

2017 Emerging Markets outlook

By Jan Dehn

We present Ashmore's outlook for fixed income and equities in Emerging Markets (EM) in 2017. EM performed well in 2016 despite the expectations of draconian trade wars, three Fed hikes and very strong US earnings growth in 2017. None of these is likely to materialise to the expected extent. Given this excellent entry point the outlook for EM fixed income in 2017 is one of the brightest in several years. Beyond the good entry point, there are good prospects for exceptional performance next year due to stronger growth, excellent valuations, currency appreciation and benign technicals.

We particularly like the outlook for much maligned EM local currency bonds, although high beta credits in sovereign space should also do well. Corporates should deliver decent returns on the back of falling default rates.

The major innovations in the global backdrop compared to recent years are the return to deficit spending in rich countries and modestly rising inflation in the US. These two developments will prove positive for EM by restoring the positive correlation, which has traditionally existed between US stocks and EM fixed income. As such, the pullback in EM markets versus US markets in Q4 2016 clearly presents a buying opportunity.

The biggest risks to EM emanate from developed economies, where political, economic and financial constraints slowly become more pressing. However, EM bond markets have already priced in the Fed's likely path for rate hikes and will prove resilient to developed market events. EM-specific risks are declining, idiosyncratic and best mitigated with active management.

We are also cautiously optimistic about EM equities on the back of better macroeconomic drivers and very compelling valuations. Our slight hesitation with respect to equities reflects the potential for negative beta effects emanating from political risks in developed economies.

Introduction

The outlook for EM fixed income going into 2017 is the strongest in several years. EM fixed income performance improved sharply in 2016 despite a late pull-back on Trump and Fed related fears, but fundamentals are solid and the foundations are in place for sustained performance for several more years.

We expect capital flows to EM to turn positive in 2017 as growth picks up, reforms bear fruit and headwinds turn to tailwinds for EM's commodity exporting countries. Yields are extremely attractive in absolute terms and relative to those on offer in developed markets. Finally, technicals look very solid. All this implies that the pull-back in Q4 2016 is an excellent entry point, since the market is pricing in draconian trade wars in EM, a generous number of US Fed hikes and a more bullish outlook for the Dollar and earnings than is likely to materialise under current economic conditions.

The biggest source of volatility for EM asset prices in 2017 will come from economic and political developments in developed countries. The most significant changes to the global backdrop in 2017 compared to previous years are likely to be the return of US

inflation and fiscal stimulus both of which will prove extremely painful for overbought developed bond markets. This should usher in a return to the positive correlation, which has traditionally existed between US stocks and EM fixed income as further reductions in exposure to developed bond markets support flows to both US stocks and EM fixed income, where duration is shorter, yields higher and debt levels much lower.

Having withstood multiple tantrums in recent years EM economies are now extremely competitive. We therefore expect them to weather the shocks coming at them from the developed world comfortably. As usual, EM shocks will be mainly idiosyncratic, country-specific and small in number. To the extent they occur they are best mitigated via active management.

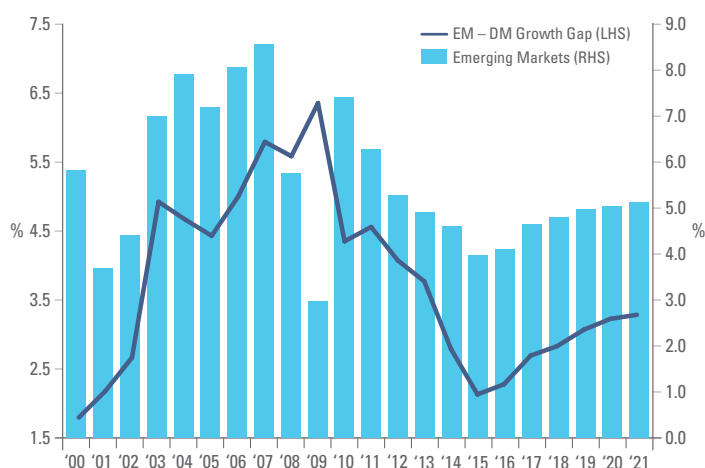
We also see a strong value case for EM equities in an environment of improving macro drivers following the longest earnings recession on record. Our cautious optimism is only tempered by the expectation of political volatility in developed economies. We believe active management will still be critical to generating returns in EM equities in 2017.

EM fixed income outlook for 2017

The case for EM fixed income in 2017 rests on the five pillars of better fundamentals, higher yield, strong technicals, currency upside and, for the nimble investor, a great entry point in late 2016 or early 2017.

EM **growth** is likely to pick up to around 4.5% in 2017 compared to about 4.0% in 2016. This pushes the EM growth premium to about 3% in 2017 from 2.5% in 2016.¹ This assumes marginally stronger growth in developed economies of 1.8% as they re-engage in fiscal spending. Stronger developed market growth provides a mildly positive backdrop for EM exporters, but will also usher in more inflation, especially in the US.

Fig 1: EM absolute real GDP growth and EM growth premium



Source: Ashmore, IMF.

