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Ashmore

Cliffhanger in Argentina

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The stand-off in Argentina intensified last week when funds intended for today's coupon payment on the 2033 Discount bonds were returned to the government. Despite continuing tensions on the ground, the situation in Ukraine improves further as President Poroshenko launches his constitutional reform proposal. More positive data out of Mexico and Vietnam, while China takes another step forward towards interest rate liberalisation. In Eastern Europe, Poland overcame a mini political crisis while Hungary took another step towards easing conditions for indebted households. In the US, Q1 growth was revised down further and so far the data points to only a tepid bounce-back in Q2. We propose an explanation for low trend growth amidst fairly conventional intra-year cyclical dynamics.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,051	–	0.87%
MSCI EM Small Cap	1,086	–	1.51%
MSCI FM	691	–	0.31%
GBI EM GD	6.54%	–	0.54%
ELMI+	3.12%	–	0.39%
EMBI GD	5.10%	255 bps	0.50%
EMBI GD IG	4.37%	177 bps	0.65%
EMBI GD HY	6.79%	447 bps	0.21%
CEMBI BD	5.04%	282 bps	0.29%
CEMBI BD HG	4.23%	200 bps	0.30%
CEMBI BD HY	6.69%	449 bps	0.27%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1961	-0.05%
VIX Index	11.26	2.55%
5 year UST	1.63%	-7 bps
10 year UST	2.53%	-10 bps
US HY	5.19%	-0.02%
European HY	4.28%	-0.23%
EURUSD	1.3657	0.45%
USDJPY	101.37	-0.53%
Brent	112.42	-1.09%
Copper	322.55	2.29%
Gold	1312.61	-0.38%

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

Emerging Markets

- Argentina: The stand-off between holdout investors and the Argentinean government intensified last week. New York 2nd District Court Judge Griesa last week ordered that funds that had been transferred to Bank of New York Mellon Corp. (BONY) by the government of Argentina to meet payments on the 2033 Discount Bonds be returned to Argentina. This makes non-payment of the coupon today extremely likely, but will not result in default, because under the terms of the prospectus Argentina has a grace period of 30 days to make the payment, thus making 30 July the critical date. Argentina is arguing that offering better terms to holdout investors would be financially devastating for the government, not just because of the requirement payment to the plaintiffs and the so-called "me toos", i.e. other holdout investors, but also because the Right Upon Future Offers (RUFO) clause, which says that any improvement in terms offered to holdout investors must also be extended to holders of performing bonds. The RUFO clause expires at year-end. While the lower court's order that BONY return the coupon payment to Argentina brings the sovereign one step closer to a technical default on New York law bonds, it should be noted that Judge Griesa left the door wide open for negotiation. He appointed a so-called 'special master' to manage negotiations between the government and holdouts and reiterated his desire to see the dispute resolved by means of negotiation. We see three possible scenarios going forward: A negotiated settlement, a failure to reach a negotiated settlement which then triggers a swap of New York law bonds into local law bonds (this possibility has been publicly stated by government officials on several occasions) or a failure to reach a negotiated settlement without a subsequent swap, for example, due to logistical challenges. We expect the situation to remain extremely fluid for some time. The case is unique to Argentina with no parallels elsewhere in Emerging Markets (EM).

- Ukraine: President Poroshenko submitted a constitutional reform proposal to parliament. The new constitution is likely to introduce greater autonomy for Ukraine's regions and a shift in power from the president to the parliament. This is an important step towards diffusing tensions in Eastern Ukraine, in our view. We also expect parliamentary elections later this year. During this time, we expect Russia to continue to seek to weaken the new Kiev administration by supporting separatist elements in the East, albeit to a degree that does not result in economically destructive retaliation from the European Union (EU). Russia's long-term objective is to prevent Ukraine from becoming a strong ally of the EU and to induce Ukraine to join Russia's rival Eurasian Economic Union. To this end, the decision by Poroshenko to sign an association agreement with the EU is a setback for

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Emerging Markets

Russia, which has yet to respond. In fact, Russia's parliament last week rescinded its authorisation for the Putin administration to use force in Eastern Ukraine. EU and the US are working on proposals for further sanctions against Russia, though it will be difficult to obtain unanimity among EU members in favour of economically meaningful sanctions against Russia. Indeed, EU leaders last week agreed not to impose new sanctions on Russia. President Poroshenko extended a unilateral ceasefire in Eastern Ukraine by 72 hours and Donetsk separatists agreed to match it.

- Mexico: More good news on the economy. Real GDP expanded 1.25% mom sa (semi-annually) in April, which is the highest print for more than one year. The volume of both imports and exports also surprised to the upside, which suggests that domestic demand is picking up.

- Vietnam: The economy accelerated in Q2, when GDP expanded at a rate of 5.5% yoy, up from 4.8% in Q1. The main drivers were exports and manufacturing. Manufacturing output rose as massive 9.1% yoy in Q2, up from 6.5% yoy in Q1. The domestic economy remains sluggish on account of bad debts in the banking system.

