January 2016

Ashmore

ANNUAL OUTLOOK 2016

Fixed Income Outlook 2016

By Jan Dehn

Introduction

2016 may well turn out to be 'Sweet Sixteen' for Emerging Markets (EM). The wobbly start for global financial markets in 2016 should not detract attention from the fact that the fundamental situation in EM is significantly better with many important shocks out of the way and major external rebalancing underway. EM growth will accelerate away from developed markets for the first time since 2011, in our view. Valuations are attractive in absolute terms with EM bonds trading at higher yields than when the Fed fund rate was 5.375% and in relative terms EM sovereign and corporate spreads over Treasuries exceed 400bps, several times previous tights. By contrast, developed markets look expensive and tired after years of excessive monetary stimulus and insufficient attention to fundamentals. The US business cycle is struggling with 'late cycle blues' and the outlook for the US dollar is more balanced than for several years.

The EM fixed income asset class likes that Fed hikes are underway and has traditionally performed well after the start of sustained hiking cycles. Flows in EM will become more two-way in 2016. Thus, as the year begins the outlook for local currency bonds – the world's most hated asset class – is the best, but EM sovereign Dollar bonds also remain attractively priced relative to developed market bonds, particularly in those EM countries that are undertaking reforms and/or dealing with temporary shocks of a political or economic nature. EM corporates risk weakness early in 2016 due to rising energy related defaults in the US high yield market, but this will be a good entry point in EM credit, because most EM energy companies are state-owned.

Contrary to the prevailing sentiment at the start of 2016, the main risks to EM and the global economy are not coming from China – after all few investors have exposure there and China has strong fundamentals. The by far bigger – systemic – risks emanate from developed markets. If the US economy begins to seriously underperform EM will have to deal with the fallout from both a US stock market correction and negative rates and/or QE from the Fed. A weaker US dollar would increase tailwinds for local bonds in EM, but pose more challenges for EM equities. If the US avoids recession then inflation is just around the corner, which would challenge the Fed on account of the strong US dollar, a heavy debt load, very low productivity and overvalued financial markets.

EM countries have significantly stronger external balances, despite lower commodity prices. Roughly 90% of EM's most traded countries have improved their current account balances by an average of 3.7% of GDP

An important cyclical adjustment

We are optimistic about EM fundamentals in 2016. Serious cyclical adjustment has been achieved in many countries. Almost below the radar, EM countries have eked out greater competitiveness and rotated their economies somewhat away from domestic demand toward net export led growth as real effective exchange rates have depreciated to the point that many EM countries are now producing significantly stronger external balances, despite lower commodity prices. At the onset to 2016 some ninety per cent of EM's most traded countries have improved their current account balances by an average of 3.7% of GDP. This is not trivial at all.

The adjustment has come about as a direct result of QE policies in developed markets and sensible policy responses in EM. QE policies have not derailed EM per se, but they certainly contributed significantly to a slowdown in EM growth by tightening financial conditions and inflicting significant currency depreciation on many EM countries. The combination of tighter financial conditions and currency depreciation is of course instantly recognisable as the central elements in conventional macroeconomic adjustment programs. Investors financed greater allocations to developed markets in response to QE by reducing exposure to EM and the resulting outflows tightened financial conditions. In turn, this weakened domestic demand and slowed growth. The result was that the excess of growth rates in EM countries over growth rates in developed economies (EM's 'growth premium') declined from more than 4.5% per annum in 2010 to just 2% in 2015.

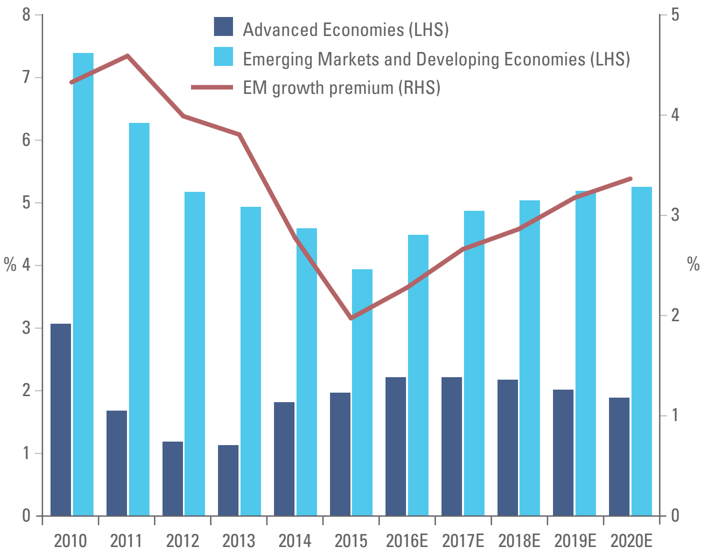
The good news is that this adjustment is now approaching completion for many countries. It is likely that 2016 will be the first year since 2011 when EM's growth premium increases rather than declines. EM countries have restored considerable external competitiveness and therefore created room to grow without risking inflation. Domestic demand will of course continue to form the backbone of EM growth, but at the margin

Ashmore

the strongest sources of growth will now come from net exports in the coming years. It is the dramatic currency adjustment (40% lower currencies with stable inflation) that is the main reason for this improvement in competitiveness.