The primary source of EM growth in 2017 will still be the considerable competitiveness advantage carved out by EM economies in recent years on the back of declining inflation and weaker currencies. However, we also expect three new growth drivers to become important at the margin. Firstly, capital flows will turn positive following better relative risk-adjusted returns compared to most developed fixed income markets in 2016 (see table below). Easier financial conditions will in turn support the gentle upswing, which is already underway.

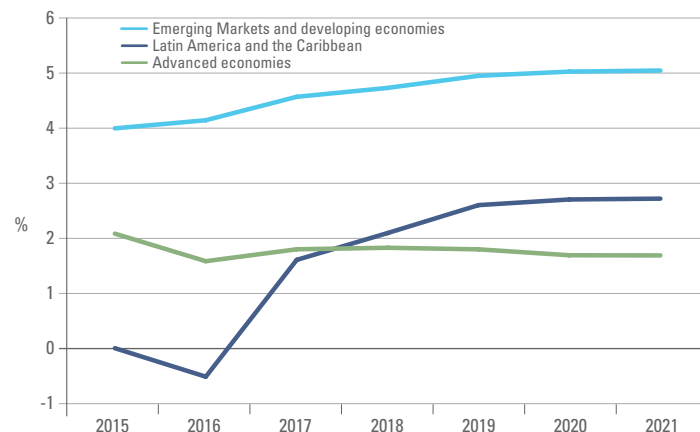
Fig 2: Sharpe Ratios (2016)

Market	Sharpe Ratios 2016
EM corporate debt	4.4
EM external debt	1.7
EM local currency bonds	0.8
US 5yr bonds	0.2
US 10yr bonds	-0.1
US 30yr bonds	-0.1
German 30yr bonds	0.6
Japan 30yr bonds	0.8

Source: Ashmore, JP Morgan, Bloomberg (Date as of close of business 15 December 2016).

Secondly, Latin America's deep economic adjustment and reforms over the last couple of years will start to bear fruit and return the region to positive growth. Reforms elsewhere, including India, Indonesia and China will also support the improving growth story, while the end of the election cycle in the CIS countries will impart greater stability. Thirdly, the stabilisation of commodity prices should breathe life into heavily commodity-dependent countries in Latin America, Africa and parts of the Middle East.

Fig 3: Latin American growth versus EM and developed economies

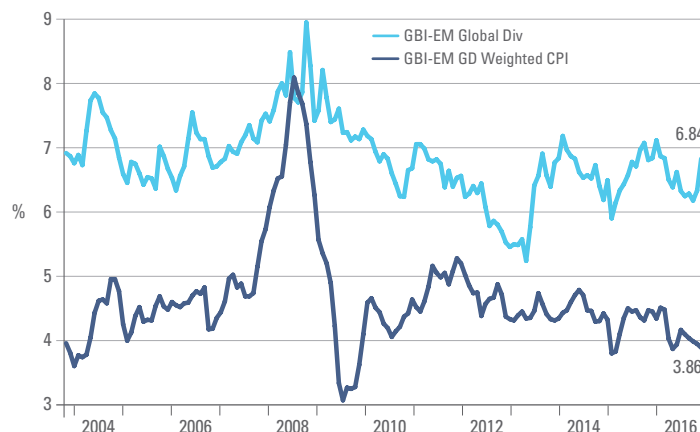


Source: Ashmore, IMF.

EM **bond yields** are extremely attractive as we head into 2017. They are high by historical standards, high in real terms and high compared to yields on offer in developed economies. At 6.82% EM local currency bond yields are currently higher than when the Fed had rates at 5.25% in late 2006. Just shy of 3% real yields in EM local bond markets are now more than 35% higher than their historical average during much of which the Fed maintained substantially higher policy rates than today. The combination of high nominal yields and a 140bps decline in EM inflation since 2011 gives EM central banks plenty of room to ease policy – and many will do so in 2017, some by a great deal, in our view. This promises returns to investors and insurance to EM economies.

In EM's Dollar-denominated debt space we also see value as sovereign spreads continue to hover at levels, which are about twice as wide as before the 2008/2009 crisis. EM high yield corporate bond spreads pay investors some 200bps more than they did in 2006/2007.

Fig 4: EM local bond yields and inflation: GBI EM GD weighted



Source: Ashmore, IMF.

¹ The EM growth premium refers to the excess of EM growth rates over growth rates in developed economies.

In addition to better fundamentals and attractive yields, we see EM fixed income technicals as extremely benign. We therefore expect positive flows to EM fixed income in 2017 for the first time in many years.

As the table below shows, institutional investors ought to have at least 58% in EM fixed income on a GDP-weighted basis, or for those who care about market size, 20% on a market-cap basis. In reality allocations are probably some ten times lower.²

Fig 5: EM share of global fixed income and GDP

USD trn	Global	DM	EM	EM Market cap-weighted share	EM GDP-share
Debt securities	96	78	19	19%	58%
Loans	87	58	29	–	–
Total	183	135	48	–	–
Share of global GDP (%)	100%	42%	58%	–	–

Source: Ashmore, BIS, IMF (Data as of end-2015).

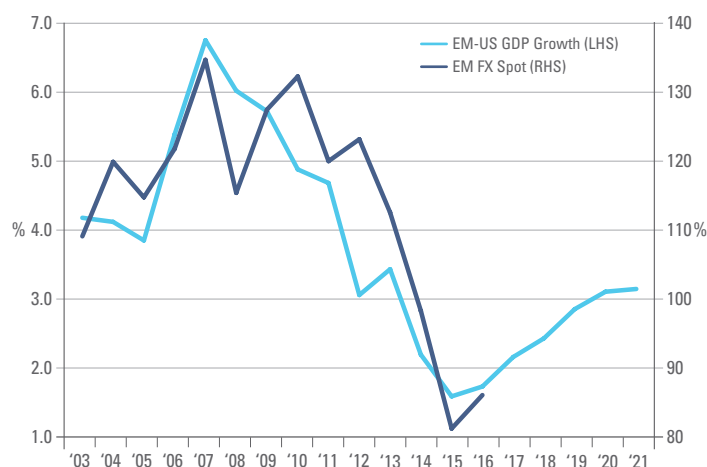
The real significance of the light positioning in EM fixed income as far as 2017 performance is concerned is that sell-offs in response to bad news will likely continue to be very shallow, while upside risks are substantial as flows return. This protects investors from downside risks. Remember that EM fixed income today is mainly owned by domestic real money investors, who tend to buy dips but otherwise do not do much. Foreign real money actually sold EM fixed income in net terms in 2016, although flows began to stabilise towards the end of the year. Fast money largely departed the asset class in the aftermath of 2013.

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Despite the solid fundamental and valuation case for EM we expect flows back to the asset class to turn positive in a gradual manner, not least because investors grapple with fears pertaining to their excessive allocations to developed markets at unattractive valuations, particularly in fixed income. A bit of fear is not a bad thing, however, because a steady trajectory for EM returns is precisely what the asset class needs after the exaggerated volatility of recent years.

We expect **EM currencies** to become a more important driver of total fixed income returns in 2017. As at the time of writing, EM currencies are largely flat against the Dollar in 2016 and they outperformed both JPY and EUR. The late-year pullbacks in November on Trump and in December following the hawkish Fed provide a great entry point, but there are also three other strong reasons to be more bullish on EM FX going into 2017. First, as figure 6 shows, the EM growth premium, which will increase again next year, is closely correlated with EM FX.

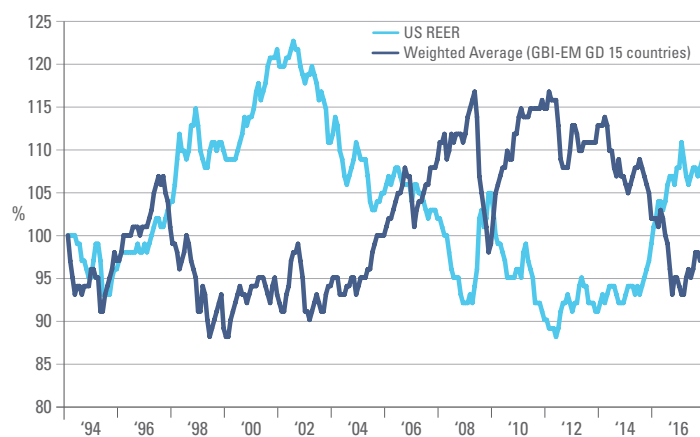
Fig 6: EM growth premium and EM FX (vs USD)



Source: Ashmore, IMF, JP Morgan, Bloomberg.

Second, EM FX is extremely cheap on a real effective exchange rate (REER) basis with REERs back to levels last seen in 2003. That year marked the start of the last great EM local currency bond rally. Incidentally, the Dollar is also very expensive now after all the money that has flowed into the US and bloated valuations and undermined productivity. Needless to say, if, as we expect, EM FX appreciates against the Dollar in 2017 this only adds to the attractiveness of EM's high yielding local currency bonds.

Fig 7: Real effective exchange rates: EM and US



Source: Ashmore, BIS (data as of October 2016 prior to late-year Dollar rally).

We see current market conditions as a great **entry point** for EM fixed income. The modest pullback in EM in Q4 was due to a cocktail of profit-taking, uncertainty triggered by Trump's election, ECB tapering, the Italian referendum, the Fed hike and the usual year-end position squaring ahead of the illiquid holiday period. None of these were EM specific events nor are they likely to have major implications for EM fundamentals. On the contrary, the fact that the market now prices great US earnings, three Fed hikes and draconian US trade wars against EM with few of these risks likely to materialise to the extent expected by the market, should make true investors sit up. The 'Trump effect' on EM FX will fade quickly as markets realise that Trump will be hemmed in by the many institutional, political and economic constraints.

¹ We believe allocations should be far higher than neutral with respect to market cap or GDP due to the far superior risk-return profile of EM debt versus developed markets fixed income.

The Dollar and US stocks are both expensive and will struggle to continue to rally strongly in 2017. As we discuss below, we fully expect the Fed to hike, but probably not three times.

Market conditions, as 2016 comes to a close, are therefore closely analogous to conditions in late 2015, when EM also pulled back due to the start of the Fed hiking cycle and year-end position squaring only to perform strongly for the rest of the year. At times like these it is extremely important to remember that EM always gets heavily oversold during bouts of market volatility and that the volatility is almost always due to investor behaviour rather than fundamental concerns. This is precisely why allocations to EM made during such times tend to have been profitable. Indeed, as the chart to the right shows, EM investors who have consistently allocated to EM during spikes in the US equity options volatility index (VIX) have racked up excess returns of 174bps to 486bps depending on asset class in question. The rise in VIX in November bodes well for returns in EM in the next 12 months.

Fig 8: Returns after VIX spikes: Active versus passive timing

12 month returns	External debt (EMBI GD)	Corporate debt (CEMBI BD)	Local currency bonds (GBI EM GD)	Equities (MSCI EM)
Excess return (in bps) from active timing	174	211	209	486
Returns: active timing (invest during VIX spikes)	11.1%	9.5%	9.1%	6.7%
Returns: passive timing (average return over all periods)	9.4%	7.4%	7.0%	1.8%
Number (years)	23	15	14	23

Source: Ashmore, JP Morgan, Bloomberg.

2016 in review: Why the better performance?

In 2016, EM local currency bonds returned 8.13% in Dollar terms, while external debt racked up 8.91% and EM corporate high yield bonds delivered 15.29% return.³ This meant that a simple average of return across the main EM fixed income asset classes was 5.30% higher than the average return of the same asset classes during the QE period (2010-2015). EM bonds, including bonds in local currency, therefore outperformed every bond on the US yield curve as well as long bonds in both Japan and Germany. EM equities were up 10.7%, but underperformed S&P 500 marginally. Why this turnaround in EM's fortunes?

Fig 9: Performance: EM fixed income (2016 versus 2010-2015)

Market data	2016 return*	Annual return (average 2012-2015)	Difference
Local currency bonds	8.1%	0.2%	7.9%
EM FX fwds	3.1%	-1.5%	4.6%
External sovereign debt	8.9%	6.7%	2.2%
Corporate bonds	8.9%	6.0%	2.9%
HY corporate	15.3%	6.4%	8.9%
Average across all the above	8.9%	3.6%	5.3%

Source: Ashmore, Bloomberg, JP Morgan (data as of close of business 15 December 2016).

Firstly, the Dollar rally against EM currencies was already coming to an end in late 2015, though the Dollar momentum against EUR and JPY continued this year.⁴ The FOMC Minutes bemoaned Dollar strength in October 2015.⁵ By early 2016 speculation was mounting that a currency accord of some sort had been struck at the G20 meeting in China. In June 2016 the IMF estimated that the US dollar was 20% overvalued in real

terms. By the end of 2016 EM currencies were broadly stable against the Dollar despite the vicious late-year Dollar rally.

Secondly, EM technicals were very favourable. EM experienced huge outflows in 2013 and in subsequent years. By 2016, positioning had become so light that risk-off events such as the Brexit vote, the Turkish coup attempt and Fed hike fears, no longer triggered major EM sell-offs. There were, in other words, very few sellers left, because retail and cross-over investors, hedge funds and banks are largely out of the market and real money investors were – and remain – underweight. In fact, institutional investors continued to pull money from the asset class throughout 2016 albeit at a slowing pace. ETF inflows to EM equity and fixed income briefly spiked to USD 50bn after Brexit, but left immediately after Trump was elected, with little overall long-term consequence.⁶

Thirdly, EM growth re-accelerated after slowing for several years. EM countries displayed considerable fundamental resilience during the years of slowing growth and shocks. They were forced to adjust to tighter financial conditions. As a result, their economies were already becoming extremely competitive in late 2015. Many EM countries instituted structural reforms. Developed market growth rates were revised lower.

Finally, EM valuations had become very compelling. In February 2016 the average bond yield in local markets hit 7.2%. Yields were also high in real terms, while spreads for Dollar-denominated bonds sat well above fair value. In developed markets investors piled into the 'last QE' trade buying 30 year bonds in H1 2016 only to suffer horrific losses in H2 2016 and ended up losing money outright in 2016, with little prospect of a turn-around barring recession.⁷

³ All 2016 returns calculated as of close of business 15 December 2016 after the Fed's December hike.

⁴ Ashmore issued an early warning about the approaching Dollar overvaluation as early as January 2015 – see "The Dollar Bubble", Weekly Investor Research, 25 January 2015 and highlighted the problem again in a landmark publication issued in September 2015 – see "The View from Kilimanjaro: EM FX in a QE world", The Emerging View, September 2015.

⁵ The October 2015 FOMC minutes noted that "Industrial production decreased in September as the output of both the manufacturing and mining sectors declined, likely reflecting the effects of the appreciation in the foreign exchange value of the dollar and the fall in crude oil prices since the middle of last year."

⁶ ETF inflows across equities and fixed income were about USD 50bn. The EM fixed income asset class alone is USD 18.5trn.

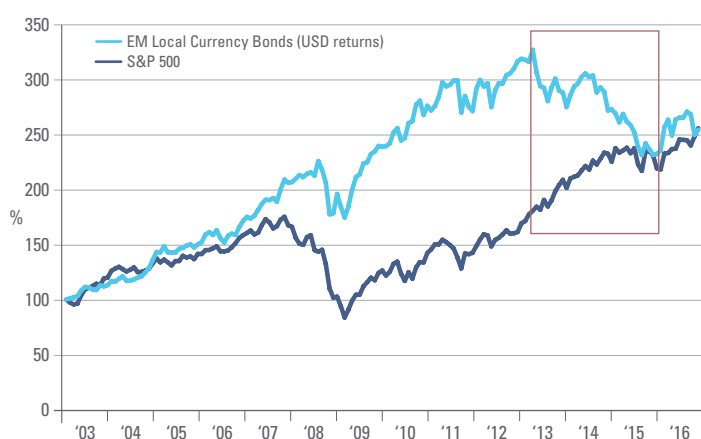
⁷ For more see "The last QE trade", Weekly Investor Research, 31 October 2016.

A realistic market scenario for 2017

The greatest potential upside in EM fixed income in 2017 is in **local currency bonds**, which could return about 7% in Dollar terms next year even without FX appreciation or capital gains. However, we expect significant rate cuts in countries like Brazil, Russia and Colombia so the index yield should decline over the course of the year. We also expect EM FX to recoup the losses in Q4 to rack up net positive returns of about 5% for the year. Hence, the total return on local currency bonds could easily be as high as 16% in 2017, excluding alpha. By contrast, we see nothing in the 5-7 year duration spectrum in developed market bonds that can compete with such a return. Indeed, the odds are favouring further losses in developed market fixed income next year as supply and inflation increase.

This relatively favourable outlook for EM versus DM fixed income raises the prospect that **correlations** between EM fixed income and US stocks turn positive as investors sell developed market fixed income and buy US stocks and EM fixed income instead. The positive correlation which has traditionally existed between EM fixed income and US stocks was temporarily turned on its head after the Taper Tantrum of 2013. During that period many institutional investors withdrew funds from EM in order to chase returns in QE-sponsored developed markets. The scaling back of QE and the return of US inflation now look set to reverse this transitory aberration. Of course, a positive correlation with US stocks could become a liability for EM fixed income given the very high valuations in the US equity market, but we expect US stocks to be supported by the rotation out of bonds and would in any case buy EM fixed income on dips in US equity markets.

Fig 10: **Correlations between S&P 500 and EM local currency bond returns** (box denotes period of negative correlation)



Source: Ashmore, JP Morgan, Bloomberg.

EM sovereign dollar-denominated bonds are attractive at 340bps over Treasuries. Sovereign spreads were as low as 166bps in 2007 at a time, when the Fed had rates above 5%. Given what is currently priced into the US yield curve next year in terms of hikes we expect EM external debt to return some 5% if spreads remain unchanged, though we actually expect spreads to narrow given very considerable alpha opportunities in country-selection and a general mispricing of the asset class.

We expect EM external debt spreads to narrow given the very considerable alpha opportunities in country-selection and a general mispricing of the asset class

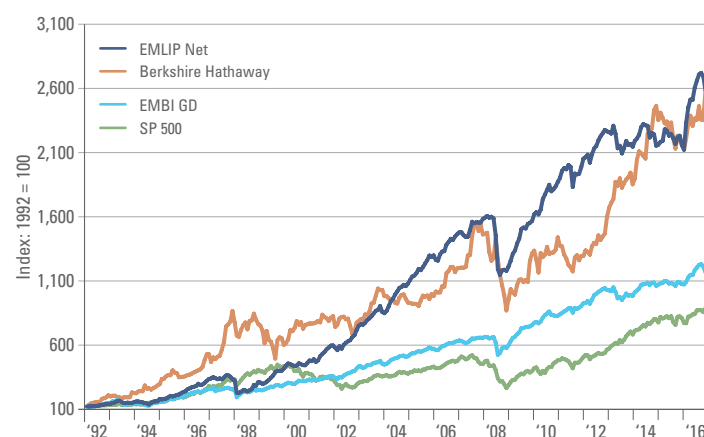
Our own analysis shows that there is about 100bps of 'free spread' in the current EMBI GD index spread.⁸ Index volatility has declined over the past decade as the number of countries in the index has doubled, but without a commensurate decline in spread. EM sovereign debt is also safer than is implied by current spreads, because the latter fail to take account of the rise in importance of local markets across EM. Although the external debt asset class continues to grow in size roughly in line with real GDP it is now only 4% of total EM bond financing and just 1.7% of total EM financing, including loans. This means that most EM sovereign bond issuers have very little to gain from defaulting on external debt relative to the cost in terms of reputational damage and legal complexities.

The main drawback for external sovereign debt relative to, say, corporate and local debt is of course its higher duration, which exposes it more to volatility in the US yield curve. Duration risk can, however, be mitigated by taking exposure to the higher beta segments within the universe of bonds, which have big fat spread cushions. An overweight to sub-IG credits also makes sense as the fundamental backdrop continues to improve in 2017.

Investment grade sovereign bonds are clearly more exposed to Treasury volatility than higher yielding credits, but they pay better than developed market IG bonds. We also expect sell-offs in the US yield curve to be modest as the Fed and US regulators will have to protect markets and the economy from excessive spikes in yield. Dips in the US Treasury market should therefore trigger buying in IG funds.

Above all, investors should never lose sight of the fact that EM fixed income delivers equity-like returns to investors with long term horizons and the discipline to buy on dips. This is what the Ashmore Emerging Markets Liquid Investment Portfolio (EMLIP) fixed income fund has done since 1992 and over this period it has outperformed Berkshire Hathaway (see chart below).

Fig 11: **EM fixed income versus US equity: Long-term returns⁹**



Source: Ashmore, Bloomberg.

⁸ See "Free money: Arbitrage opportunities in EM external debt", Market Commentary, 14 June 2016.

⁹ EMLIP is Ashmore's longest running fixed income fund. EMLIP returns are net of fees. Berkshire Hathaway and S&P 500 returns are total returns.

The outlook for **EM corporate bonds** is stable. Corporate bonds offer the same yield as sovereigns, so most of the mispricing in this segment is now a thing of the past. However, we expect corporate bond markets to perform in line with – albeit possibly lagging – the expected further improvement in corporate fundamentals. Easing financial conditions via greater flows into EM should improve business conditions and gradually push down default rates. Spreads should follow.

Outlook for the Dollar and US Treasuries

The outlook for the US economy is especially important to EM, because the most liquid EM currency crosses are US dollar crosses and the bulk of EM external debt – corporate as well as sovereign – is denominated in Dollars and prices off the US government yield curve. Fundamentally, most EM central banks are also extremely exposed to US currency and duration risks by virtue of their heavy exposure to such securities.

We expect the outlook for US fixed income to become much more challenging next year for two reasons. First, inflation stages a return as the US economy approaches full employment. House price appreciation has already eroded negative housing equity and households have nearly deleveraged back to pre-Greenspan Bubble levels.¹⁰ When inflation returns we expect it to be broad-based with increases in wages, consumer prices and inflation expectations. Core CPI inflation is already above the Fed's 2% target. The Fed is behind the curve and likely to remain so. The table below shows how far the current Fed funds rate is below the starting point for hiking cycles at previous troughs in unemployment. Trump's proposed fiscal policies and easing of bank regulations would add further fuel to the fire. Only a recession which cannot be ruled out (as recessions are never closer than when the economy reaches full capacity) would significantly change the inflation trajectory, in our view.

Fig 12: **US: Fed funds rate and unemployment**

Year of trough in unemployment	Fed effective funds rate (lower bound)
1969	9.2
1973	11.9
1979	10.3
1989	10.0
2000	6.5
2007	5.3
2016	0.5

Source: Ashmore, Bloomberg.

In addition to the drag on developed market bonds from higher inflation we think they will suffer from the switch from monetary stimulus/QE stimulus towards fiscal easing across developed countries. This implies a complete about-face as far as bond technicals are concerned, since, under QE, governments bought bonds, while under fiscal easing they sell them.

A serious further bond market sell-off in the US is the biggest market-related risk we see going into 2017. Bear steepening would be particularly damaging. Expectations of further bear steepening declined in late 2016 following Fed hawkishness, but that is precisely why this is big risk.

Bear steepening would impale the Fed on the horns of a dilemma – if the Fed chooses to crush inflation by raising real rates (bear flattening the yield curve) then it risks causing a recession (which it then cannot remedy). On the other hand, if the Fed opts to protect the shallow recovery and bloated financial markets then the long end of the yield curve blows up. This can also kill off the economy, especially via the impact on housing.

The core reason for this dilemma is that the underlying economy is so sluggish. Clearly, a miraculous return to a high productivity economy would eliminate the dilemma entirely, but that seems unlikely. Productivity growth rates are very low and have been falling for a long time, while the US REER is overvalued and debt levels are very high.¹¹ Hence, the eventual 'solution' to the Fed dilemma may be to live with higher inflation and to take steps to hold down the long end of the yield curve via financial repression.

Our base case as far as the Fed is concerned is that Janet Yellen and Co will seek to strike a balance between acting on rising inflation and protecting the economy

Trump's fiscal plans would probably worsen matters at the margin. Trump has indicated that he wants to pursue 'Reaganesque' policies of deficit spending and deregulation. However, the US economy is in a very different place from where it was the early 1980s. While Reagan inherited an economy with an overall debt stock of 160% of GDP and then oversaw eight years of declining interest rates, which steadily reduced debt service costs for consumers Trump inherits an economy with 330% of debt to GDP and the prospect of higher debt service costs going forward. Piling more debt upon the existing mountain of debt will likely reduce trend growth rates and push debt service costs even higher. See box for further details.

Given the economic constraints our base case as far as the Fed is concerned is that Janet Yellen and Co will seek to strike a balance between acting on rising inflation and protecting the economy. The best way for the Fed to appear to be hawkish, while at the same time doing very little is to (a) try to appear as hawkish as possible when the economy is doing better in order to have ammunition to ease when the inevitable downturn comes and (b) target broadly stable real rates. Hence, the Fed should hike more or less in line with inflation. This does not actually kill inflation due to the low starting point for rates, so the Fed's credibility slowly crumbles and the Dollar gradually begins to decline versus EM currencies.

¹⁰ We have been expecting inflation to return around this time for several years, see for example *"A Pleasant Fiction"*, The Emerging View, September 2013 and *"Fed Captain and the World of Tomorrow"*, The Emerging View, November 2013.

¹¹ The Fed could have somewhat eased the dilemma by heeding San Francisco Fed Chairman Williams' early call to raise the inflation target. Then at least the Fed would appear ahead of the curve when inflation rises. But it did not do so.

Economic limits to yield curve bear steepening in the US

The pain from bear market steepening first shows up in mortgage markets. The roughly 100bps of yield curve steepening in H2 2016 has already pushed down mortgage applications by 30%. This decline is exactly in line with the impact on housing during the Taper Tantrum in 2013, when mortgage applications eventually dropped by 65%, which triggered a U-turn on tapering by the Fed.

The broader economic sensitivity to rising real yields is high due to overall high levels of debt. The US public and private debt stock is 330% of GDP with an average duration of approximately six years. Given the 6-year US Treasury yield of 2.25% the annual debt service cost is approximately 7.4% of GDP.¹² If the 6-year US Treasury yields rise by 100bps, the debt service cost to 10.7% of GDP. This means that the US economy would have to grow about 5.0% to keep consumption flat.

Fig 13: Debt service costs for the US under different interest rate scenarios

Scenarios	Yield	Debt service cost (as % of GDP)	Required additional GDP growth to keep consumption stable (%)
Yield today	2.25%	7.4%	–
+50bps	2.75%	9.1%	1.7%
+100bps	3.25%	10.7%	3.3%
+150bps	3.75%	12.4%	5.0%
+200bps	4.25%	14.0%	6.6%

Source: Ashmore, US Treasury.

Donald Trump and EM trade

Our big picture view of the US under Trump is that of a country gradually shrinking from its former economic spheres of interest abroad. This creates room for others to advance and China in particular will benefit.¹³

Donald Trump's rise to power triggered an irrational kneejerk reaction in EM due to his protectionist campaign rhetoric. However, Trump's main focus in his first term is likely to be on domestic issues, not foreign policy. Indeed, the single most important lesson from modern US political history is that newly elected presidents should avoid getting bogged down in complex foreign policy issues during their first term. Former presidents Carter and Bush Sr. made the mistake of getting stuck with complex foreign policy problems in countries voters could not even place on a map. It ate up their political capital, the domestic economy suffered and they were booted out after their first term.

Trump's domestic agenda is also so full that he will have little time for foreign policy. He is going to overhaul the tax code, negotiate infrastructure spending with the fiscal hawks in Congress and repeal Obamacare, Dodd-Frank and climate commitments. Indeed, we may already have seen his most important foreign policy initiative: cancellation of TPP, which is actually good for China.

Having said that, we do expect plenty of hostile rhetoric – tweets – from Trump: they are politically effective. But the transition from hostile rhetoric to draconian trade wars, a total repeal of NAFTA and 45% blanket tariffs on China would be bad for the US economy and meet with serious institutional push-back. Trump is more likely to protect vulnerable and unproductive US industries, such as steel, and to use fiscal incentives to encourage US companies to relocate workers back to the US. As every trade economist knows such policies increase the cost for consumers by increasing deficits, pushing up prices (while sometimes lowering quality) and slowing the trend growth rate.

The Sea of Risk

EM countries have successfully weathered major shocks in recent years with remarkably few casualties. Indeed, default rates for EM corporate high yield bonds are lower than those for US high yield bonds and sovereign defaults have been very few in number (and with high recovery rates). There have also been very few balance of payments crises and IMF has not been particularly busy in EM recently.

Even so, EM countries do sail on a sea of risk. Developed economies are clearly struggling with major problems. Many are desperate to grow faster and need to fix deepening distributional problems. However, so far there are not many signs that governments are willing to tackle the deep-seated productivity and debt issues that are the underlying causes of their current malaise. In fact, the direction of travel is towards greater populism, which only worsens the long term outlook.¹⁴

Our long-term base case remains that developed economies can only escape their dual productivity and debt predicaments by means of inflation and devaluation, which also happen to be a more politically palatable solutions than reforms and outright deleveraging.

The silver-lining for the world's investors is that EM countries have very different political dynamics. EM countries are generally not afforded the luxury of populism for very long. They cannot pursue QE or endless fiscal stimulus. Due to the relative poverty of large segments of their populations there is a very low tolerance for macroeconomic mismanagement. EM countries therefore tend to fix serious structural problems as soon as they arise, which generally keeps them fundamentally healthier than developed economies.¹⁵ So even if developed countries go down the route of populism we think most EM countries will not be sucked into the same maelstrom. To the extent that populism creates global market volatility investors should ruthlessly buy the dips.

¹² Most borrowers in the US face higher debt service costs than the US government, so this estimate understates the full impact of rising yields on debt service costs.

¹³ For more details see *"Chinese reforms and American populism"*, The Emerging View, November 2016.

¹⁴ See *"Beyond 'conventional unconventional' policies"*, The Emerging View, April 2016.

¹⁵ Oil countries tend to be the exception to this rule. Oil economies often have more authoritarian governments, which can sometimes repress populations to delay adjustment.

EM equity outlook for 2017

We are cautiously optimistic about EM equities going into 2017, but it will still be imperative to be pro-active in top-down dynamic allocations and in the pursuit of high conviction bottom-up security selection.

Our caution stems from the potential for adverse beta effects emanating from developed markets. Yet, the value case in EM equities is quite compelling. For example, a re-rating to 3-year median valuations – a particularly bearish period for EM equities – would generate low double digit upside for stocks.

EM stocks have just been through a near-uninterrupted earnings decline since mid-2011, which is the longest earnings recession on record, but EM's macro drivers now point to outright earnings improvement. The reasons for the long period of weakness were a combination of government interventions across major EM geographies, lower commodity prices and weaker EM currencies. The good news is that many EM governments are becoming far more pragmatic and market friendly, particularly in Latin America, but also in EMEA and Asia. The two other headwinds – EM FX declines and falling commodity prices – are also turning into tailwinds.

Without in any way making specific return predictions for 2017 on account of the constantly fluid market and macro-economic conditions one can nevertheless easily establish credible scenarios with decent upside for EM equities.

Figure 14 presents our current base / bull / bear case scenarios for rolling 12-month returns for the MSCI EM as at mid-December 2016.¹⁶

As always, timing will matter. We see the late 2016 market volatility as an opportunity to increase EM equity exposure. In 2017, returns are then likely to follow a non-linear progression. January and the first quarter may well start on a volatile note as the reality of a new US president sinks in. Spring and summer should then bring rising equities due to rising earnings, while the fourth quarter usually bring some volatility as the year draws to a close.

Within this broadly positive beta view our top positive active bets include insurance (+9%), which benefits from rising rates, and banks (+9%), which should do well in a macro turn-around environment. We particularly like Russia (+7%), where we see the risk premium falling, and Brazil (+3%), where the risk premium is also falling and where state companies present interesting restructuring plays.

Our negative bets include consumer discretionary (-8%), as EM consumers emerge from frugality slowly, and industrials (-6%) on what we expect to be too-cautious government infrastructure investment programmes and still low commodity prices relative to recent history. We enter the year underweight Taiwan (-6%) as the recent upturn in macroeconomic conditions is largely priced, and Malaysia (-3%), where a stagnant macroeconomic story and no near-term structural improvements are currently evident.

Fig 14: EM equity scenarios (MSCI EM)

Scenario	Return (%)	Δ Price	Dividend yield	Target	Current	P/E	EPS	Notes
Base case	12	10	2.7	961	875.5	13.3	72.4	Rolling forward 12m eps x 3y medium p/e
Bull case	35	32	2.7	1160	875.5	14.5	80.0	2014 eps x 3y + 1stdev p/e
Bear case	-16	-19	2.7	708	875.5	11.5	61.6	Current eps -15% eps x 3y -1stdev p/e

Source: Ashmore, Bloomberg, MSCI.

Markets summary (as of close of business 15 December 2016)

Emerging Markets	Year to date	3 years	5 years	Global Backdrop	Year to date	3 years	5 years
MSCI EM	10.70%	-2.03%	1.93%	S&P 500	13.04%	10.69%	15.65%
MSCI EM Small Cap	2.30%	-0.73%	4.06%	1-3yr UST	0.65%	0.45%	0.47%
MSCI Frontier	1.52%	-2.03%	4.76%	3-5yr UST	0.47%	1.34%	0.98%
MSCI Asia	6.39%	1.00%	5.80%	7-10yr UST	-0.38%	3.06%	1.74%
Shanghai Composite	-10.10%	14.96%	10.11%	10yr+ UST	-0.66%	7.31%	2.31%
Hong Kong Hang Seng	2.35%	-1.23%	3.55%	10yr+ Germany	6.45%	10.15%	6.87%
MSCI EMEA	16.43%	-6.42%	-1.02%	10yr+ Japan	7.20%	6.36%	5.63%
MSCI Latam	26.11%	-8.00%	-5.93%	US HY	16.50%	4.60%	7.51%
GBI EM GD	8.13%	-4.94%	-1.51%	European HY	9.31%	5.84%	11.22%
ELMI+	3.15%	-4.05%	-1.33%	Barclays Ag	5.01%	4.06%	4.73%
EM FX Spot	-0.54%	-10.88%	-7.68%	VIX Index*	-29.65%	-20.09%	-47.26%
EMBI GD	8.91%	5.89%	5.78%	DXY Index*	4.48%	28.69%	28.40%
EMBI GD IG	6.04%	4.75%	4.14%	CRY Index*	8.14%	-32.09%	-35.43%
EMBI GD HY	12.07%	6.93%	7.97%	EURUSD	-3.87%	-24.16%	-20.01%
CEMBI BD	8.91%	5.06%	5.87%	USDJPY	-1.53%	14.77%	52.01%
CEMBI BD IG	5.16%	4.50%	5.02%	Brent	45.41%	-50.93%	-47.55%
CEMBI BD Non-IG	15.29%	5.64%	7.53%	Gold spot	6.79%	-8.69%	-29.11%

*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.

¹⁶ 14 December 2016.

Contact

Head office

Ashmore Investment Management Limited

61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

 @AshmoreEM

www.ashmoregroup.com

Bogota

T: +57 1 347 0649

Dubai

T: +971 440 195 86

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

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