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Ashmore

Turkey's tactical involvement

By Jan Dehn

Tensions on Turkey's southern border reflect broader shifts in the geopolitical situation in the Middle East, but Turkey is unlikely to get deeply embroiled in the fight against ISIS, in our view. China took further steps to move the reform process forward as the percentage of suspended stocks in the A share market returns to near-normal. The Brazilian government eases its fiscal targets – the remaining risks are now a ratings downgrade and impeachment of President Dilma Rousseff. Venezuela finds another source of Dollars amidst dwindling reserves, while Colombia's external balances show signs of improvement. South Korea passes a supplementary budget and takes further steps to stabilise domestic debt. Approval of a Malaria vaccine moves closer with potentially major positive implications for growth in most African countries. In the global backdrop, we note that American-style 'Dutch Disease' is now showing up in US earnings.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.7	–	-3.28%
MSCI EM Small Cap	20.1	–	-2.33%
MSCI Frontier	10.9	–	-1.08%
MSCI Asia	11.9	–	-1.92%
MSCI EMEA	12.2	–	-4.42%
MSCI Latam	20.7	–	-7.00%
GBI-EM-GD	6.73%	–	-1.96%
ELMI+	4.65%	–	-1.26%
EM FX spot	–	–	-1.76%
EMBI GD	5.85%	356 bps	-0.38%
EMBI GD IG	4.62%	226 bps	-0.41%
EMBI GD HY	7.97%	582 bps	-0.34%
CEMBI BD	5.56%	349 bps	-0.27%
CEMBI BD HG	4.46%	238 bps	-0.12%
CEMBI BD HY	7.62%	557 bps	-0.53%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.2	–	-2.19%
2 year UST	0.67%	–	-0.04%
5 year UST	1.60%	–	0.09%
10 year UST	2.24%	–	–
30 year UST	2.93%	–	2.07%
US HY	7.19%	574	-0.99%
European HY	4.54%	451	-0.19%
Barclays Ag	–	441	0.55%
VIX Index*	13.74	–	1.79%
DXY Index*	96.67	–	-1.36%
CRY Index*	205.04	–	-9.50%
EURUSD	1.1066	–	2.08%
USDJPY	123.26	–	0.83%
Brent	53.7	–	-5.14%
Gold spot	1096	–	-1.13%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

- **Turkey:** Tensions are rising on Turkey's southern border as Turkish forces engaged in artillery strikes and air raids in Syria and Iraq following attacks on Turkish soil by ISIS, a militant organisation seeking to overthrow pro-Western governments in the Middle East region. ISIS's involvement in Turkey marks a departure from the past, where ISIS has focused mainly on gaining territory in weaker, dysfunctional states as part of a long-term strategy to take over more established regimes in the region. The reason for this departure from ISIS's strategic objective is purely tactical, in our view. Given a high probability of fresh elections in Turkey in the near-term, ISIS is hoping to encourage Turkey into the conflict – with American involvement – in a bid to cause further polarisation in the region. This hope appears to have been fulfilled as Turkey responded to the ISIS attacks by re-opening the Incirlik air base to US bombers. The Turkish attacks immediately drew a sharp criticism from Iran. The pan-Middle East ambitions of ISIS over the past few years has significantly shifted the centre of gravity in Middle East politics away from the Arab-Israeli conflict – which is now mainly a localised Israeli-Palestinian affair – towards a battle for control of oil-rich Arab states by appealing to a broader Islamic identity. In response, the US and other Western powers have also had to shift their strategy to seek influence by sowing divisions in the region away from Israel and towards pitting Sunni versus Shia factions of Muslims against one another. It is within this broader canvas that the Turkish actions against ISIS have to be understood. The government may benefit politically from taking decisive action against ISIS ahead of possible elections, but it must also ensure that it balances its rapprochement with the US with its strong economic interest in exploiting closer ties with Iran following the recent agreement to dismantle sanctions. In this balancing act, we believe Turkey will not seek a very deep or lasting involvement in the conflict with ISIS in Syria and Iraq.
- **China:** China is not about to U-turn on reforms despite recent stock price volatility. To the contrary, the State Council last week stated that China will take further steps to reform, including increasing two-way exchange rate flexibility by widening the currency's trading band. China also launched its first ever Real Estate Investment Trust

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Emerging Markets

last week, which was received with strong investor interest. These developments are entirely consistent with the thrust of Chinese reforms which are based on the view that China must rely more on domestic consumption-led growth. In turn, this implies greater capital account liberalisation, RMB internationalisation, FX flexibility, interest rate liberalisation, promotion of domestic bond markets and other market deepening measures, expansion of the mutual fund industry and a raft of other reforms. We do not think that greater currency flexibility should be seen as a signal of strong directionality in RMB versus the USD. China is likely to continue to keep the currency stable as it undertakes deep structural reforms.

As for cyclical developments, China's manufacturing indicators, including fixed asset investment, weakened last week, while monetary conditions improved and industry profits accelerated month on month. Industrial production and retail sales were in line with expectations.

More importantly, however, the recovery in China's housing market is gaining traction. Property sales are now up 18% yoy with second and third tier cities now outperforming first tier cities. Land sales also rose in both June and July.

The percentage of suspended stocks in the A share market has returned close to normal. Suspensions now stand at 19% of total stocks compared to 51% in early July. Chinese companies have the right to request suspension of stocks for up to three days. Hence, the 'frictional' level of suspended stocks is typically between 10% and 20% of the total stock market.

Finally, a new study from China's academy of social sciences shows that China's net asset position – a so-called stock measure which subtracts total debts from total assets – improved at both national and sovereign level. At sovereign level, China's net assets increased from CNY 14.5trn in 2004 to CNY 103.3trn in 2014, while at national level the net asset position has doubled from CNY 165.8trn to CNY 352.2trn between 2007 and 2013. At the end of 2014, China's Gross Domestic Product (GDP) – in economic terms a so-called flow – stood at CNY 63.6trn. China's net sovereign assets to GDP rose from 91% in 2004 to 162% in 2014, according to the study. On a national level, net assets remained roughly constant at 620% of GDP between 2007 and 2013.

- Brazil: The market has been focused on four sources of potential downside risk in Brazil over the past 12 months, namely: (a) the economic downturn; (b) slippage of the fiscal targets; (c) downgrade of Brazil's investment grade rating; and (d) the possible impeachment of President Dilma Rousseff. The economic downturn is now fully priced in and last week investors could cross off another one of the risks, namely fiscal slippage, as the government formally reduced its primary surplus target by about 1% from 1.1% of GDP to just 0.15% of GDP for 2015. The target for 2016 was also watered down from 2% of GDP to just 0.7% of GDP. The need to revise the primary surplus target lower was becoming obvious as the economy shrank under the weight of tough fiscal measures and rising monetary policy rates. As 'The France of South America', Brazil's public sector is rife with statutes and earmarked spending, which makes it very hard to adjust public spending in downturns. This has forced Finance Minister, Joaquim Levy, to cut precisely the types of spending that could help the economy bounce back, such as investment spending. Brazil's problems are almost entirely self-inflicted and have taken a toll not just on the economy, but also on President Dilma Rousseff's popularity, which is now just 7%. Given the slippage in the fiscal targets, the market is now going to focus on Brazil's credit ratings. The new fiscal targets imply that Brazil's debt to GDP ratio will continue to rise and should exceed 70% over the next couple of years. Even so, we think the formal revision of the fiscal targets – which had been widely expected– now removes one of the most important uncertainties in the market. A downgrade from the ratings agencies would mainly have a temporary technical effect on the market, while an impeachment – unlikely in our view – would ultimately usher in a more market friendly government. Hence, for those that can stomach a bit of volatility, these events would present opportunities to add to Brazilian exposure, based on the view – which we share – that the country's deeper fundamentals are still strong enough to pull through and recover. Indeed, a number of economic indicators are already turning positive, including the current account deficit, which has begun to shrink for the first time this year. The key near-term focus, however, will be the COPOM – Brazil's central bank's monetary policy committee. The COPOM meets this week to set interest rates. We expect another hike, because inflation remains higher than target, while the looser fiscal stance will now require an offset from higher rates.

- Venezuela: The government continues to find new, small inflows of USD to add to its dwindling pool of FX reserves. As reported last week, the government has completed a deal with Jamaica, whereby the latter repaid its debt owed to Venezuela under the PetroCaribe initiative at deep rates of discount (Jamaica successfully placed a bond in global bond markets in order to raise the required financing). The deal should augment Venezuela's USD 15-16bn FX reserves by nearly 10%. The Jamaican deal was the final PetroCaribe deal available to Venezuela.

- Colombia: The trade deficit is beginning to narrow faster than expectations. The May trade deficit was USD 1.1bn versus USD 1.2bn in April. As a major oil producer, Colombia's exports fell sharply in the past 12 months, but imports have also been managed lower and these efforts are now bearing fruit. In other news, the government announced that taxes on profits in the Colombian bond market may be further reduced. As global financial conditions tighten, the 'winners' will be found among those countries that preserve or increase their share of global capital. Opening capital markets will help to achieve this.

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Emerging Markets

- India: Proposals have been put forward by the Financial Sector Legislative Reforms Commission to give a majority to government representatives on the monetary policy committee and removing the governor's veto power. The proposal challenges an initial proposal from the Reserve Bank of India (RBI) that would give a majority of votes to the members of the RBI. Neither the RBI nor the government oppose inflation targeting and the government's counter-proposal should be seen as part of a longer process of negotiation. Our view is that the role of government is to set the overall mandate for monetary policy, while the task of policy implementation should be undertaken by the monetary authorities. As such, the adoption of the government's proposal over that of the RBI would call into question the credibility of monetary policy in India, in our view.

- South Korea: The National Assembly passed a supplementary budget stimulus to cope with the effects of MERS, which has recently impacted GDP growth. Q2 GDP expanded only 0.3% qoq sa in Q2, which was slower than both the Q1 growth number (0.8% qoq sa) and the central bank's expectation (0.4% qoq sa). The government took further measures to stabilise household debt, including measures to increase the proportion of household fixed rate and amortising loans.

- Africa: The European Medicines Agency has given a 'thumbs-up' to a new vaccine for Malaria. Malaria has been a major impediment to growth in Sub-Saharan Africa – it is estimated to reduce growth rates by about 1.3% per year. The World Health Organisation will rule on the new drug later this year.

Snippets:

- Mexico: Inflation in the first half of July increased by just 0.09% compared to 0.2% expected. Meanwhile, economic activity picked up. The monthly economic activity indicator rose to 1.5% yoy in May versus 1.15% expected.

- Nigeria: The Monetary Policy Committee left rates unchanged at 13% – in line with expectations.

- Philippines: The trade surplus rose to USD 0.5bn in May from USD -0.3bn in April, mainly due to weaker imports. In a positive development, the government appears to be making progress in executing infrastructure spending. Capital outlays rose by 28% yoy in May following another strong capex spending number in April.

- Singapore: Industrial production declined 3.3% mom sa in June. This was weaker than expected.

- South Africa: The central bank (SARB) raised rates to 6% (+25bps). Governor Lesetja Kganyago signalled the SARB's intention to hike further in the coming two years. The SARB is opting to err on the side of caution – CPI inflation was softer than expected in June at 4.7% yoy versus 5.0% expected.

- Ukraine: The Organisation for Security and Cooperation in Europe said last week that Ukraine and pro-Russian rebels in Eastern Ukraine have agreed to reduce the presence of tanks and smaller weapons systems from the battlefield. Skirmishes continue, however. President Poroshenko last week confirmed that the IMF has approved disbursement of USD 1.7bn to Ukraine.

- Zambia: The government issued a USD 1.25bn sovereign USD denominated bond with 11-year average life and redemptions in 2025, 2026 and 2027.

Global backdrop

The global backdrop was not favourable to Emerging Markets (EM) in the past week. For once, however, Europe was not the main culprit. In fact, Europe notched up another big current account surplus (EUR 18bn), while Greece re-opened its banks after passing the reforms required to proceed to the next phase of its bailout program. Instead, the focus shifted back to the US and weak company earnings, especially among big consensus names. While growth has picked up from the abysmal performance in Q1, the strengthening Dollar is causing real exchange appreciation at a speed that far exceeds the pace of productivity in the US economy. This has already seen exports and investment take a dive, but now American style 'Dutch Disease' is also beginning to infect US company earnings. Earnings as well as guidance for future earnings disappointed last week. This helped to push the US stock market down by 2.2%.

Perversely, as always, risk aversion pushed the Dollar higher. In turn, this pushed commodity prices lower. Both in turn weakened stock markets. The S&P 500 index is now valued at higher levels than the A share market in China on a 2016 forward price earnings basis. This will only compound the problems for American exporters, stocks and the beleaguered shale sector further.

Despite rhetoric to the contrary, the US economy's performance is not dramatically different from that of Europe. The US has eked out about 2% real GDP growth per year in the past four years and is now not likely to grow

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Global backdrop

any faster this year. After correcting for differences in population growth this means that the US economy is barely outperforming the European economy (as anyone can verify for themselves if they visit the US and continental Europe).

Perhaps that is why leaked staff projections from Fed officials suggested a somewhat less bullish outlook than the public messages delivered by the FOMC itself. After all, the Fed staffers have to try to depict reality, while the FOMC has to 'maintain the faith'. The FOMC does so by balancing a permanently over-bullish message on the economy with extremely dovish policies, knowing that any material tightening in monetary policies would sink the economy. Expect more of this ambiguity in this week's FOMC meeting.

Our view is that the Fed would love to hike, ideally this year. A hike is not intended to stamp out rampant excess domestic demand, but rather to put down a marker that can symbolise that the economy is making progress on a very long path towards normalisation. The risk facing the Fed is that even a modest rate hike could inflict considerable damage on the economy. It is not just that underlying productivity of the US economy is now running at just 1% after many years of neglected reforms and lack of investment. It is also that the economy carries nearly 400% debt to GDP and that the US stock market in particular has become addicted to the 'hot money' from repeated bouts of money printing. Performance has already disappointed following the end of fresh QE flows (an enormous stock of past QE still underpins the hyper-easy monetary policy stance). Finally, of course, there is the growing Dollar problem. The DXY index is already up 40% since 2011 and Dollar strength is now really hurting the economy. Hikes would probably drive the Dollar higher and inflict even more pain.

So far the Fed has done a great job in maintaining the illusion of underlying economic strength. But its real challenge lies ahead. A reappearance of inflation towards the end of next year, when the drags from negative equity, household debt and unemployment will have faded back to levels consistent with higher propensities to consume, would pose major challenges, in our view. It would impale the Fed on the horns of a nasty dilemma: sacrifice meagre growth by tightening in real terms or live with higher inflation by only inflicting nominal tightening but keeping real rates low or even allowing them to fall. After squandering years of hyper-easing without reforming or deleveraging in aggregate, the government has left the Fed with little room for manoeuvre. The Fed must therefore pick its poison. And so must investors.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-6.02%	-3.15%	-13.48%	2.82%	1.31%
MSCI EM Small Cap	-4.89%	3.00%	-6.53%	7.29%	3.17%
MSCI Frontier	-1.62%	-5.05%	-17.36%	11.84%	5.98%
MSCI Asia	-4.68%	0.59%	-3.99%	8.77%	5.70%
MSCI EMEA	-5.09%	-1.21%	-18.90%	-1.55%	-0.93%
MSCI Latam	-9.46%	-15.12%	-34.32%	-10.21%	-7.89%
GBI EM GD	-2.22%	-7.00%	-18.19%	-4.50%	-0.22%
ELMI+	-2.22%	-3.40%	-12.22%	-2.38%	-1.04%
EM FX Spot	-3.00%	-9.77%	-22.07%	-9.33%	-6.92%
EMBI GD	0.10%	1.77%	-0.45%	3.56%	6.09%
EMBI GD IG	-0.09%	0.45%	1.21%	2.30%	5.31%
EMBI GD HY	0.37%	3.51%	-4.06%	5.56%	7.25%
CEMBI BD	0.13%	3.84%	2.20%	4.62%	5.87%
CEMBI BD HG	0.25%	2.52%	3.01%	4.20%	5.79%
CEMBI BD HY	-0.07%	6.33%	0.21%	5.73%	6.18%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.90%	2.14%	6.76%	18.30%	15.93%
2 year UST	-0.05%	0.84%	1.17%	0.56%	0.75%
5 year UST	0.06%	1.46%	2.59%	0.77%	2.38%
10 year UST	–	–	–	–	–
30 year UST	2.41%	-2.44%	3.92%	0.20%	5.29%
US HY	-1.08%	1.64%	-1.42%	6.12%	8.19%
European HY	1.25%	3.65%	3.73%	11.45%	11.10%
Barclays Ag	-0.27%	-3.34%	-6.99%	-1.00%	1.58%
VIX Index*	-24.63%	-28.44%	8.27%	-17.72%	-40.75%
DXY Index*	1.24%	7.09%	19.31%	16.88%	17.63%
CRY Index*	-9.74%	-10.84%	-31.27%	-31.56%	-22.47%
EURUSD	-0.78%	-8.55%	-17.68%	-10.19%	-14.78%
USDJPY	-0.92%	-2.77%	-17.38%	-36.35%	-28.73%
Brent	-15.49%	-6.26%	-50.42%	-49.53%	-29.41%
Gold spot	-6.65%	-7.76%	-15.87%	-32.50%	-5.54%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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