The better growth outlook for EM versus developed markets is not likely to be a flash in the pan. Figure 1 below shows the IMF's expectation of the EM growth premium out to 2020. EM growth should continue to accelerate relative to growth rates in developed economies for several years beyond 2016 as the latter increasingly struggle with 'Mars bar' effects, that is, the combination of excessive debt levels, overvalued currencies and other problems accumulated over many years of short-term populist economic policies.[1] Another important consequence of EM's improving external balances is that EM's FX reserves will also stabilise at very high and comfortable levels in 2016, particularly if the US dollar and commodity prices also stabilise (our base case).

Fig 1: **EM growth premium versus developed markets**



Source: Ashmore, Bloomberg.

Revealed robustness

The recent commencement of Fed hikes is a particularly important positive turning point for EM. EM fixed income has priced in far more hikes than the Fed is likely to deliver in the near term. For example, local bond yields have risen by nearly 200bps since April 2013 prior to the Taper Tantrum. EM fixed income has traditionally underperformed in the run-up to a sustained phase of Fed monetary policy tightening only to outperform strongly once hikes begin. An IMF Working Paper from December 2015 finds that flows to EM are indiscriminately hit in the run-up to hike only to improve after hikes have begun.[2] This is classic EM inefficiency, which happens as markets overshoot to the downside ahead of hikes. As the uncertainty associated with the timing of hikes diminishes – the yield curve gets anchored in time – EM countries are free to return to fairer valuations.

EM fixed income has traditionally underperformed in the run-up to a sustained phase of Fed monetary policy tightening only to outperform strongly once hikes begin

Despite very negative sentiment towards EM, it is noteworthy that there has been a distinct lack of balance of payments crises, emergency IMF programs and sovereign defaults across the EM space in spite of bad price action and noxious sentiment. Argentina and Ukraine are the only two sovereigns to default out of an asset class comprising more than sixty index names and most informed observers will readily admit that these two countries are not typical of EM countries in general. EM corporates have also stubbornly refused to heed predictions of widespread defaults due to alleged balance sheet FX mismatches. There have been no classic contagion events except, perhaps, in the minds of investors, and importantly no Soros-style reflexivity (i.e. the tendency in 'old EM' for capital flight to trigger major economic crises).

EM 'accidents' are normal; buy the dips

Looking beneath the hood, there has clearly been considerable variation in performance across countries. This heterogeneity can be expected to continue in 2016. It is almost certain, for example, that a few 'decent' EM countries will get themselves into a mess in 2016, just as happens every year. EM 'accidents' happen for a variety of reasons; sometimes voters in EM elect sub-par leaders, just like their counterparties in rich countries. Sometimes even decent EM policy-makers – of which there are many – simply make mistakes. Sometimes external shocks happen. In most cases, however, the problems are temporary in nature and the quality of the policy response tends to be more important than the shock itself. Mostly the policy response is decisive and effective, not least because voters in EM countries are so intolerant of bad economic performance.[3] EM 'accidents' create temporary nervousness, but since the problems tend to get fixed such episodes usually turn out to be good investment opportunities as the chart below suggests.[4]

Fig 2: **Recent EM panics: Spreads at the peak of the panic and post-panic**

Country and year of market panic	Spread at peak of market panic (bps)	Spread one year later
Russia (December 2014)	700	258
Turkey (January 2014)	343	204
Indonesia (October 2013)	377	219
India (2013)	376	130
South Africa (December 2015)	439	–
Brazil (December 2015)	559	–

Source: Ashmore, Bloomberg.

1 See Weekly Investor Research, 14 December 2015.
2 Swarnali Ahmed, *'If the Fed acts, how do you react? The lift-off effect on capital flows'*, IMF Working Paper, WP/15/26, December 2015.
3 This is because voters in EM tend to be poor with few or no means of softening economic blows.
4 Recent examples of how cyclical problems or shocks that have induced decisive policy changes include India's alleged 'Fragile Five' stagnation in 2013, the brief market panic over Turkey in early 2014, Russia's tiff with the West over Crimea in late 2014 and China's stock market volatility in H1 2015. Remarkably, in the case of China, markets appear to worry because the country is reforming.

Pay particularly attention to the ugly – they deserve it

EM has its share of genuinely 'ugly' countries and 2016 is certain to produce some juicy headlines from this category of countries. Large permanent losses, however, tend to be extremely rare even among the most challenged EM countries and they can certainly be ameliorated with active management. EM's seriously challenged countries are particularly interesting, because they also tend to be those countries that have the highest potential for returns, because high beta credits in general tend to be the most mispriced of all EM credits. 2015 was a case in point: Figure 3 shows the best performing EM fixed income markets in 2015. Among the best performing we find a strong dominance of the most risky credits, but all the countries in this list strongly outperformed US fixed income markets last year, in some cases by many orders of magnitude.

