Poroshenko wins big in Ukraine

By Jan Dehn

We provide our views on the elections in Ukraine, Colombia and Egypt. Modi appoints his finance minister in India. Dilma's approval ratings stabilise. Will Medina use his mandate and the strong economy to change the constitution? We also discuss political divisions within the Argentinian government, possible sanctions against Venezuela and Thailand's coup. As for Europe's lurch towards populism we see no immediate impact on Emerging Markets (EM).

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,036	–	0.76%
MSCI EM Small Cap	1,067	–	1.50%
MSCI FM	677	–	3.93%
GBI EM GD	6.62%	–	0.79%
ELMI+	3.20%	–	0.35%
EMBI GD	5.21%	265 bps	0.31%
EMBI GD IG	4.42%	181 bps	0.24%
EMBI GD HY	7.15%	490 bps	0.43%
CEMBI BD	5.19%	303 bps	0.22%
CEMBI BD HG	4.28%	213 bps	0.18%
CEMBI BD HY	6.99%	483 bps	0.28%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1901	0.85%
VIX Index	11.36	-8.53%
5 year UST	1.54%	3 bps
10 year UST	2.54%	3 bps
US HY	5.32%	0.02%
European HY	4.44%	-0.01%
EURUSD	1.3647	-0.31%
USDJPY	101.89	0.62%
Brent	110.93	-0.22%
Copper	325.02	-0.25%
Gold	1284.14	-0.84%

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

Emerging Markets

- **Ukraine:** Petro Poroshenko won a decisive victory in last week's presidential election, beating Yulia Tymoshenko by a large margin. His mandate is strong enough that the case for secession in Eastern Ukraine has been weakened significantly. We expect the de-escalation that began following the second round of Western sanctions against Russia to continue, albeit unevenly. An early focus is likely to be gas payments. Why uneven progress? Because Russia is likely to continue to exercise its influence in Eastern Ukraine in order to extract concessions from the Poroshenko administration to ensure that Ukraine does not become a Poland-like, staunchly pro-Western country. Longer-term, we think Russia is still hoping to create the conditions that push Ukraine towards joining the Eurasian Economic Union (an EU-like institution with the Ruble as the main currency for setting investment and trade transactions).
- **Colombia:** Incumbent President Santos and former finance minister, Oscar Ivan Zuluaga, will face each other in the second round of the presidential election on 15 June. Neither candidate was able to obtain sufficient votes in last week's first round for a first victory. Both believe in the same (sensible) economic policies, but differ in two regards, in our view. First, Santos favours continuation of the peace process with the FARC while Zuluaga does not. Second, Santos has broader experience. We believe this makes Santos the marginally more market friendly choice. Both candidates will now vie for the support of the conservative party, which has shrewdly positioned itself right in between Santos and Zuluaga on the question of the peace process; their official position is that they favour talks, but only for a finite four-month period.
- **Egypt:** Abdel Fattah el-Sisi, former head of the armed forces, was widely expected to sweep to power on the back of a landslide victory in the presidential election that concluded this past weekend. A survey conducted prior to the vote suggested that el-Sisi would win comfortably. Next up are legislative elections slated for this September. Once the re-engineering of Egypt's political institutions has been completed following the coup against the Morsi government, the government is likely to turn its attention to Egypt's substantial economic challenges.
- **India:** Prime Minister Narendra Modi was sworn in over the weekend. Arun Jaitley will be India's new finance minister. We expect the Modi administration to use its substantial mandate to make significant reforms to India's economy. Meanwhile, India's external balances continue to improve. The current account deficit narrowed to just 0.2% of GDP in Q1 2014 from 0.9% of GDP in Q4 2013. The sharp turnaround in India's external balances illustrates the superficiality of the analysis that led to India being classified as a 'fragile five' country last year. India faced challenges last year – all countries do – but they were cyclical rather than of a structural nature that the 'fragile five' label implied. India has been able to fix the cyclical imbalances in its economy with a standard dose of monetary, fiscal and FX policy adjustment.

Continued overleaf

Emerging Markets

- Brazil: The latest poll numbers in Brazil show that Dilma Rousseff has managed to arrest the recent decline in her poll ratings by capturing a larger share of previously uncommitted potential voters. Her approval rate thus rose 1% to 35%, while voting intentions rose 3% to 40%. In the Brazilian economy, unemployment fell to the lowest level ever recorded. Only 4.9% of the labour force is unemployed, well below the 5.2% unemployment rate expected and 5.8% at the same time last year. Unfortunately, the move lower in unemployment owes more to falling participation rates rather than rampant job creation. Brazil's growth rate is very sluggish due to a combination of rate hikes and very low levels of business confidence due to the heterodox policies of finance minister, Guido Mantega. Stilll, we expect Brazilians to return President Dilma to power in the October 2014 presidential election.

