WEEKLY INVESTOR RESEARCH

Ashmore

Summary

We explain our view on political dynamics in Emerging Markets in light of the recent turmoil in Egypt. Political dynamics across Emerging Markets remain strongly supportive of prudent economic policies. Egypt falls into a category of countries, however, with proclivity to higher levels of political risk, wherefore the events in Cairo this past week fall within the realm of reasonable scenarios for Egypt. There are now so many investable Emerging Markets today and they are so diverse that political upheavals in a small handful of countries should not deter investors from seeking exposure to the asset class. Most Emerging Markets have very different political dynamics than Egypt.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	906		-1.30%
MSCI FM	533		0.80%
GBI-GD	6.46%		-1.68%
ELMI+	4.23%		-0.84%
EMBI GD	5.79%	304 bps	-0.31%
EMBI GD IG	4.85%	208 bps	-0.63%
EMBI GD HY	9.17%	659 bps	0.39%
CEMBI BD	5.68%	334 bps	-0.33%
CEMBI BD HG	4.83%	246 bps	-0.19%
CEMBI BD HY	7.58%	529 bps	-0.07%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,632	1.19%
VIX Index	14.89	-11.68%
5 year UST	1.58%	20 bps
10 year UST	2.69%	22 bps
10 year Bund	1.71%	-1 bps
EURUSD	1.2826	-1.86%
USDJPY	101.02	1.35%
Brent	$108	5.03%
Copper	$318	-1.35%
Gold	$1222	-2.49%

Emerging Markets

The Emerging Markets investment universe includes some 160 countries of which 65 are readily investable. This is an extraordinary richness in terms of political systems, economic structures and policy priorities and many countries have both fixed income and equity markets in addition to opportunities to trade currencies. The asset class has become far more diverse over the past 25 years as countries have thrown off the shackles of Cold War politics to develop their own unique political systems. Political power no longer hinges on money and guns from foreign superpowers, but requires the trust of domestic populations, which in turn hinges on delivering growth and stability. This is especially true in the poorest Emerging Markets, where the majority have no access to a welfare state. In wealthier Emerging Markets, sizeable middle classes now also demand better quality government services. Governments that fail to deliver stability and growth and improvements in services usually experience rapid depreciation of political capital, which soon triggers policy change. Brazil and India are recent examples of precisely this type of feedback loop from poor policy into domestic unrest into policy change. The contrast with developed economies is therefore stark: developed countries rarely reform, because such a large part of the electorate depends on state support, whether it be free education, free health care, free infrastructure, allowances for families, single parents, children, free bus passes, winter fuel allowances, agriculture subsidies, even policing and defence spending. Governments in developed economies have also convinced investors that their bonds are risk-free, so when misfortune strikes they tend to extend the reach of the welfare state further, financed by debt, rather than adjusting. This luxury of endless bond issuance is not available to Emerging Markets.

That is not to say that Emerging Markets do not experience bad governance, macroeconomic mismanagement, and other problems. Political failure is certainly not exclusive to developed countries. In addition to the odd accidental election of bad leaders, there are at least three groups of Emerging Markets countries that are structurally more risky than others. What these countries have in common is that demand for good governance fails to translate into sensible policies. The first group is a handful of countries, which, for historical, ethnic, or other reasons are stuck with highly confrontational zero-sum politics. Examples include Ecuador, Argentina, Rwanda, and Ukraine. The resulting power death matches subsume broader economic considerations to the more immediate political objective of winning and holding on to power. Fortunately, politics in most Emerging Markets countries is typically far more pluralistic. Oil producers also tend to be more unstable. The enormous wealth conferred into governments from oil revenues does, in some countries, allow leaders to assume quasi-dictatorial powers, again severing the link between long-term voter preferences and economic policy. Venezuela and Ecuador are excellent examples of countries with this type of problem. Finally, a number of countries in the Middle East still find themselves caught up in Cold War politics, where foreign powers exercise disproportionate influence on domestic politics. The war in Syria, tensions between Israel and Palestinians, the fragility of the political situation in Lebanon, and the current political upheaval in Egypt are all examples of this problem.

Continued overleaf

Emerging Markets

When we look at Egypt today, it is worth remembering that when the Cold War ended in 1989 most Emerging Markets went through a decade long adjustment period to overcome deeply entrenched reputations for instability, rectify legacy economic imbalances, and build from scratch legitimate domestic political institutions. In many countries, the transition lasted more than a decade. Thus, on the subject of President Morsi's removal from power it should not surprise that Egypt is unstable. Even if Egypt manages to escape the clutches of Cold War politics – which is highly uncertain given its strategic importance in the region – it will take many years before the zero-sum antagonism between the military and the Muslim Brotherhood is swept away in favour of more representative mainstream political institutions. This does not mean, of course, that Egypt is a no-go territory for investors. To the contrary, Egypt is now a very active 'credit story', where both price and the credit itself evolve constantly. While Egypt is very unrepresentative of Emerging Markets in general, the country's predicament underlines the importance of having a strong credit focus when investing in Emerging Markets. There is no such thing as a risk free investment.

Global backdrop

The US labour markets improved last week, which sets the Fed on the path to commence tapering of Quantitative Easing in September. The ECB also introduced forward guidance, despite a recent pick-up in the economic activity in Europe. The ECB knows that Europe cannot handle higher rates, because the banking system is insolvent. The contrasting direction of policy in the US and Europe pushed the dollar sharply higher against the JPY and EUR, while US treasury yields reached fresh post-2011 highs. The global manufacturing cycle showed tentative signs of improvement for the first time in four months, with decent readings in developed economies and in Eastern Europe. Due to the interconnectedness of the manufacturing supply chain we expect an upturn soon to show up in Asian and Latin American PMIs as well. But manufacturing cycles do not drive growth rates. Indeed, the past week saw the Q2 growth rate in the US revised down by -0.6% due to worse than expected trade numbers. Q2 growth is now tracking just 1% (roughly equivalent to America's annual growth in population). The lingering constraint on growth in the HIDCs (Heavily Indebted Developed Countries) is debt. Average public debt/GDP ratios in the HIDCs rose from 74% of GDP in 2007 to 113% in 2013, according to the IMF, but factor in private sector debt and the debt burden is several times larger. By contrast, Emerging Market public debt/GDP has remained flat at 33% throughout the crisis. High levels of debt are causing difficulties in the European periphery (Portugal and Greece all experienced tensions in their bonds markets last week), but debt is still largely ignored in the US, Japan, and the so-called 'core' European economies. Ignoring the stock of debt in 'risk free' countries is dangerous. The current conditions of record high rates of money printing, unprecedentedly high levels of debt, and – still – very low interest rates are not equilibrium conditions.

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