Fig 3: **2015 USD total return (%)**

Ukraine	40.55
Argentina	26.76
Belarus	22.52
Russia	21.99
Venezuela	17.33
Belize	11.04
Jamaica	9.71
Honduras	7.95
Pakistan	7.64
Serbia	7.17
Kazakhstan	7.02
Hungary	5.53
Georgia	4.76
Latvia	4.66
Armenia	4.63
India	4.01
Lithuania	3.84
Croatia	3.14
Philippines	3.10
China	3.03

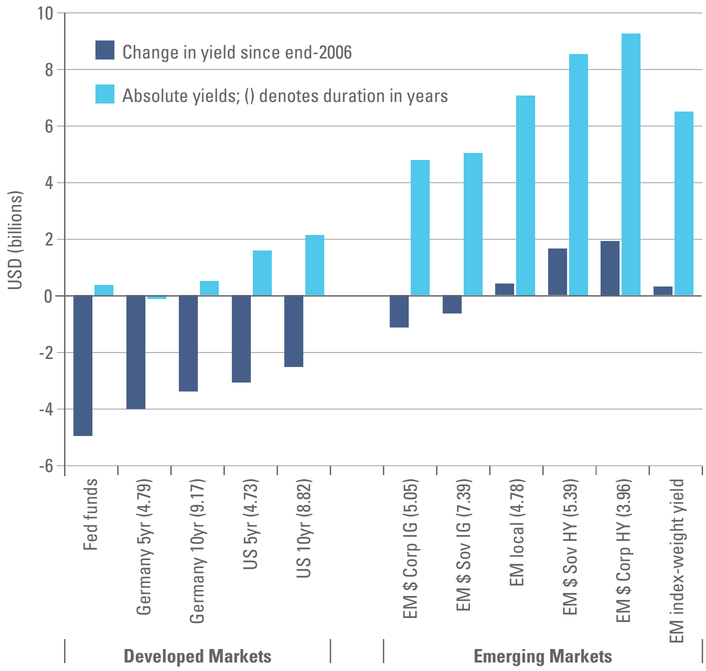
Source: Ashmore, Bloomberg, JP Morgan.

Attractive valuations

The improving cyclical picture for EM as a whole should provide a reassuring fundamental backdrop for investors looking to take advantage of what is now an attractively valued asset class. After years of little or no investor sponsorship EM bonds are cheap by almost all conceivable standards. Figure 4 compares absolute yields and the change in yields since the end of 2006 for EM and developed economies. A few points are worth highlighting:

- The average yield across EM fixed income is today *higher* in absolute terms than in late 2006 when the Fed had pegged interest rates at 5.375%.
- Local currency bonds as well as HY corporate and sovereign Dollar-denominated bonds in EM now pay higher absolute yields than before the Subprime Crisis.
- Even EM IG sovereign and corporate bonds now pay markedly higher absolute yields than IG sovereign bonds in developed markets (yields between 340bps and 510bps).

Fig 4: **EM and DM yields**



Source: JP Morgan.

FX outlook less directional, but more volatile

Currencies form a big part the total return in local markets and sentiment in currency markets also tends to infect sentiment in EM's Dollar markets. It is therefore encouraging that the outlook for EM currencies now looks better than for some time. That is, we think the main phase of EM FX weakness is behind us, partly this is due to the aforementioned external rebalancing in EM, but also because the outlook for the US dollar is slowly changing.

The US dollar has rallied strongly in the past few years mainly on the back of anticipated stronger US growth and anticipated Fed hikes. But the Dollar has increasingly become a victim of its own success as policy makers have neglected fundamental reform and companies have bought back stock instead of investing. Our base case scenario is therefore that the Dollar is more stable this year than in the past few years and that in turn means a more balanced outlook for EM currencies. Local bonds in EM become particularly attractive on account of their 7%+ yield.

US inflation arrives in late 2016 or early 2017. This poses major problems for the Fed, but will not be traded until it actually happens. So be ready. Having said that, whether inflation arrives on time is increasingly a legitimate question. US dollar strength is impeding growth and the pace of Fed hikes much more than we had even anticipated. US manufacturing and the HY show strong symptoms of 'late cycle blues' so the Fed may well end up cutting rather than hiking in 2016.

How are the risks to EM currencies tilted around this base case of US dollar stability in 2016? Possibly strongly to the upside. The US dollar is the one remaining meaningful easing option available to US policy makers, so a mild manufacturing or HY-led recession in America could quickly usher in a weaker US dollar policy, initially through a quick reversal of the Fed's December rate hike and then a plunge into negative rate space. A strong argument for a weaker Dollar is that it would no longer pose the same major fiscal risks that a weak Dollar would have posed a few years ago. After all, America's net foreign financing needs are now much smaller.

The other upside risk to EM currencies versus the US dollar is that US inflation re-appears sooner than expected. Inflation would impale the Fed on the horns of a dilemma by forcing it to decide whether to hike decisively to crush inflation in its infancy, but in so doing risking to hurt an indebted, uncompetitive economy with bloated financial markets, or to live with higher inflation while protecting tepid growth. Our view is that the Fed would ultimately favour growth over inflation if forced to choose. Given the many neglected structural drags on the US economy there is very little room to achieve both targets at the same time.

There is one fly in the ointment. FX may become less directional, but it will also be more volatile. QE has pushed bond yields to zero and at zero yield currencies are arguably more attractive than bonds, because they pay the same yield (zero), but currencies offer greater liquidity and no credit risk. This simple observation suggests more and more money will enter FX markets from asset markets with the effect that overall investment horizons shorten across all markets. Moreover, the ascendency of currencies is only beginning. In the medium-term FX directionality will resurface as inflation re-emerges in the QE economies. The still-enormous global savings and investment imbalances will unwind via currency re-alignments on a global scale. This process will strongly favour non-QE currencies; we see this part of the global FX story starting in late 2016, barring as US recession.

