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MARKET COMMENTARY

Emerging Markets after the summer sell-off: Hold or Add? By Jan Dehn

We believe Emerging Markets (EM) debt and equities are likely to offer attractive returns over the next 12 months due to strong technicals, improving fundamentals, and attractive valuations in the wake of the summer sell-off.

Strong technicals

- After 17 weeks of outflows, the technical position in EM is the strongest it has been since 2008/2009
- Cross-over investors are out, hedge funds and banks are either out or outright short and could get squeezed back into the market
- We believe Asian central banks are underweight in EM and will steadily increase their allocations over the next decade
- The pipeline of RFPs from institutional investors is long and solid

Fundamentals improving

- We expect EM real GDP growth to accelerate from around 4.5% in 2013 to about 5.5% in 2014. The upswing began to take hold in Q2 2013
- An on-going recovery in global manufacturing should also provide tailwinds for EM in the next few months
- China's economy bottomed out in June and is now experiencing a steady broad-based upswing. Growth in other larger Emerging Markets countries, such as Brazil, is now also accelerating
- The long-term fundamental arguments for investing in EM remain unchanged. They include: better demographics, rapid productivity growth, lower debt, and large central bank foreign currency reserves plus the rapid expansion of the investable universe

Valuations are attractive

- We believe, the near-indiscriminate sell-off this summer has created value across all EM asset classes, but we particularly like equities, local currency government bonds, and corporate debt
- **EM equities** are trading at a 40% discount to the S&P500. Earnings should recover strongly in 2014. Frontier Markets are in a position to deliver both super economic and earnings growth in the next decade due to structural advantages, such as urbanisation, infrastructure spending, increasing fiscal responsibility, benign inflation, and consumer spending. We like actively managed exposures targeting value across selected sectors and countries[1]
- **EM local currency government bond yields** have re-priced to levels last sustained when US 10 year treasury yields were 4.5% prior to the subprime crisis. Note that 4.5% is also the current terminal rate priced in for both 10 year and 30 year treasuries). Given the current levels we expect bonds to produce healthy returns over the next 12 months, with significant upside currency optionality as investors return. The temporary high correlations between local currency government bond yields and US treasury yields should collapse towards zero over the next few months
- **EM currencies** began to stabilise well before the Fed's tapering U-turn due to positive economic surprises and intervention from reserve-rich central banks, yet forwards are still paying more than 4% yield for less than 60-days risk. And in our view, the long-term case for EM currencies has been strengthened further by the postponement of QE tapering
- **Corporate high yield bonds** benefit from short duration, a healthy spread cushion of 550bps, and an improving growth outlook. We expect corporate high yield to produce healthy returns in the next 12 months, even assuming modest spread compression

The summer sell-off in Emerging Markets debt was technical, not fundamental[2]

- Strong returns and declining volatility in 2012 led to strong inflows into EM debt in early 2013, particularly in local currency, as investors belatedly chased the opportunity created by the Greek problems in H2 2011
- The technical position in local bonds deteriorated sharply in April 2013 as banks, hedge funds, and cross-over investors added to leveraged positions significantly on speculation that Japanese institutional investors would allocate to EM debt in the wake the 40% rally in Japanese stocks
- Fed tapering talk in May collapsed the Japanese stock market, thus removing the premise for April's speculative positions and triggered sharp declines in liquidity as banks reduced trading books due to uncertainty about the future path of Fed policy

Continued overleaf

[1] For more information on the long-term case for Emerging Markets equities see *"The benefits of diversification in Emerging Markets equities"*, The Emerging View, April 2013.
[2] For further discussion see *"Emerging Markets and tapering"*, The Emerging View, July 2013.

- The unwinding of speculative EM debt positions went on for longer than normal due to the onset of poor summer liquidity and the uncertainty ahead of September's FOMC meeting
- A small number of prominent EM countries (Brazil, India, Indonesia, and Turkey) are undertaking macroeconomic adjustment to unwind short-term cyclical imbalances. They are not facing crises and adjustments are happening rapidly against a backdrop of generally strong structural fundamentals. The vast majority of EM countries are not experiencing any stress
- Despite negative headlines,[3] heavy outflows, and sharp moves in both currencies and rates EM have shown strong resilience. In particular:
  - No EM sovereigns faced or currently face funding problems. On the contrary, several new countries entered global capital markets (and benchmark indices) over the summer.[4] Indonesia successfully tapped markets during the peak of negative sentiment about EM
  - EM central banks, even those in deficit countries, retained full control of their currencies due to strong reserve positions, without seeking IMF support. Indeed, central bank reserve cushions were barely touched with cumulative intervention by Asian central banks since 1 June never exceeding USD 20bn (compared to reserve holdings of more than USD 2trn by Asian central banks ex-China)
  - EM banking systems remained stable despite sharp moves in both currencies and rates. Only a small number of central banks provided temporary liquidity support[5]
  - EM corporates were unaffected by tighter global financial conditions due to healthy maturity profiles

Outbreaks of uncertainty in global markets nearly always trigger excessive price adjustment in EM. While keeping a careful view on the risks in each individual credit, such sell-off typically create opportunities in EM. We think this summer's sell-off is no different.

[3] The headline grabbing stories included brief protests during the Confederations Cup in Brazil, short-lived clashes with environmentalists over Gezi Park in Istanbul, a tightening of liquidity in the Chinese interbank market to end regulatory arbitrage by two mid-sized banks, and the military coup in Egypt.
[4] See *"Happy 60th"*, Ashmore Weekly Investor Research, 9 September 2013.
[5] For details on China's brief interlude of higher interbank market rates see *"China funding markets: Yes, we can!"* Ashmore Market Commentary, 21 June 2013.