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WEEKLY INVESTOR RESEARCH

Ashmore

IMF – read the West – comes good in Ukraine

By Jan Dehn

Good news for Ukraine as the IMF approves a two year standby agreement. Venezuela finally launches SICAD II with a major de facto devaluation. Argentina taps the local bond market for the first time in five years. Brazil is downgraded and no one cares, while a fresh poll shows a sudden decline in support for President Dilma Rousseff. Results of Turkey's municipal election are out, and Mexico reforms a bit more. We discuss Weidmann and Draghi's verbal intervention in the EUR and the latest European bank survey. Speculation about Japanese stimulus is rising ahead of corporate tax changes and we summarise the latest state of play in US household deleveraging.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	985	–	3.30%
MSCI EM Small Cap	1,031	–	0.97%
MSCI FM	626	–	2.25%
GBI EM GD	6.90%	–	2.08%
ELMI+	3.88%	–	0.82%
EMBI GD	5.58%	285 bps	1.17%
EMBI GD IG	4.76%	197 bps	1.07%
EMBI GD HY	7.58%	510 bps	1.37%
CEMBI BD	5.45%	307 bps	0.69%
CEMBI BD HG	4.55%	217 bps	0.58%
CEMBI BD HY	7.31%	492 bps	0.93%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1858	0.05%
VIX Index	14.41	-4.51%
5 year UST	1.77%	4 bps
10 year UST	2.75%	2 bps
EURUSD	1.3745	-0.68%
USDJPY	103.24	0.97%
Brent	107.09	0.71%
Copper	306.14	0.62%
Gold	1292.35	-1.27%

Additional benchmark performance data is provided at the end of this document.

Emerging Markets

- **Ukraine:** Ukraine's parliament approved the budget changes required as prior action for IMF support, and reached staff level agreement on a two year standby arrangement. In addition to the USD 18bn available in support under the program, both the US and Europe have committed an additional USD 12bn-15bn. There are no plans to include haircuts on private sector debt, which is intelligent, because (a) Ukraine's problem is not a solvency problem and (b) private sector recovery hinges on re-establishing strong private sector buy-in. Yulia Timoshenko announced her candidature for the presidential election scheduled for 25 May. She is from eastern Ukraine, but is supported by the West, so she 'ticks' important boxes as Ukraine attempts to turn westwards without alienating the industrially important eastern region.

- **Venezuela:** The third official currency market was formally launched last week after weeks of false starts. The so-called SICAD II currency market was launched at an exchange rate of 51.86 Bolivars to the US dollar. This compares to the SICAD I rate of 10.80 and the official preferential rate of 6.3 per Dollar. For comparison, the unofficial parallel exchange rate is about 60 Bolivars per US dollar. The SICAD II market will be open every weekday and the exchange rate will be published daily by the central bank on its website. SICAD II looks set to be the closest approximation to a floating rate in Venezuela today, though this ultimately depends on how many transactions the government will allow to take place at the SICAD II rate. In principle, individuals, banks, corporates, broker-dealers, PDVSA and the central bank can all participate. If the volume of US dollars transacted is not restricted then the launch of this market will constitute a major de facto devaluation, which would be extremely positive for Venezuela's oil dependent public finances. Two caveats: First, the impact on bond prices depends on the proportion of Dollars supplied to the system via newly issued bonds versus cash. The more bonds the less the upside on bonds due to the offsetting effect of more supply. Second, devaluations only have permanent positive effects on the economy to the extent that they are accompanied by corrections of the underlying sources of excess stimuli in the economy. In a classic example of ratings agencies being behind the curve, Fitch downgraded Venezuela from B+ to B with negative outlook.

- **Argentina:** The government tapped the domestic bond market for the first time since 2008 when it auctioned a three year peso floating rate bond last week. This reduces the government's reliance on the central bank for monetary financing, which is ultimately important in order to manage inflation. The government also formally cut energy subsidies, albeit by less than had been expected. Argentina is undertaking the minimum adjustment required to avoid a balance of payments crisis.

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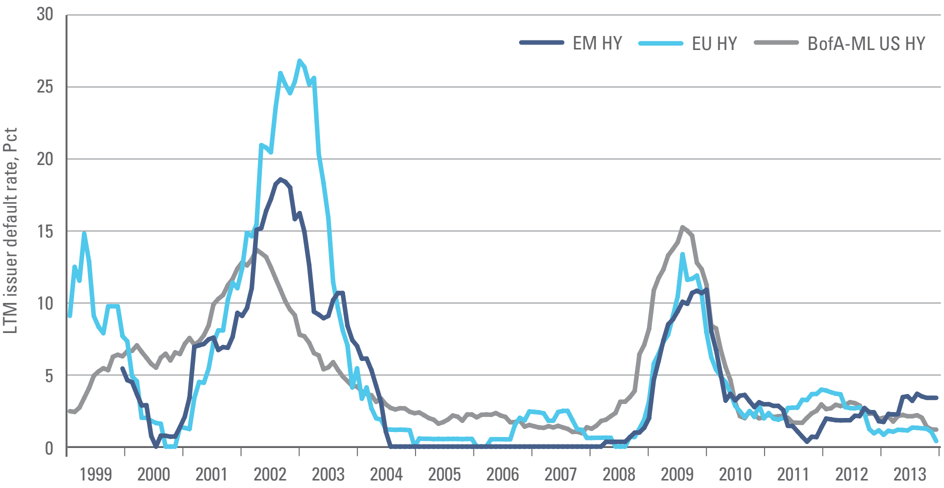
Emerging Markets