We believe the main phase of EM FX weakness is behind us, partly due external rebalancing in EM, but also because the outlook for the US dollar is slowly changing

Fewer incremental macro shocks ahead

Ask yourself this question: If you wanted to truly 'sink' EM countries what would you do to them? You would probably unleash a series of shocks that would include: a massive US dollar rally, a 60% collapse in commodity prices, massive outflows and the start of a Fed hiking cycle. The good news, of course, is that all these shocks are now a thing of the past and as noted previously most EM countries have shown considerable robustness. The robustness justifies greater investor confidence in the asset class.

2016 will undoubtedly dish up plenty of new shocks for EM to contend with. The main source of shocks will of course continue to be the developed world on account of bad economic policies, lack of reforms and far too much debt. EM investors should be vigilant of such events and be ready to allocate far more to EM if developed economies blow up. Truly systemic risks to the global economy today can only come from developed markets.

Among the potential shocks to hit EM in 2016 see the following:

- The US treasury curve will certainly move about. Much of the movement will be the consequence of fairly innocuous speculation around FOMC meetings and major US data releases. But there is a more serious risk that markets have not adequately priced in, in our view, namely inflation risks in the QE economies in general and in the US in particular. Inflation is eventually likely to materialise as a result of the hyper-easy monetary policies being pursued in the developed economies. In the US, the first QE country likely to see inflation return, inflation would pose major risks to the shape of the yield curve and the Dollar

The main source of shocks will continue to be the developed world on account of bad economic policies, lack of reforms and far too much debt. EM has shown considerable robustness in the face of past shocks

because the Fed will likely be seriously constrained in its policy response to inflation by excessive debt, low productivity, bloated financial markets, the size of its balance sheet and an overvalued exchange rate. The pace of hikes will be very slow and if inflation returns more quickly that the Fed can hike (due to the tepid economy) then the yield curve will have to reprice by bear steepening. This will have to be accompanied by more financial repression to prevent a housing market collapse, in our view.

- US credit markets are likely to see higher default rates in 2016 than EM credit markets as lower commodity prices push more US firms into bankruptcy. EM commodity extractors face the same commodity prices shock, of course, but they tend to be state-sponsored quasi-sovereigns with a sovereign backstop. They will for the most part avoid default. And that makes all the difference from an investment perspective; EM quasi-sovereigns will not suffer as large permanent losses as private energy corporates in the US and any temporary weakness in EM corporate spreads imparted by selling of the over-owned US HY asset class should be bought.
- Political risks within developed markets are becoming ever more serious. The US election is already now looking as if it will offer voters a choice between 'more of the same' (Clinton) or far-right populism (Trump). Europe's failure to deal with a problem as simple as Syrian refugees is already closing the borders that took decades to pry open. A UK referendum on EU membership would only add to concerns over Europe. In Japan, the odds of an early election are rising, while the marginal effectiveness of further stimulatory policies wears off.
- Geopolitical tensions (political risks between as opposed to within countries) will continue to rise. Low quality policy-making combined with deeper economic malaise in developed countries is increasingly worsening social tensions. Rich are pitted against poor, residents against immigrants and voters against their politicians. The net effect favours populists over reformers, which in turn increases the risk of economic nationalism and confrontational foreign policies. The only silver-lining is that developed economies no longer have the economic or military might to impose their will on a large number of EM countries as they did during the decades of the Cold War. In any case, EM countries will be passive. They will increasingly work together. The most visionary and advanced of all EM countries, China, will continue to lead from the front by pushing for – and winning – an ever greater role within the global political economy.

Structural challenges in EM: An important qualification to public perceptions

Most EM countries remain far less structurally challenged than in the past, particularly in the period immediately after the Cold War. EM countries are also far less structurally challenged than developed countries. They grow faster (despite externally induced drags), have lower debt, own more reserves and have much better demographics. Above all, their economies and markets are not addicted to cheap money from QE programs.

Yet, EM countries have to deal with repeated allegations that they do not address structural problems. Yet, EM countries overcome structural hurdles all the time. Some of this is achieved via explicit reforms in response to economic necessity. China is undertaking more structural reforms than all the world's countries put together, including interest rate liberalisation, bank reform, capital account liberalisation, privatisations, RMB inclusion in the SDR, SOE reform, etc. India has undertaken draconian measures to cut red tape, improve infrastructure and fix bank balance sheets. Brazil has removed currency controls and removed subsidies. Colombia has changed the tax regime for foreign investors and undertaken major reforms of the public finances. Russia made its local bond market Euroclearable and changed its exchange rate regime after the 08/09 oil price crash. Mexico changed its constitution to allow private investment into its oil sector. Saudi Arabia has opened its markets to foreign investors etc., etc.

