that it will be tough to tighten at all. Besides, there has been total neglect of reforms and aggregate deleveraging by the government, so the underlying economy's trend growth rate is very weak.

Over half of US oil rigs have now been shut down since the drop in oil prices began in June last year. While oil inventories have risen in recent months as companies have sought to increase output to offset lower prices, we think the ability of companies to continue to do so is limited by existing spare capacity limits, collapsing investment in the industry and the sharp fall in the number of active rigs. Indeed, inventories have levelled off recently. Last week, Brent crude set new highs for the year as prices pushed north of USD 65 per barrel. This means that oil prices have now rallied about 40% this year. One immediate consequence of higher oil prices is that popular trades such as long TRYRUB or long INRRUB are being unwound very quickly, while the bonds of oil dependent countries such as Venezuela and Russia are rallying. Also, we expect most countries to start to see higher yoy inflation rates in the second half of 2015 as adverse base effects arising from last year's sharp fall in oil prices begin to bite. While this is a purely technical effect – mom numbers should be well behaved – the fact that it coincides with further speculation on when the Fed will raise rates could easily activate the law of unintended consequences.

*See Ashmore Emerging View, April 2015, 'The failure of QE'

Continued overleaf

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Market data	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	8.98%	11.41%	8.47%	4.51%	3.53%
MSCI EM Small Cap	7.95%	11.83%	7.83%	7.55%	3.94%
MSCI FM	3.73%	0.04%	-6.95%	11.77%	5.26%
S&P 500	2.50%	3.47%	15.03%	18.05%	14.07%
GBI EM GD	2.08%	-1.97%	-9.63%	-3.23%	0.80%
ELMI+	2.62%	0.15%	-7.28%	-2.35%	-0.73%
EM spot FX	1.94%	-4.51%	-16.63%	NA	NA
EMBI GD	2.18%	4.24%	6.94%	5.76%	7.29%
EMBI GD IG	1.17%	3.80%	8.85%	4.91%	6.74%
EMBI GD HY	3.70%	4.69%	3.24%	7.11%	8.14%
5 year UST	0.37%	2.25%	4.61%	1.57%	3.83%
7 year UST	0.39%	2.78%	7.20%	2.30%	5.62%
10 year UST	0.27%	3.09%	9.67%	3.93%	7.43%
CEMBI BD	1.78%	4.18%	5.62%	5.84%	6.32%
CEMBI BD HG	1.06%	3.47%	6.76%	5.78%	6.50%
CEMBI BD HY	3.14%	5.50%	3.07%	6.16%	6.04%
US HY	1.45%	3.91%	2.25%	7.86%	8.82%
European HY	0.51%	3.94%	5.27%	12.81%	11.13%
Barclays Agg	0.90%	-1.04%	-3.54%	-0.06%	2.53%

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

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

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

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