- Dominican Republic: President Danilo Medina's approval ratings are in the 80s and elections in 2016 are increasingly likely to focus Medina's mind. Under the constitution, Medina cannot run again, but an amendment that would allow him to do so is currently supported by 70% of the electorate. Growth in Q1 2014 hit 5.5% yoy on the back of strong mining activity as well as construction and banking. Growth was 4.1% in 2013, well above the official target of 3.0%. The Dominican Republic has been the second fastest growing economy in Latin America over the past three decades. The impressive growth performance has taken place in spite of a decisive fiscal adjustment that Medina implemented early in his term, which reduced the fiscal deficit from 6.6% of GDP in 2012 to 2.8% in 2013. Economic data released last week showed that the current account has also swung into surplus in Q1 2014 to the tune of 0.1% of GDP following a 0.3% deficit in the same quarter of 2013.

- Argentina: A public quarrel between the finance ministry and the central bank over the direction of macroeconomic policy appears to have come to an end with a verdict, for now at least, in favour of the central bank. The central bank earlier this year managed to win presidential support for a number of adjustment measures intended to prevent the country from running out of reserves before the end of Cristina Kirchner's term next year. The measures, however, soon triggered a backlash from more populist elements within the political establishment, especially from the Minister of Economy, Axel Kicillof, whose economic prescriptions have been mined from an extremely rich seam of policies that have caused innumerable economic crises in Latin America in the past. Our view is that President Kirchner's number one priority is to serve out her term without a crisis. This is the main reason why she has allowed some liberalisation of prices and the exchange, while raising rates moderately. These policies have predictably caused growth to slow, although they have also begun to significantly improve the external balances. Thus the trade balance in April improved sharply to a surplus of USD 926m from an average surplus of just USD 40m in Q1. We do not expect the adjustment to be profound, but we think the government will do enough to continue to service debt and to avoid a balance of payments crisis during the remainder of Kirchner's term.

- Venezuela: The imposition of largely meaningless sanctions against individuals in Emerging Markets oil producing nations is becoming increasingly fashionable. A committee of the US Senate approved a draft bill supporting sanctions for Venezuelan government officials responsible for acts against anti-government protesters in Venezuela. The bill still needs to be passed on the floor of both the Senate and the House of Representatives. There is no talk of imposing sanctions that would impact Venezuelan oil exports.

- Thailand: The Thai military first declared martial law and formally took power in a coup last week. This follows a long-standing and intractable conflict between opposition and pro-government supporters. This conflict has locked Thailand into a political impasse for some time and the intervention of the military was therefore far from surprising, although the precise timing was always going to be uncertain. We don't think there will be 'spill-over' to other countries and that the impact on Thailand itself will be quite marginal. After all, military take-overs have almost become a fixed part of the political business cycle. Military intervention is a symptom rather than a cause of the country's deeper political challenges and these latest developments do not, in our view, alter the outlook for Thailand significantly. Instead, it is likely, as has been the case in the past that the impact on business activity will be relatively muted given that the economy has already softened significantly due to the lengthy political tensions (Q1 GDP declined 0.6% yoy). Indeed businesses may take the view that the military take-over could usher in some more stability, at least for a time. However, we believe the military will eventually cede power to a civilian administration, possibly following fresh elections, as has been the pattern in the past. This will then shift the focus back to the deeper political divisions within civilian society in Thailand that led to the military take-over in the first place. Longer-term, it matters more to Thailand's fundamental outlook how these civilian divisions are resolved than what the military did this week. Civilian society is divided between a lower income, less educated and largely rural majority of the electorate that has supported recent governments with links to political strong-man, Thaksin Shinawatra, and a more urban-based, educated and affluent minority opposition movement. Recent developments have weakened Thaksin's support among rural voters but, in our view, the risk is high that a future election would still fail to bridge these deep political divisions.