> EM countries are far less structurally challenged than developed countries. They grow faster (despite externally induced drags), have lower debt, own more reserves and have much better demographics

But there are equally if nor more structural changes that occur in EM without explicit government involvement. These processes are continuous and ongoing and they constitute one of the main avenues of global economic convergence. They are the discrete decisions taken by firms, governments and households to do things for the very first time. Examples of this kind of structural progress are almost too many to count. They happen when governments and corporates enter capital markets for the first time, when savers enrol in pension systems, when mobile phone technology spreads like wildfire through previously unconnected populations, when whole new economic sectors emerge out of nowhere, when workers move from informal to formal employment, when new roads and ports get built, when girls get educated, when women join the labour market, when remote villages get access to clean water and electricity, when urban manufacturing and services industries replace primary industries, when credit markets deepen and broaden, when courts replace mob justice, when policy makers make mistakes and learn, etc.

China – the world's leading reformer

China is reforming. A lot. This in itself is an excellent reason to be bullish on China, because the country is putting itself in a position to grow where others will stagnate sooner or later. But China's outlook is also good, because the country has a bright future ahead of it as a consumption-led economy, because of its saving rate of nearly 50%.

China's adoption of a more flexible exchange rate (pegged to a basket of currencies instead of the US dollar) is making markets nervous and encouraging some speculation. But it is eminently sensible that China does not fall into the trap of pegging itself to a currency that is clearly getting seriously overvalued. Besides, the short-term volatility in the RMB is likely to wane as directional currency bets are neutralised and more institutions become involved in the onshore markets in China. There is no strong argument for a very large directional move in the currency nor do we think China wants to 'rock the boat' with just 10 months until formal adoption of the RMB into the SDR in October 2016. China will continue to open its capital markets to the rest of the world. We expect a growth rate of about 6.5% in 2016 aided by fiscal stimulus.

Markets will undoubtedly fret about China again this year, because markets tend to get nervous when EM countries reform aggressively, not least because it causes growth to slow when consumers and investors delay spending decisions to see where the chips land. Still, with a population more than four times that of the United States and a growth rate three times as fast as the US China's per capita income will catch up with that of the US before the middle of this century. At that point, China's currency and government bond markets will have replaced the US dollar and the US treasury market as the world's benchmark currency and bond markets.

All investors need to have a China strategy and this realisation will drive flows into China in 2016 and beyond. China will help to bring this about by pushing hard to get her markets included in the main benchmark indices.

Argentina – are you ready for romance?

What do Brazil, Venezuela and Argentina have in common? They were all led by populist governments whose policies were exposed as both economically and politically unsustainable by relatively modest external and domestic headwinds. All three countries are now undergoing major political changes, though only Argentina has completed this political transition. Argentina is now run by one of the strongest economic teams in the whole of EM and it would not surprise if investors were to fall in love with the country. That is not to underestimate the challenges facing the Macri administration. The economy is very far from equilibrium. President Macri does not command a strong position in parliament, but he has made a strong start and the main focus in 2016 is likely going to be to restore normal relations with the global financial system. Once this hurdle has been scaled we see no reason why Argentina cannot tap markets to help smooth the transition back to economic equilibrium. If so, the country can yet offer significant reward to investors.

India – steady as she goes

India will implement GST in 2016. It is difficult to overstate the importance of this reform. Today India functions like a de facto collection of autonomous states, each with their own barriers to trade because of an archaic tax structure. GST will create a single market in India, which in turn will increase the scope for economies of scale in nearly all industries across the country. Meanwhile, the economy is likely to continue to grow strongly with modest inflation as consumption picks up and the government persistently unravels red tape and removes other administrative obstacles to investment. We also expect the RBI governor Raghuram Rajan to continue to work quietly behind the scenes to prepare India's banking institutions – and more importantly its entrenched interest groups – for a more open fixed income market.

Iran – sanctions come down

Iran is the main beneficiary of the new US Middle East of dividing the region along Sunni-Shia lines instead of along Arab-Israeli lines. For international investors, this has certain advantages, but also poses risks. Iran will start a long journey out of international isolation. It is a large country with a population greater than France and a well-diversified economy. Iranian businesses will desperately be seeking external financing and international investors should actively explore opportunities to provide such financing at a price acceptable to both. Saudi Arabia will not be comfortable with the US policy towards Iran and may want to force the US to prove its loyalty towards the Kingdom. This may increase tensions regionally, but it also means that Saudi Arabia will continue to open its markets to foreign investors. Net net, the EM universe continues to grow.

EM countries with serious structural problems are few and far between. They are known and their associated risks are priced in

The most challenged EM countries

Structurally risky countries are rare in EM, but their predicament can infect sentiment about the whole asset class. The worst countries in EM almost all suffer because of extremely poor policy choices, often quite deliberate, which in turn are caused by excessive dependence on single commodities combined with acute domestic political divisions that compels them to sacrifice the long-term needs of the economy in the pursuit of short term political objectives.

Such countries pose major risks to investors and warrant particular vigilance. At the threshold of 2016, the good news is countries with such serious structural problems are few and far between. They are known and their associated risks are priced, although one can debate if they are priced correctly. The simple fact that these countries are known to be risky makes them far less risky than, say, so-called 'risk free' countries where risks are not even perceived (the latter are almost all in the developed world).

EM's challenged oil exporters

One of the most challenged groups in EM at the start of 2016 is the oil exporters. The vast majority of EM countries import oil, so their conditions have actually improved sharply. Not so the exporters. Even before oil prices began their precipitous decline the oil exporters found themselves in a risk class of their own. They are less economically diversified (due to Dutch Disease that wipes out non-oil sectors). Many have authoritarian governments. This combination means that their economic crises tend to go hand in hand with political crises. As sharply lower oil prices have thus brought these vulnerabilities to a head how should investors think about EM's oil exporters in 2016?

Firstly, it is critical to distinguish clearly between fundamentals and asset prices. Oil countries are likely to offer the most compelling returns in 2016 in spite of lower oil prices provided they take the right policy measures. This is exactly what happened to Russia in 2015. The lesson is clear: Oil prices per se do not matter; what is far more important is each country's level of preparedness for lower oil prices, the quality of its policy response once the shock arrives and the extent to which markets have mispriced the credit.

Second, investors need to recognise the specific policy moves that change a particular credit from a sell to a buy. The best managed oil countries tend to pay down debt, accumulate reserves and fix their exchange rates during periods of high oil prices. When oil prices fall they then quickly let their currencies go and restrict domestic demand using fiscal and monetary policies until demand is in line with (lower) national income. Reserves and the public finances in the best managed oil countries therefore remain healthy. Badly managed countries can primarily be identified by their refusal to adjust. Sooner or later this means that they run out of reserves or accumulate excessive debt both of which bode very badly for investment returns.

Going into 2016, we remain positive on Russian Dollar credit as Russia still occupies that spot of best managed of EM oil credit. We are negative on Nigeria because the policy response has been dreadful and markets have simply not priced the risks adequately yet. We are bullish on Venezuela despite poor economic and political conditions, because the credit is now so cheap that investors will make money even if the country restructures its debt. Most other EM oil credits sit within the extremes defined by Russia and Venezuela and they will become interesting directional plays in 2016, including Malaysia, Kazakhstan, Ghana, Ecuador, Azerbaijan, Saudi Arabia and other GCC countries as well as Colombia.

Brazil – the fixed income opportunity of 2016

Brazil's economy will continue to contract in 2016, but inflation will also finally begin to respond to very high real policy rates and collapsing real wages. Or to put it slightly differently, Brazil's fixed income markets will bottom out this year, so this is the time to build major positions. Brazil's current account deficit is already covered by FDI inflows and in 2016 Brazil may even reach a current account surplus. It is clear that Brazil will neither have a balance of payments crisis nor default. There is major upside risk if President Dilma Rousseff is impeached, because this would introduce a technocratic administration with the mandate to put in place reforms to ensure that the mistakes of the recent past are not repeated. More patient investors should even begin to bottom fish in the stock markets in Brazil in 2016, but there is less urgency compared to the fixed income markets.

Regarding oil credits, we remain positive on Russia as well as Venezuela (despite poor economic and political conditions). Other EM oil credits will become interesting directional plays in 2016

Turkey – reforms versus populism

Turkey has the potential to take a seat at the table of the world's biggest financial powers, but to do so the country must change. 2016 will be the year when President Erdogan makes his choice. The government's ambition is admirable – to place Turkey on an Asian-style development path, but this requires the satisfaction of two fundamental conditions that Turkey currently does not satisfy. Firstly, Turkey must implement a program of aggressive supply-side reforms to improve productivity and key institutions so as to ensure the most efficient possible allocation of capital.

This includes greater central bank independence to set monetary policies. Asia's political leaders were able to deliver sustained strong economic performance by defining the broad brush strokes of economic policy, while letting a strong technocratic civil service devise the most effective way of achieving the objectives. Secondly, Turkey must dramatically increase its domestic savings rate. Asia grows fast, because it has high investment rates financed by high domestic savings rates. Turkey has very low savings rates and therefore relies on extremely unreliable foreign savings, which, if anything, could become scarcer as global financial conditions tighten. The promotion of a domestic savings base in Turkey inevitably requires development of a deep and broad Turkish Asset management sector with the highest level of global knowhow.

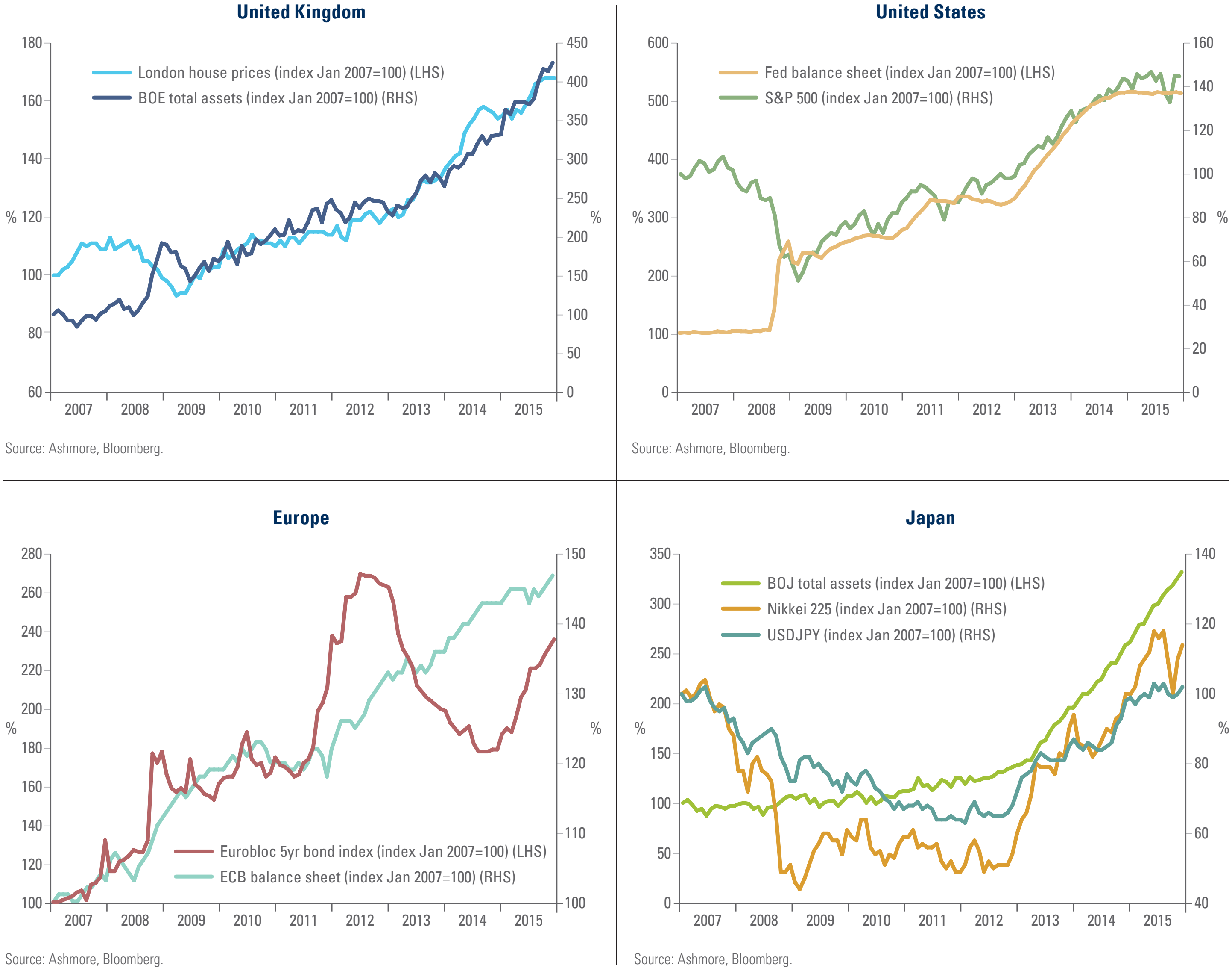
South Africa – never did a Budget matter so much

President Zuma was served a cold dish of political accountability in late 2015, when his attempt to replace the finance minister with his choice of political 'yes man' was thwarted by a backlash from a broad swathe of South Africa society. Good. The focus in early 2016 will now squarely be on the 2016 Budget, whose quality will indicate whether current Finance Minister Pravin Gordhan has the political clout to continue South Africa's erstwhile orthodox line on fiscal policy. South Africa stands before a kind of economic Rubicon – whether it returns to the sound and forward looking economic policies that characterised the early post-Apartheid years or to let populism emanating from the highest levels in government set the country on a path akin to Brazil's.

Global backdrop: Diminishing returns in developed markets

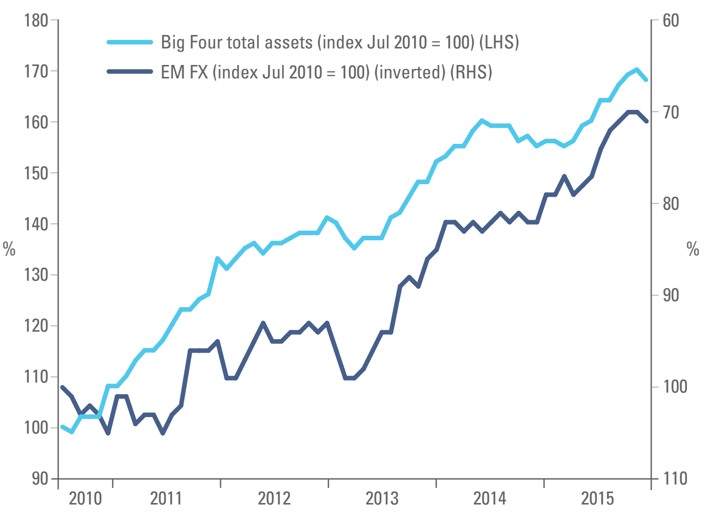
Almost all the price action in global financial markets in the past five years can be explained directly or indirectly by the programs of unconventional monetary policy pursued by the 'Big Four' QE central banks (Fed, ECB, BOJ and BOE). Combined asset purchases of more than USD 11trn combined with carefully constructed narratives guided institutional money to chase the US stock market, Europe's bond market, housing in the UK and a weaker JPY in Japan.

Fig 5: **Big Four: QE programs and their target markets**



What about EM during this period? None of the 'Big Four' QE central banks bought even one Dollar of EM assets and no EM central bank engaged in QE. Needless to say, EM had no sponsorship. If anything, the old prejudices of EM as a derivative asset class whose very survival hinges on foreign portfolio investor flows, high commodity prices and low US interest rates made a powerful renaissance mainly because it suited the direction of QE-related flows. Global asset allocators bought into all the narratives on offer by increasing their exposures to the subsidised markets in the developed economies and funding these purchases by reducing exposure to non-QE markets, notably EM. The resulting portfolio shift – a portfolio shift of global proportions – ensured that the prices of bonds and stocks in developed economies outperformed, while EM assets underperformed. This was particularly the case in EM currencies, whose performance has been an almost perfect inverse reflection of the combined asset purchases of the Big Four QE central banks.

Fig 6: **EM FX and Big Four asset purchases**



Source: Ashmore, Bloomberg.

Tired QE valuations, perky EM valuations

The single biggest difference in global financial markets in 2016 compared to previous years is that developed markets and EM are starting out with such radically different valuations. The consensus QE trades of the past four years have begun to lose their potency and hence their upside potential. US stocks ended up negative in 2015, USDJPY did not move at all, nearly half of European government bonds now trade with negative yields and in the UK house price appreciation peaked in Q3 2014.

Hyper-supportive monetary policies are likely to continue in the QE economies, but their impact on asset prices at the margin is waning, even turning negative.

The exhaustion of these markets is a natural consequence of repeated stimuli without accompanying reforms or deleveraging. Asset prices have simply become very inflated relative to fundamentals.

This idea may be simple to grasp, but it leaves investors in the QE markets with a difficult question: where to find the next 10%? The answer, of course, is self-evident: Take profits in the QE markets and rotate them into the non-QE markets.

Asset allocation from a great height

Try to look back on today's bond markets from an imaginary point in the future. It is likely that very little of what we see in today's financial markets will make very much sense. QE and zero interest rates policies will be seen for what they are; a drunken night on the town. Memories of the hangover – in the form of inflation, currency weakness or both – will be far more vivid. After all, if QE policies actually made people rich we would all be sitting on the beach next to a printing press, sipping a cold drink.

In 2016, developed markets and EM are starting out with such radically different valuations. The consensus QE trades of the past four years have begun tolose their potency and hence their upside potential

A glance back to the present from some imaginary point in the future will also put fixed income markets into sharp perspective. In the early 1980s, 10 year UST yields were 16%. Today they are barely over 2%. It is likely that the 30 year rally in fixed income is over. The right investment decision for the long term is therefore to sell bonds and put money into equities instead!

Except, of course, it is not quite as simple as that; for one, the timing of the inevitable collapse of fixed income markets is far from clear. Also, there will undoubtedly be cyclical ups and downs along the way during which it will be beneficial to have some fixed income. And of course it is entirely possible that the fixed income rally continues indefinitely! For all these reasons it is advisable to have some fixed income the portfolio.

The question then becomes what fixed income? This answer will largely depend on how global economic conditions normalise. Barring outright defaults on government debt in developed economies the most likely outcome is that the QE economies will have inflation and devalue their way out of their debt problems in preference to inflict horrible austerity and reforms on their populations. This strategy has the distinct advantage that it works politically; inflation and currency debasement would pass the cost of adjustment to future generations and foreigners neither of whom votes in elections. US inflation is probably going to be upon us as early as late 2016 or early 2017.

When global currency realignment arrives how will EM central banks respond? EM central banks hold a pivotal role, because between them they control some 80% of global currency reserves. Today some 97% of all global currency reserves are invested in the four QE currencies. Central banks jealously guard their reserves, so they will do everything in their power to protect their purchasing power. This means that when QE currencies go down central banks will have no choice but to allocate to non-QE currencies.

There will be nuances in the debasement of QE currencies, not least because they face different inflation outlooks. Not all QE currencies can therefore depreciate at the same time, nor will all EM currencies be equally affected because many are not big enough yet individually, though as a block they represent a formidable and easily investable asset class. What seems clear, however, is that RMB will be big and can become a new anchor for global currencies and many Asian currencies would form part of such a block. The US dollar can fall against EUR if the US has more inflation (and a looser central bank mandate, including possibly a higher inflation target. All CEMEA EUR-proxy currencies could benefit together with the EUR and thus present opportunities.

China has clearly figured this out. Everything China is doing right now is aimed at preparing its economy for the coming collapse in QE currencies, including qualifying the RMB for inclusion in the SDR. RMB is likely to double in value versus the USD over the next 10 years as the global currency realignment gets underway.

That makes China extremely interesting for fixed income investors. RMB appreciation will slow China's growth by making Chinese exporters less competitive. A stronger RMB will also cause inflation to fall, so PBOC will cut rates. In other words, China is very much a fixed income trade. China's markets are opening and will be part of global benchmarks. Technicals over the medium to long term are mind blowing. Other major EM countries have the same potential as China to become global reserve currencies and their local bonds market will be attractive.

EM central banks hold a pivotal role in global currency realignment because they control roughly 80% of global currency reserves. When QE currencies go down, central banks will have no choice but to allocate to non-QE currencies

For smaller EM countries whose currencies will not be targeted by central banks the experience of global currency realignment will be a different one. They will not experience crippling currency appreciation as central banks shun their less liquid currencies. Instead, they will benefit from a weaker US dollar, particularly if they are commodity producers. Frontier market equities will be particularly favoured, while small cap markets will perform strongly in larger EM countries, where domestic demand will slowly replace exports as the main growth drivers.

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

Riyadh
T: +966 11 483 9100

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