Taking stock of Saudi Arabia

By Jan Dehn

In a very eventful week, Saudi Arabia opened its USD 530bn stock market to foreign investors for the first time. The Saudi Market is under-valued, under-owned and, until now, under the radar. US mutual fund flows are returning to Emerging Markets (EM) local markets, but so far less than a third of what left has returned. This means that technicals in EM local markets are still good, which is helpful as risk aversion became more pronounced in global markets last week due to the situation in Russia-Ukraine and the Middle East. We also provide updates on Argentina, Russia, Ukraine, Indonesia, Mexico, China, Brazil, India and South Korea. Away from EM we note that the US government took steps to support its own short-term debt market by putting an end to 'risk free' money market funds, while Europe's policy makers enjoyed a weaker EUR after US core inflation declined and the Bundesbank appeared to condone inflationary wage settlements.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,080	–	1.63%
MSCI EM Small Cap	1,105	–	0.87%
MSCI FM	704	–	-0.19%
GBI EM GD	6.48%	–	0.53%
ELMI+	3.04%	–	0.27%
EMBI GD	5.05%	257 bps	0.47%
EMBI GD IG	4.34%	180 bps	0.52%
EMBI GD HY	6.72%	444 bps	0.38%
CEMBI BD	5.07%	286 bps	0.13%
CEMBI BD HG	4.28%	205 bps	0.17%
CEMBI BD HY	6.77%	458 bps	0.03%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1978	0.24%
VIX Index	12.69	-0.94%
5 year UST	1.70%	2 bps
10 year UST	2.49%	2 bps
US HY	5.56%	0.24%
European HY	4.63%	0.19%
EURUSD	1.3435	-0.64%
USDJPY	101.87	0.51%
Brent	106.21	-0.33%
Copper	331.30	1.74%
Gold	1304.63	-0.61%

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

Emerging Markets

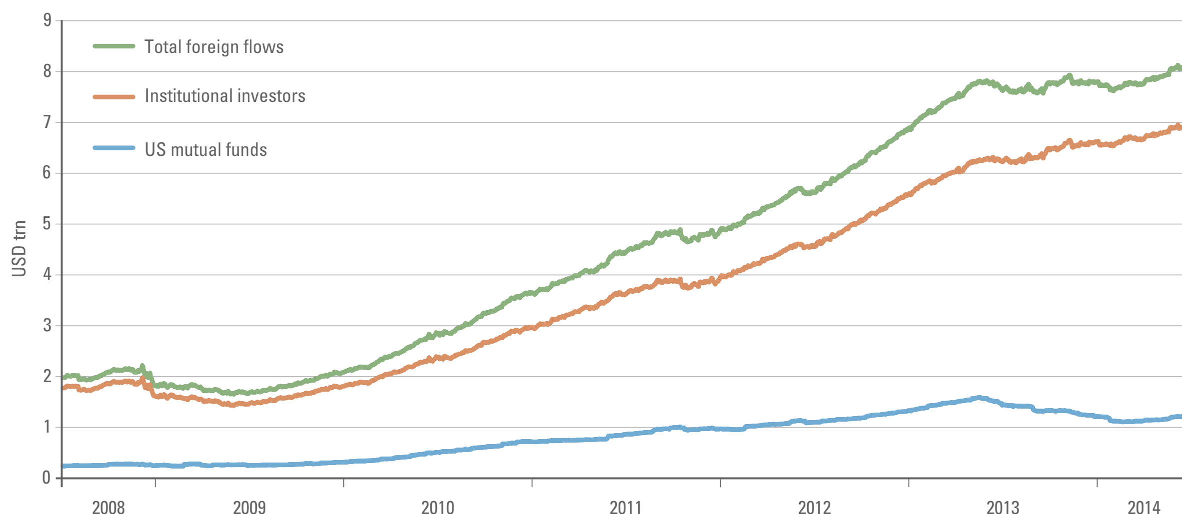
- Saudi Arabia: Saudi Arabia is opening its equity markets to foreign direct investment. Saudi Arabia is a very large, liquid market. The Tadawul All Share index comprises over 160 companies with a total market cap of USD 530bn and a USD 2.2bn average daily trading volume (last 3 months) – this is on par with the likes of South Africa and Malaysia, and larger than either Turkey, Indonesia or Mexico. Saudi companies offer a rich selection of opportunities from banks to consumer-driven businesses. Due to lack of index inclusion, valuations are at a discount (and at times a significant one) to their peers in other markets. There are no listed oil companies in the Middle East and in any case energy stocks only make up 2% of the region's equity markets, primarily exploration and production outside the region. We continue to see positive earnings results from companies in Saudi Arabia.