Continued overleaf

Emerging Markets

In other news:

- **Russia:** The Crimean incident had led to a potential threat to Russia's long term gas revenues from supplying Europe, but this threat receded sharply when Russia struck a major long-term (30 year) agreement with China to supply 38 billion cubic meters of gas to China within the next 4 to 6 years. This news turns the direction of the risk on its head. The big question now is whether Europe will be able to replace the supply of gas that Russia will now be sending to China instead of to Europe. In the past week Russian tanks were withdrawn from the border with Ukraine and the Russian economy continued to perform less badly than many expected; industrial production rose 2.4% mom in April, up from a 1.4% increase in the month of March. As market sentiment has changed in favour of Russian assets, the Russian central bank last week announced a reduction in the daily intervention in FX markets by USD 100m per day. Russia is likely to continue to increase the flexibility of the currency. The value of a flexible currency became very evident in the past few months as a weaker RUB proved strongly supportive for Russia's public finances, allowing the government to cancel a half dozen domestic bond auctions during the peak of the Crimea incident. Indeed, Finance Minister, Anton Siluanov, said last week that Russia is likely to produce a 0.5% budget surplus in 2014 and may cut its original borrowing requirement by RUB 435bn.

- **China:** The past week saw China take another very important step forward towards establishing a large efficient domestic bond market. Ten local governments were given formal permission to begin to issue their own bonds. The local government administrations of Shanghai, Zhejiang, Guangdong, Shenzhen, Jiangsu, Shandong, Beijing, Qingdao, Ningxia, and Jiangxi will now issue bonds within quotas approved by the central government. The bonds are fixed coupon bonds with 5, 7 and 10 year maturities. The bond market is going to be the main transmission mechanism for monetary policy as the government shifts China's growth model from an export-led to a domestic demand-led footing. Local government bond issuance is likely to grow rapidly in the future, increasingly replacing intransparent local government financing vehicles and bank loans. Transparent bond financing introduces market discipline to harness errant administrations by pushing up their borrowing costs. Bonds will also provide an important alternative asset to equities and property in the portfolios of China's savers – as bonds will help to stabilise these savings pools over the business cycle they will reduce the precautionary savings motive and thereby help to boost domestic consumption. In other Chinese news, the manufacturing sector showed signs of clear recovery in HSBC's flash PMI print, which rose to 49.7 in May from 48.1 in April.

- **Turkey:** The Central Bank of Turkey (CBRT) wasted no time in reversing recent rate hikes when it cut the main policy rate by 50bps in last week's monetary policy meeting, taking policy rates to 9.5%. Contrary to popular perceptions, we think Turkey's main economic vulnerability is not the current account, but rather the domestic credit markets, which have fuelled much of Turkey's strong growth over recent years. As such, the CBRT is keen not to raise interest rates more than absolutely necessary. It only raised rates in January due to stresses in global markets. On the other hand, we think Turkey is keen to have a weak currency in order to stimulate its export and investment led growth model. Turkish nominal bonds rallied strongly following the rate cut.

- **Taiwan:** Export orders picked up smartly in April, accelerating to a pace of 8.0% yoy compared to 5.9% in March. The market had expected a decline to 5.7% yoy. Demand was strong from all regions, including Japan, China, Europe, and the US. Taiwanese export orders are often regarded as a bell-weather for export demand more broadly in Asia, because many Taiwanese companies produce goods in plants based in other Asian economies, though this is not always the case. Indeed, Korean exports, another common bell-weather, moderated somewhat in early May.

- **Mexico:** Retail sales rose 1.7% yoy in March, which was much faster than expected by the market consensus (-0.9% yoy). This follows three weak monthly prints. There are a number of drags on consumer demand in Mexico, including weakness in the homebuilder sector, recent tax increases, the uncertainty arising from recent reforms, and so on. Mexican consumption is likely to gradually improve this year and prospects for the economy look very bright over a longer horizon, in our view.

- **Senegal:** The government is preparing to issue a USD 500m Eurobond by July, market conditions permitting. According to the Finance Ministry, the government is considering a 10 year benchmark bond following a successful recent IMF review. The last time Senegal issued external debt was in May 2011. Senegal is one of a dozen sub-Saharan African countries that have slowly been finding their way into the JP Morgan EMBI index, the main benchmark index for EM issuers of dollar denominated bonds under New York law.

Monetary policy:

- **Nigeria's** central bank left rates unchanged at 12%.
- **Israel's** central bank left rates unchanged at 0.75%

Continued overleaf

Global backdrop

There is a bittersweet irony in the outcome of this week's European elections. Populist movements, such as Golden Dawn and Syriza in Greece, Front Nacional in France, UKIP in Britain and Dansk Folkeparti in Denmark, among others, individually purport to further national self-interest at the expense of closer European integration. Yet, in so doing they are being very European. After all, these movements are merely the latest manifestation in a long European tradition of lurching towards populist, nationalistic, and xenophobic policies at times of economic stress. Indeed, it was this very proclivity to nationalism that led European politicians to set up the European Union in the first place. Europe's founders were so cognisant of the risks posed by nationalistic populism that they designed a system with plenty of checks and balances and bureaucratic safeguards to disarm the worst excesses of Europe's tribalistic voters. Thus, while the rise of European populism makes for great headlines the reality remains that the conventional (pro-European) parties comfortably retain control in Brussels. The election outcome in Europe is largely irrelevant for EM countries. That is not to say that this won't change in the future but, until nationalist populism actually gains real power in national institutions and the top European decision-making bodies, it remains more of a spectacle than a tragedy.