- China: China took another step towards interest rate liberalisation last week, when the PBOC gave banks the freedom to set deposit rates freely on foreign currency accounts in Shanghai. It also said it intends to extend this freedom to the whole economy within one to two years. Foreign currency deposits are a small part of the deposit base, but we think domestic rates will also be fully liberalised as China transitions the economy from export to domestic demand led growth. This will require the government also to transition from using exchange rates as the main tool of macroeconomic control to using interest rates. For interest rates to work efficiently, China needs bank rates to be able to adjust and a liquid bond market to act as the transmission mechanism for monetary policy. This makes the structural transformation of China's bond markets one of the most interesting opportunities in EM fixed income right now, in our view. In other China news, manufacturing picked up sharply in June according to HSBC data. The June PMI print rose to 50.8 from 49.4 in May (versus 49.7 expected).

- Poland: The government last week overcame a mini-crisis when it won a confidence vote. This follows the release of a tape recording of a conversation between a senior central bank official and a senior minister about possible government bond purchases in exchange for changes to the act governing the operation of the central bank.

- Hungary: Hungary further eased the burden of households exposed to foreign currency denominated mortgages. Unlike many other EM countries, some Eastern European economies took on excessive amount of debt leading up to 2008/2009. In the case of Hungary, the excessive debt was concentrated in the household sector. The Orban government has pursued a gradualist approach to easing household interest rates and currency liabilities for households at the expense of foreign banks. We expect this process to continue until the issue disappears. Last week Hungary's Q1 current account surplus reached EUR 984m versus EUR 795m expected.

Policy actions:

- Turkey's central bank cut repo rates by 75bps to 8.75%
- Hungary's central bank reduced rates by 10bps to 2.3%

Global backdrop

US Q1 growth was revised down further, this time to an extremely weak -2.9% qoq seasonally adjusted annual rate. The US economy is now likely to expand little more than 1.5% in 2014, even if sequential quarterly growth returns to a 3% handle in the next three quarters. So far, Q2 growth is tracking around 3%, which means that growth in Q2 will not make up for the absolute loss out output in Q1. The higher frequency data is somewhat more mixed. On the one hand, US durable goods were softer than expected in May and home price appreciation slowed in April, but on the other hand, existing home sales, consumer confidence and manufacturing numbers beat expectations, while claims for unemployment were roughly in line. What is going on with the US economy? The higher frequency numbers suggest conventional intra-year business cycle dynamics, but the underlying trend growth rate remains very weak. The explanation for this ambivalence is simple: The US economy like most western economies is labouring under major structural drags, such as excessive debt, increasingly poor infrastructure, lack of long-term policy reform and so on. This does not prevent ordinary cyclical ups and downs, but it does mean that trend growth rates remain low. We expect this pattern to continue until the US household

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Global backdrop

sector has deleveraged, probably in late 2016, although each subsequent growth disappointment postpones the conclusion of household deleveraging. Until then, we think the combination of weak underlying output trends, improvements in labour markets and generally low investment rates imply declining productivity, exactly as happened in the 1970s. In fact, we think the situation in the US economy today is analogous to the 1970s, except about twice as bad.

In Japan, May household spending and disposable income dropped sharply, down 8% yoy and 3% yoy, respectively. The pullback in consumption is likely due in large part to be 'payback' for an earlier acceleration in spending prior to recently implemented tax hikes. Rising consumer prices (also due to taxes) will also have eroded real incomes. Core consumer prices rose 3.4% yoy in May of which 2.0% is due to the recent tax hike. This means that core inflation net of the tax hike contracted by 0.1% to 1.4% in May from 1.5% yoy in April.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.7%	5.7%	16.7%	0.8%	9.5%
MSCI EM Small Cap	1.8%	8.3%	15.1%	1.7%	11.7%
MSCI FM	-0.4%	19.3%	34.9%	12.4%	10.1%
S&P 500	2.10%	7.17%	24.10%	17.80%	18.82%
GBI EM GD	0.92%	5.91%	3.91%	1.58%	7.52%
ELMI+	0.47%	2.23%	2.69%	-0.58%	2.71%
EMBI GD	0.43%	8.75%	12.10%	7.60%	10.47%
EMBI GD IG	-0.13%	8.08%	9.94%	6.02%	8.54%
EMBI GD HY	1.52%	10.08%	16.67%	10.44%	13.37%
5 year UST	-0.28%	2.11%	1.72%	1.94%	3.74%
7 year UST	-0.22%	4.10%	2.42%	3.25%	5.16%
10 year UST	-0.34%	6.94%	3.59%	5.48%	5.85%
CEMBI BD	0.65%	6.35%	9.79%	6.54%	9.74%
CEMBI BD HG	0.36%	6.29%	9.26%	6.46%	8.75%
CEMBI BD HY	1.24%	6.43%	10.93%	7.00%	12.86%
US HY	0.82%	5.75%	12.69%	10.48%	14.79%
European HY	0.83%	6.19%	15.61%	13.94%	17.57%
Barclays Ag	0.52%	4.72%	7.04%	2.55%	4.51%

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