Flows: Following the largest outflows ever during last year's 'Taper Tantrum', US mutual fund investors are now coming back to EM local markets. This has added to continuing allocations by institutional investors to accelerate the pace of total foreign inflows to EM local markets in the second quarter of 2014, according to a seminal new data set from Standard Chartered Bank (updated up to 10 July 2014). The data shows that US mutual fund investors, whose flows are captured in weekly data from EPFR Global, are by far the most volatile component of the foreign investor base in EM local markets, but it also shows that they comprise less than 15% of total foreign holdings and only 2% of total holdings. Institutional foreign investors added continuously throughout 2013 and have continued to do so this year.

Continued overleaf

Emerging Markets

Fig 1: **Foreign holdings in EM local bonds markets**



Source: Ashmore, Standard Chartered Bank.

- Argentina: As of Monday morning this week, there was no material progress in the stand-off between holdout investors and the government. In a hearing chaired by Judge Griesa last week the two parties were ordered to hold continuous talks, while Argentina's request for a suspension of the ruling that Argentina must pay holdout investors was denied by the judge. Argentina has already sent funds to service performing bonds, but Judge Griesa refused to allow the payment agent either to pay holders of performing bonds or to return the money to Argentina. Judge Griesa also revealed last week that he had not previously been aware that a good portion of the exchange bonds (those bonds subject to dispute between Argentina and holdout investors from the default in 2001) were issued under various laws other than New York law, including Argentina, English and Japanese law. This further complicates the picture as the grace period for the 2033 Discount bonds draws nearer; it expires at midnight on 30 July 2014. Meanwhile, the cash to service the bonds just sits on account at Bank of New York Mellon. Argentina has on many previous occasions stated that it will not pay holdout investors. This is partly for domestic political and legal reasons, partly due to the size of the total claim (approximately USD 15bn) and partly due to the so-called RUFO clause, a provision in the existing bonds that requires any offer made to holdout investors also be extended to holders of performing bonds. This clause expires at year-end, or in the event that the bonds are accelerated. Argentina has also on previous occasions stated publicly that it would offer to swap New York Law bonds for local law bonds in the event it becomes impossible to service New York Law bonds.

- Indonesia: Joko Widodo, aka Jokowi, won the presidential election in Indonesia with a convincing 6% margin over his main challenger. The result was more decisive than expected and attention will now shift to cabinet appointments and the economic and political reform agenda. Jokowi never expressly defined a program ahead of winning power, so there is considerable uncertainty about what to expect. More importantly, however, is the question of parliamentary coalitions. Based on his record as governor of Jakarta, Jokowo is likely to be very hands-on and should pursue better monetary and fiscal policies than in the previous administration, but we believe his scope to reform will depend crucially on his ability to negotiate alliances in parliament. This, then, is the area of focus right now in Indonesia.

- Russia: The situation on the ground in Eastern Ukraine deteriorated markedly last week in a sharp turnaround from earlier in the week, when there were signs of de-escalation. Separatists in Eastern Ukraine allowed bodies from the downed Malaysian airliner to be collected, the black boxes were handed over, Russia supported a UN Security Council resolution, and the US government stated openly that they saw no evidence of Russian involvement in the shooting down of the Malaysian airliner. That détente was however driven by short term political considerations following the Malaysian airlines disaster. As attention began to shift elsewhere, fighting re-intensified on the ground and Europe played up its plans for further sanctions. Citing rising inflationary risks, the Russian central bank raised rates by 50bps to 8%. This will adversely impact Russian growth, but also underscores the credibility of the central bank in its efforts to meet its 4% medium-term inflation target. As for the new European sanctions, they are likely to be unveiled this week. The market is of course right to pay close

Continued overleaf

Emerging Markets

attention to sanctions. History is littered with examples of governments putting guns to their heads and pulling the trigger. EU foreign ministers are rumoured to have proposed sanctions that go well beyond those imposed by the US recently. We think the eventual sanctions will be far less punitive. Europe and Russia are very closely integrated economically, locked, in effect, in a bad marriage. Europe is dependent on Russian energy and we note that oil prices did tick higher towards the end of last week. Meaningful European sanctions against Russia would likely backfire on the Europeans by hitting their vulnerable economies hard. Hence, we think European heads of state will find it hard to establish unanimity around very tough sanctions. Instead, it is likely that some watering down of current proposals will take place once the heads of state get together. Meanwhile, a busy election-schedule in Ukraine in the coming months means that Ukrainian unity will be low, which gives Russia strong incentives to continue to interfere in Eastern Ukraine. And, given that armed conflict often works well politically, there may even be incentives for Ukraine to also push for a confrontation at this point. We note in passing that President Vladimir Putin's approval rating is 83%, the highest level since 2008.