German Q1 2014 GDP expanded 0.8% qoq, which was in line with expectations. This translates into a healthy 2.3% yoy pace of growth for Germany. German growth was investment and domestic demand led. Perhaps for these reasons plus the fact that EURUSD has depreciated more than 2% since ECB President Mario Draghi's recent verbal intervention, Bundesbank president, Jens Weidman, indicated that easing by the ECB is not a 'done deal' for June. Greece and Spain had their sovereign debt ratings upgraded. Thus, in yet another illustration of why investors should shun ratings changes as a guide to where and when to invest, these upgrades are taking place literally at the end of an almighty rally in peripheral European debt, which was not caused by a return to sustainable macroeconomic fundamentals, but rather due to implicit ECB support in our view.

Watch the UK. The UK is further ahead in the recovery process than the US. Consumption has been picking up, inflation has been rising, and house prices have been reaching bubble levels. Both the UK and the US are able to create inflation and weaken their currencies, but both countries also struggle with enormous debt burdens. These debt burdens have been unproblematic due to zero interest rates for several years, but as inflation begins to make itself felt central banks will face a serious conundrum: Fight inflation or keep rates low to protect the economy from the evils of debt service. The total US debt stock is about 400% of GDP, the UK's even higher. Our expectation is that the desire to sustain growth will ultimately trump the desire to fight inflation, not least because inflation also helps to reduce debt. This means that even as the British and US central banks begin to tighten policy they are likely to do so slowly, slower in fact than the rise in inflation expectations. The result will be lower real interest rates and therefore weaker, not stronger, currencies.

Minneapolis Fed President, Narayana Kocherlakota, aired the idea that the Fed should allow the inflation rate to drift above the 2% target for a few years to make up for the last few years of below target inflation. This is hardly the public position of the Fed yet, but we think inflation will become increasingly acceptable, even desirable, as deleveraging draws to a close. This is because rising yields in the context of low inflation becomes extremely painful when the economy still carries so much debt. It is the good fortune of the United States that it will be able to generate inflation; it is less clear that Europe and Japan can do the same on a sustained basis, in our view. Meanwhile, US data continues to be rather mixed. Existing home sales rose 1.3% mom versus 2.2% mom expected. PMI manufacturing rose to 56.2 from 55.4 last month. Claims for unemployment ticked higher to 326K, which suggests a somewhat softer next payroll print.

Continued overleaf

Ashmore

Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.4%	4.7%	4.2%	0.0%	10.0%
MSCI EM Small Cap	2.8%	6.9%	1.7%	0.5%	12.1%
MSCI FM	3.1%	15.6%	25.3%	11.0%	10.8%
S&P 500	1.09%	3.68%	17.58%	15.47%	18.93%
GBI EM GD	2.56%	5.44%	-4.53%	1.69%	7.83%
ELMI+	1.36%	2.13%	0.26%	-0.40%	2.88%
EMBI GD	2.14%	7.27%	2.55%	7.29%	10.49%
EMBI GD IG	2.20%	7.30%	1.32%	5.97%	8.49%
EMBI GD HY	2.02%	7.23%	5.21%	9.64%	13.38%
5 year UST	0.97%	2.37%	-0.17%	2.56%	3.64%
7 year UST	1.13%	4.16%	-1.02%	3.82%	5.12%
10 year UST	1.28%	6.81%	-0.52%	5.85%	5.91%
CEMBI BD	1.42%	5.07%	2.87%	5.86%	10.18%
CEMBI BD HG	1.36%	5.31%	2.91%	6.19%	9.03%
CEMBI BD HY	1.56%	4.55%	2.79%	5.52%	13.98%
US HY	0.67%	4.64%	7.55%	9.62%	15.56%
European HY	0.56%	5.02%	11.53%	12.99%	18.32%
Barclays Ag	0.22%	3.79%	4.52%	2.46%	4.56%

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

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

Other locations

Shanghai

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 © 2014.

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. Past performance is not a reliable indicator of future results. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment.