Ashmore

Outlook for EM and global backdrop

By Jan Dehn

- Emerging Markets (EM) asset prices over-reacted to the downside in recent years, especially given that EM fundamentals held up far better than expected in the face of serious headwinds. EM fundamentals are now improving in absolute terms and relative to fundamentals in developed economies, so EM asset prices offer exceptional value. Global asset allocators are beginning to recognise the opportunity by swinging resources back in favour of EM. 2017 will be the first year since 2013 with net positive inflows to the asset class.
- Asset prices and currencies are increasingly overpriced relative to risks in developed markets. The Dollar has begun a longer period of weakness as US growth slows in the context of excessive debt, lack of reforms, low productivity, an overvalued real exchange rate and gradual monetary tightening.
- EM local currency bonds are likely to be the best performing fixed income market in the world over the next five years with returns up to 50% in Dollar terms. Inflows into local markets are especially important because they help to reverse the financial tightening of recent years. This will further boost growth as well as improve public finances, increase equity earnings and justify tighter spreads on Dollar bonds.
- The main risks within EM are likely to be country-specific and idiosyncratic and therefore, best mitigated with active management. Events in developed markets are likely to be the most important source of volatility for EM as an asset class, but since the fundamental impact tends to be very low, investors should systematically buy into big bouts of volatility.

Introduction

This report provides an update on the case for EM following a strong start to 2017. EM have weathered serious financial and economic headwinds in recent years with surprisingly few 'casualties'. Asset prices overreacted and EM now offers excellent value, both in its own right as well as relative to developed economies. A larger global re-allocation of capital away from QE economies towards the non-QE universe, including EM, has already begun and will likely continue for several years. This means that return prospects are very positive for EM assets. We expect returns between 25% and 50% over the next five years across EM fixed income with the highest return prospects in local currency markets, while EM equity returns over the same time period could be as high as 75-80%, in our view. As usual, there are risks. EM specific risks can be mitigated with active management. We view China mainly as source of upside risk rather than downside risk given the heavy emphasis on reforms. The main source of volatility for EM asset prices will be developed economies, where valuations and fundamentals – political as well as economic – continue to deteriorate. Fortunately, bouts of volatility emanating from developed economies tend to have very little impact on EM fundamentals, so investors should use such events to buy into EM systematically. We expect the US economy to continue to grow slowly and for the Fed to remain very dovish. This constitutes a bearish outlook for the Dollar.

EM now offers excellent value as developed markets valuations looks stretched and the shift in global asset allocation is underway

Proven resilience

EM weathered a series of financial and economic headwinds between 2010 and 2015, including the Taper Tantrum, a massive Dollar rally, the 50% fall in commodity prices and the start of the Fed hiking cycle. Being severely finance constrained, EM economies began to grow more slowly as global asset allocators re-allocate capital into the QE-sponsored developed markets. Yet, despite these headwinds EM fundamentals held up far better than most expected. EM growth rates never dropped to less than 2x the growth rates in developed economies and the EM growth premium already began to pick up again more than year ago. It now looks set to continue to rise for several years into the future. EM resilience also showed up in other areas. For example, there was no widespread outbreak of sovereign defaults or balance of payments crisis and very few EM countries had to resort to IMF support over this period barring a small number of the most vulnerable economies. In the EM corporate high yield sector default rates remain materially lower than for similarly rated corporates in the US.

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EM's resilience can be attributed directly to EM's stronger 'deep fundamentals', such as much lower debt levels, inflation targeting, establishment of pension funds, high levels of FX reserves, high savings and investment rates, room to ease both fiscal and monetary policies, better demographics and a greater proclivity to reform as soon as troubles arise. Of course, these are precisely the reasons why many investors put money into EM in the first place. In short, investor convictions proved rather fragile during the QE period, which is why prices fell, but EM fundamentals held up. And that, in a nutshell, is why EM now offers excellent value.

A powerful value proposition

The powerful value proposition created during the QE years has now begun to translate into positive returns, which look set to be sustained for a number of years.[1] EM valuations are attractive relative to what is on offer in developed markets, but EM is now also very attractive in its own right. We see the key drivers of returns as the following:

- At 6.5% yield local EM government bonds now offer real yields of about 250bps against a backdrop of GBI index-weighted inflation of just 4%.[2] For 4.5 year duration government bonds this is a very high yield, particularly since fundamental stresses are easing.
- EM growth has been accelerating since 2015, but there is a lot more upside given the large slowdown in growth between 2010 and 2015. EM's recovery has so far been led by improving external balances on the back of real exchange rates at 13-year lows, but capital inflows are likely to augment growth rates going forward.
- Many EM countries have undertaken deep structural reforms in recent years, including Colombia, Brazil, Argentina, India, Indonesia, Mexico, Russia and others. Reforms remove obstacles to growth and allow countries to grow faster before running into inflationary constraints.
- Positioning is extremely light. Most foreign investors are heavily underweight. This is reflected in benign price action in response to bad news, which no longer induces large sell-offs. There are simply very few sellers left.
- Foreign flows back into EM will ease domestic financial conditions, which in turn will stimulate growth. Hence, the QE-related financial tightening of recent years now looks set to be reversed. This should support spread compression as well as local market returns.

Developed market valuations look stretched

The opportunity cost of investing in EM is to forego returns in developed markets, but the latter look increasingly unattractive. Years of enormous financial asset purchases by central banks in developed economies have rendered asset valuations extremely stretched in those economies. Technicals are also challenging following massive allocations over many years. Developed countries have largely ignored their underlying debt and productivity issues during the boom years and hardly any reforms have been undertaken. Hence, a major wedge now exists between valuations and the state of the underlying economies in most developed economies. Moreover, as inflation gradually resurfaces the QE central banks will no longer be able to print money to stimulate asset prices and without this subsidy and without strong underlying growth the outlook for financial assets in developed markets looks increasingly cloudy. Indeed, the likely path for developed economies will now be to return to yet more fiscal stimulus in a bid to prolong the party, but this only increases debt burdens and may crowd out private investment and therefore hurt productivity further. Yields are too low to offer protection against tail risks, let alone rising inflation or greater supply. Barring recession, investors will seek protection by rotating out of bonds and into stocks, but stock markets in developed economies are also very expensive. Hence, there are few hiding places and even less room to make money in developed economies. It is time to reverse the original QE trades by taking profits on positions in developed markets and shifting funds back into the non-QE world, particularly EM.

The shift in global asset allocation is already underway

The shift back to EM is already underway, albeit still in its infancy. EM still suffered net outflow in 2016 and 2017 is likely to be the first year since 2013 when the asset class will see net positive inflows. The flows are already showing up in terms of performance. EM's outperformance versus developed markets has accelerated meaningfully in 2017 compared to 2016 with local markets up more than 7% in Dollar terms YTD and EM currencies outperforming the Dollar by more than 3.5%. Equities are up twice as much as US equities and external debt returns are twice as high as similar duration US treasury bonds.

Potential returns: EM local and external markets the next five years

As the big rotation back to EM gets underway how much can investors expect to make? Below we present our estimates of what the various asset classes in EM can reasonably expect to deliver over the next five years:

- **EM local bond markets:** EM local bonds will likely outperform all other government bond markets in the world over the next five years. EM bonds should continue to yield at least 6% per year. This will keep real yields comfortably within positive territory, since EM inflation can be expected to rise gradually towards 5% over the period. After falling more than 40% between 2010 and 2015, EM currencies have room to recover at least half of their losses over the next five years under reasonable assumptions for the EM-US inflation differential. Taking into account both carry and FX upside, we expect total return to EM local currency bonds between 48% and 63% in Dollar terms over the next five years. Active management may augment these returns, of course.
- **EM external sovereign debt:** The bullish outlook for local bonds has important positive implications for external debt. The flow of capital back into the local markets should ease financial conditions and stimulate investment, consumption and growth. This should improve government tax revenues and even reduce the need to issue debt, thus justifying tighter spreads. At a spread of about 300 bps over Treasuries, EM sovereign Dollar-denominated bonds today still trade nearly 100bps wider than in 2010 and 130bps wider than before the 2008/2009 crisis. Incidentally, the number of countries in the EMBI GD

[1] See *'The Myth of EM FX pass-through'*, The Emerging View, March 2017.
[2] Excluding Argentina.

index has doubled since 2006, which has pushed down the index volatility, so we think EM external debt spreads ought to be 100bps narrower than they are today. This 'free spread' is currently available to investors. Over the next five years, we expect a total return in external debt of about 25% to 32%.

- EM corporates: Corporates will also benefit from the easier financial conditions. Earnings will rise and refinancing risks will decline. Default rates should therefore also gradually decline, especially in the high yield segment. In fact, this process has already begun. As of the end of February the EM corporate high yield default rate had fallen to 3.96%, which is below the long-term average default rate. Spreads are still about 430bps over Treasuries compared to 270bps before the 2008/2009 crisis. We see EM HY corporate bonds return between 20% and 25% over the next five years, net of defaults. As such, they should continue to outperform US high yield corporates, which have materially higher rates of default (6.01% as of the end of February), narrower spreads (372bps) and more leverage than identically rated EM corporates.
- EM equities: EM stocks will benefit from the same improvement in financial and economic conditions that also support corporate fixed income, but with greater upside potential. Returns will come from dividend yields and capital gains plus the currency upside. We expect no change in the annual 2.5% dividend yield, but if earnings per share rise in line with nominal GDP growth then capital gain will rise from about 8% to about 10% per year over the next five years. With EM currencies rallying about 20% over the same period we see the total return on EM stocks within the 75%-80% range over the full five year period. This assumes no compounding and no major re-rating of valuations.

These return prospects mean that EM offers the best risk-return proposition in global finance today. Within fixed income, local bonds will do best, but with decent gains in the sovereign and corporate spaces too. EM equities will offer even better returns than bonds, though this comes with greater volatility. Active management has scope to augment returns in the themes significantly, while at the same time mitigating risks.

We expect developed markets to contribute the main sources of short-term volatility and risk to EM. However, this will not impact the long-term fundamentals in EM

Valuation risks

The strong returns year to date naturally lead to speculation that maybe markets are getting a bit ahead of themselves? Well, are they? The answer is no. Given the 5 year return prospects there is plenty of value left in all EM asset classes, so the only issue is whether the returns are materialising at too rapid a pace. This is possible. For example, the table below shows that if the current pace of returns is sustained for the whole of 2017 then returns in Dollar terms in EM local currency bonds will be 24%, while EM currencies would outperform the Dollar by a whopping 11%. External debt and corporate debt would also rack up returns of more than 16% and 12%, respectively. While such returns are not impossible – and we cannot rule them out – we generally do not expect straight-line returns in EM. Pullbacks almost always happen.

Fig 1: **Market performance: EM and selected developed markets**

Asset class	% return (USD terms)		
	2016	2017 year to date	2017 annualised
Fixed income			
EM local currency bonds	**9.94%**	**7.68%**	**24.17%**
EM external debt (USD)	**10.15%**	**5.11%**	**16.07%**
EM corporate debt (USD)	**9.65%**	**3.99%**	**12.55%**
3-5yr UST	*1.33%*	*1.23%*	*3.88%*
7-10yr UST	*1.04%*	*2.01%*	*6.34%*
Currencies			
EM FX	**0.54%**	**3.59%**	**11.30%**
*DXY Index**	*0.53%*	*-2.94%*	*-9.26%*
EURUSD	*-0.55%*	*3.29%*	*10.35%*
USDJPY	*0.58%*	*-4.97%*	*-15.65%*
Stocks			
EM stocks	**11.27%**	**14.44%**	**45.43%**
US stocks	*11.95%*	*7.29%*	*22.94%*

Source: Ashmore, JP Morgan, Bloomberg.

We believe that the outlook for EM remains extremely solid over the next five years. EM's proven resilience in the face of major global financial headwinds and sound return prospects imply that investors should indeed be vigilant about pullbacks, but mainly because such events will be excellent opportunities to add.

The big picture is clear: EM asset prices are currently cheap after years of irrational selling. Valuation risks are firmly concentrated in developed markets. Of course, there will obviously come a day when valuations are much more elevated. When, a few years from now perhaps, investors are once again overweight EM, bond yields are a few hundred basis points lower and currencies some 20%-25% stronger then it may be prudent to take profits if there are better opportunities and better fundamentals elsewhere. But not today. The rally is only just beginning.

Risks to the outlook

EM specific risks

There is no such thing as a risk free investment, even in EM. Every year a small number of EM countries mess up. Today's primary candidates for mess-ups include Turkey and South Africa, but undoubtedly others will mess up over the coming years. After all, EM electorates, like their counterparts in developed countries, occasionally elect idiots to power or their governments make a big policy mistake or the country simply experiences large external shocks, which they struggle to manage. The flipside is that there are now more than 65 readily tradeable EM countries, so idiosyncratic/country-specific risks are best mitigated with active management. The occasional bad news in a few individual countries should never deter investors from staying invested in the remaining EM universe, because classic Soros style reflexivity, that is, the capacity of volatile asset prices to impart terminal economic contagion across the EM universe ended in the early 2000s with the establishment of local pension systems.

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China

Investors perceive EM to be particularly sensitive to China's outlook, because of a simple narrative that paints China as commodity importers and all other EM countries as commodity exporters. This narrative is far too simplistic. Two thirds of the most investable EM countries are commodity importers, for example. Markets are generally bearish about China on the view that China allegedly has too much debt. This is why growth is slowing and why capital is trying to flee the country. Yet, China continues to defy predictions of a hard landing. We believe that the perceived risks in China are wildly overstated and that growth, capital flight and debt are largely unconnected issues.

- Debt: China's debt stock is not out of line with that in order EM countries after taking account of China's extra-ordinary high 49% savings rate. China is simply a high saving, high investment, high growth economy.
- Growth: The primary reason why China's growth is slowing is that China is implementing an extremely ambitious reform programme, which creates considerable temporary uncertainty and therefore leads to postponement of investment and consumption decisions. The policy reforms underway are meaningful, including interest rate liberalisation, price liberalisation and capital account liberalisation. China is rotating its growth away from investment exports towards consumption. This will naturally slow the rate of growth, but it will not be politically destabilising, because higher consumption will be popular among the Chinese.
- Capital flight: China's financial markets are still underdeveloped. China's savers can only invest in property and stocks. They need bonds and foreign assets. Hence, Chinese savers naturally want to buy foreign assets as the capital account opens. They are also infinitely better informed about the rest of the world than the rest of the world is about China, so this creates a temporary asymmetry during which Chinese appetite for foreign assets exceeds foreign appetite for Chinese assets. This imbalance should ease, however, as (a) Chinese savers get their fill of foreign assets, (b) China is included in the main indices and (c) China's domestic retail fixed income market develops.
- Longer-term prospects: China is a winner. Assuming 5% real GDP growth in China and 2% real GDP growth in the US China's economy will be 2-3 times larger than the US economy by 2050. Over the next 30 years China's consumption will grow even faster than its GDP as savings slowly decline. This will deliver the largest consumption boom the world has ever seen. Good news to exporters the world over as the US slowly turns more protectionist. An additional consequence of China's assumption of the role as the world's largest economy and its largest financial market is that CNY and GGBs will gradually supplant USD and US Treasuries as the main benchmarks for global currency and bond market trading.

Non-EM sentiment shocks

We expect the main sources of volatility as well as risk to emanate from developed markets. Such events can impart considerable volatility onto EM asset prices, but experience shows that EM fundamentals are almost never meaningfully impacted by such bouts of volatility. In fact, our own analysis shows that investors can significantly beat indices by buying into globally induced bouts of volatility. We find that buying into VIX spikes of 10 points or more in any given month adds annualised alpha of between 110 and 410bps across EM fixed income and equities relative to passively timed allocations.[3]

US growth, the Dollar and US rates

The US matters far more for EM than Europe or Japan because EM currencies mainly trade against the Dollar and EM bonds mainly trade as a spread over US Treasuries. With prospects of a Border Adjustment Tax receding, the main threat to EM local markets from the Trump Administration is rapidly fading. An unfunded tax cut is now more likely and would generally be bullish for EM, in our view. However, the tax cut is likely to be small due to the deficit implications and difficulties in winning support from Democrats. There is even a risk that a tax reform does not happen at all, though this is not our base case. A small tax reform means less stimulus, less growth, less inflation and therefore fewer rate hikes. This is a bearish scenario for the Dollar, which we expect to weaken gradually. The US no longer needs so much capital from abroad, so outflows from the US would actually help to stabilise America's overvalued financial markets and help American businesses to compete.

[3] See *'The myth of Emerging Markets' vulnerability to external shocks'*, The Emerging View, February 2015.

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