- Ukraine: The governing coalition in Ukraine broke up and Prime Minister Yatsenyuk resigned over failure of Parliament to approve a budget amendment required for the disbursement of the next IMF tranche. An extra-ordinary parliamentary meeting could still be convened to try to pass the legislation (pertaining to laws governing the gas sector). If this fails, the disbursement of the next IMF tranche could be delayed until after October's election, provided that the election produces a reform friendly parliament. The internal political situation in Ukraine (aside from Eastern Ukraine) will now become somewhat more fluid as candidates adopt positions conducive to winning votes. Ukrainian politics has in the past been extremely beholden to oligarch interests and vulnerable to populism. Much of Ukraine's economic weakness, which constitutes the biggest challenge to Western hopes of turning the country into a Western ally, stems from this very problem. Russia is interested in weakening the Kiev government and making it beholden to a populist parliament, because ultimately a weak government would lose IMF support and be forced into the arms of Putin. The best chance of avoiding this outcome would be to neutralise the situation in Eastern Ukraine, but this would require the introduction of some sort of neutral third party to act as a buffer between the Russians and pro-Western forces in Kiev. After all, neither Russia nor the West is likely to get their way entirely in Ukraine and their objectives are mutually exclusive. Seen in this light, a Russian proposal earlier in the week to allow OSCE observers on the border with Russia could have been part of a solution, but Europeans continued to push for the next round of sanctions. The US, meanwhile, has an incentive to escalate tensions further in order to improve prospects for shale gas exports to Europe. The conflict does not yet appear to have extracted sufficient costs to induce both sides to make the necessary upfront concessions to allow serious talks of a settlement to begin.

- China: China's central bank has extended CNY 1 trn in credit support to priority sectors via China Development Bank against collateral. The aim is to continue to support key sectors, especially sections of the housing market as the broader economy is subjected to restructuring, including interest rate liberalisation. The credit extensions will have money supply consequences, but inflation in China remains low. Besides, the measure is very targeted, and intended as such; otherwise the PBOC would just have cut reserve ratios broadly across the board. The manufacturing sector is continuing to recover. HSBC's PMI index rose to 52 in July versus 51 expected and a low of 48 in March. This follows a slight acceleration in GDP growth in Q2 to 7.5% from 7.4% in Q1. We do not expect very strong growth in China. The government is in the middle of a massive operation to rotate the economy away from relying on export led growth in preparation for a world – which we see unfolding in just a few years – where developed market currencies begin to decline on the back of inflationary policies. The required structural changes are deep and will cause growth rates to stay lower than recent averages for the foreseeable future. China's forward looking policies will help the country position itself for continuing growth even when its export markets come under pressure in the maelstrom of developed market inflation and currency devaluation.

- Brazil: The central bank eased credit conditions last week to the tune of BRL 30bn. The level of non-performing loans is low, but Brazil's economy is weak on account of a complete loss of confidence in the economic team. The policy interest rate is 11%, but inflation is still near the top of the target range, so rate cuts are not yet possible. We think the Dilma administration will win the next election, but with a much eroded mandate, which will require a turn towards the centre in Brazilian politics in order to avoid the worst downside risks associated with lame duck status. This shift is likely to involve changes to the composition of the cabinet which in turn could boost business confidence somewhat. Brazil's broader economic fundamentals remain solid.

Continued overleaf

Emerging Markets

- India: It is raining. Monsoon rainfall has been 24% higher than average in the past week after significant short-falls in rainfall in the past few months. This means that recent fears of higher inflation and resulting monetary policy tightening are now receding. Indeed, in other good news for the bond market, the government announced that a quota allocation of USD 5bn earmarked for sovereign wealth funds will now be made available to all foreign investors in Indian fixed income. Investments are still restricted to maturities in excess of 3 years, but there are no holding period restrictions as previously feared. India is very slowly opening up its bond market to foreigners, but there is great fear of the instability that could be generated from fickle foreign flows. We think those fears are completely misplaced. The domestic Indian bond market is nearly USD 800bn in size, while India's index weight would be capped at 10%, meaning that foreign flows would only be a small fraction of the total market.

- Korea: The economy expanded 3.6% yoy in Q2 2014, which was 0.1% slower than anticipated by the market. The cause of disappointment was domestic demand. This may in part be due to a harrowing ferry disaster earlier this year, but the government has already responded with stimulus measures to support the economy. The current account surplus surprised to the upside at 6.1% of GDP, the largest surplus in 15 years.

- Mexico: Secondary legislation for the Hydrocarbons Law passed the Energy Committee stage of Lower House approval and has also been passed in the Senate. The reform now needs formal approval on the floor of the Lower House, something that is likely to happen shortly in our view. This means that Mexico is on track to pass all secondary legislation for the Energy Reform by the middle of August. In other news, Mexican retail spending rose 1.6% yoy versus 1.0% yoy expected, the third month in a row when retail spending has exceeded expectations, but industrial production gave up a bit of momentum after a spell of more rapid expansion.

Monetary policy actions:

- Hungary's central bank cut rates by 20bps to 2.1% and signalled the end of the cutting cycle
- Russia raised interest rates by 50bps to 8%

Global backdrop

The global backdrop is one of very stretched valuations for developed market assets. US stocks trading near all-time highs, while US treasury yields are trading near all-time lows. Spanish 10 year bonds set new lows for yields last week. Given the FOMC and payrolls this week, the focus will be on the US in particular. US growth, after a very weak Q1, is widely expected to improve in the coming quarters. If that happens what will it do to America's stretched financial markets? The US stock market barely paused for breath despite weak Q1 growth as the market immediately latched onto the hope of stronger growth in Q2 and beyond. Unfortunately, this increases the risk that stocks are more sensitive to interest rates than to growth numbers if growth picks up. On the other hand, if growth continues to disappoint then stocks could fall. We think this makes the outlook for stocks somewhat precarious, while, barring a scenario where the economy weakens seriously, yields in the US bond market should rise. The best scenario in the US markets is probably a continuing weak recovery.

It was a reasonably good week for Europe, all things considered. US core CPI fell back to a monthly pace of 0.1%, which pushed further into the future prospects for a rate hike by the Fed, while in Germany the Bundesbank publicly condoned above inflation wage settlements. Both these developments – lower US yields and higher European inflation – offer temporary relief from what we see as the single most important threat to Europe's over-indebted economy, namely the prospect of higher real rates as the US moves glacially towards normalisation of interest rates. Promptly, the EUR was able to weaken a bit and make everyone in Europe feel a sigh of relief. Unfortunately, this feeling is likely only to be temporary. Europe will genuinely struggle to generate inflation to help keep real rates low, and the US is likely to hike rates well ahead of Europe finding a solution to its banking problem. The threat of higher real rates in Europe and as a result a stronger EUR has therefore not gone away at all. In fact, it is very much still our base case for the medium term.

The US Securities and Exchange Commission ended the 'pleasant fiction' that money market funds can offer risk free return (by recognising that money market funds can 'break the buck', i.e. should have floating NAVs). This is unlikely, however, to end the illusion that risk free assets exist, notably US treasury bills, and could therefore result in a shift out of money market instruments into short dated US treasury securities. This is of course very convenient at a time when the government, the economy, and the Fed all want to see government borrowing costs stay at very low levels. Over time this will require more and more financial repression, because the economy is slowly recovering. Indeed, last week saw weekly initial claims for unemployment benefit decline to 284K from 303K the previous week, though this was partly due to seasonal effects. Core durable goods orders, meanwhile, weakened after significant downwards revisions.

Continued overleaf

Ashmore

Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.4%	9.5%	15.3%	0.8%	8.5%
MSCI EM Small Cap	2.2%	11.5%	14.2%	1.1%	10.4%
MSCI FM	1.7%	22.2%	31.8%	13.5%	10.9%
S&P 500	1.03%	8.24%	19.49%	16.43%	17.53%
GBI EM GD	1.00%	7.06%	4.26%	1.28%	6.78%
ELMI+	-0.01%	2.29%	1.91%	-0.85%	2.20%
EMBI GD	0.89%	9.63%	10.39%	7.47%	10.04%
EMBI GD IG	0.76%	8.88%	8.50%	6.00%	8.23%
EMBI GD HY	1.13%	11.11%	14.31%	10.18%	12.81%
5 year UST	-0.20%	1.96%	1.31%	1.92%	3.72%
7 year UST	0.19%	4.38%	2.88%	3.42%	5.28%
10 year UST	0.70%	7.82%	5.41%	5.86%	6.27%
CEMBI BD	0.23%	6.59%	8.64%	6.15%	9.21%
CEMBI BD HG	0.31%	6.59%	8.20%	6.22%	8.36%
CEMBI BD HY	0.09%	6.55%	9.57%	6.32%	11.85%
US HY	-0.38%	5.33%	9.62%	9.55%	13.69%
European HY	-0.16%	5.85%	12.87%	13.43%	15.99%
Barclays Agg	-0.34%	4.58%	6.04%	2.09%	4.24%

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

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.