• **China:** Corporate defaults are all the rage. We think the market needs to shift itself psychologically to the place where it expects the same default rates in China as in any other country. Default rates on corporate high yield bonds in Europe, the US, and EM sit between 0% and 5%. China's default rates should ultimately reach similar levels. The Chinese government recently undertook a major audit of debt and concluded that the economy was robust enough to forge ahead with interest rate liberalisation. We believe China is comfortable with the economy's ability to withstand the rise in defaults associated with interest rate liberalisation. Emerging Markets corporate high yield bonds are trading several hundred basis points wide of identically rated US corporate high yield bonds with about 80% of the leverage, meaning that they offer significantly better returns per turn of leverage than US high yield corporate bonds.

Fig 1: **High yield default rates (%)**



Source: Bank of America Merrill Lynch.

Meanwhile, China's reform of state owned enterprises (SOE) continued when CITIC Group announced that it is listing all its operating assets outside of China. This improves the perception of corporate governance and gives China watchers more disclosure about the financials and strategic planning of a major SOE in China. We expect SOE reforms to continue.

• **Brazil:** Perhaps the most anticipated ratings downgrade of the decade finally took place last week, when ratings agency, S&P, lowered Brazil's long-term foreign currency sovereign bond rating from BBB to BBB- and changed the outlook from negative to stable. S&P cited fiscal deterioration and slower growth as reasons for the downgrade, but stressed Brazil's institutional and balance sheet strengths (both fiscal and external) as reasons to retaining Brazil within the club of investment grade countries. The local currency bond rating was lowered from A- to BBB+. S&P's decision to downgrade Brazil took place literally years after the fundamental deterioration began in Brazil under the stewardship of Finance Minister Guido Mantega. The downgrade will have no impact on the main fixed income indices and was fully priced in by the market. The extreme delay between changes in credit quality and the resulting ratings action is one of the many reasons why basing investment decisions on ratings is a bad idea. Unfortunately, the entire global regulatory system is now based on ratings.

Meanwhile, in the world of politics a week is a very long time. Just a week after polls of voting intentions showed President Dilma Rousseff winning by a handsome margin in the upcoming election a new poll this week showed her approval falling to 36% from 43% in December. Worse, the poll was undertaken before news that Dilma signed off on the purchase by Petrobras of a US energy refinery while she was Energy Minister. The USD 1bn asset has since had to be entirely written off this week.

• **Turkey:** Turkey went to the polls in municipal elections this weekend. The results today put PM Erdogan's AK Party at 45.5% of the popular vote, with the opposition CHP and MHP at 27.9% and 15.2% respectively. Importantly, the AK Party won in Istanbul and managed to hang on to Ankara as well, in a narrow vote. This is a clear victory for the AK Party and a defeat for the opposition forces led by Fetullah. However this was not entirely surprising and is indeed very close to the results forecast released last week by Konda, a credible pollster. The municipal election marks the start of a busy 18 month period of elections, including presidential elections and parliamentary elections this summer and next, respectively. The AK Party's strong showing makes

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Emerging Markets

it more likely that Erdogan will run in the presidential elections this summer. Meanwhile, the corruption allegations and other attempts to destabilise him will probably continue and will create a challenging political backdrop to the economic adjustment under way.The market welcomed the AK Party clear victory this morning, though, because the odds of economic adjustment in Turkey increase sharply once the political distractions go away. Turkey belatedly began to adjust its macroeconomic policies earlier this year. This will produce 'results' later in 2014. Turkey's deeper fundamentals remain sound (low debt, dynamic flexible economy, good infrastructure, sound fiscal policies etc.).

- Mexico: Reforms are continuing in Mexico. Last week the lower house approved a new federal competition law, which will erode monopolies and increase competition in the Mexican economy. One way this will happen is through a strengthened and financially autonomous competition commission. The Senate is due to vote on the bill in late April.
- Policy actions: Hungary's central bank cuts policy rates by 10bps to 2.6% and signals it is done cutting unless global conditions worsen significantly. Nigeria's central bank left rates unchanged at 12% and raised reserve requirements by 3% to 15%. South Africa's reserve bank left rates unchanged at 5.5%. Philippines started its tightening cycle with a 100bps increase in banks' reserve ratios to 19%, but left policy rates unchanged. The Czech Republic's central bank left rates unchanged at 0.05% and maintained the bias to intervene to weaken the CZK. The Bank of Zambia raised rates by 1.75% to 12% and the National Bank of Romania left rates unchanged at 3.5%.

Global backdrop

ECB policymakers, including ECB President Mario Draghi and Bundesbank President Jens Weidmann once more revealed that the ECB's verbal intervention zone begins around 1.39 when they said that the ECB could consider negative interest rates or even QE if the EUR gets too strong. Draghi and Weidmann's verbal intervention level match those used by other ECB officials a few months ago when the EUR last reached these levels. The EUR has been performing strongly despite the Fed's recent hawkish tilt. The EUR is strong for the 'wrong reasons': the Eurozone will find it difficult to generate inflation due to lingering banking sector problems. By contrast, the US will inflate away its debt problem having recapitalised its banks early in the crisis. The ECB sees its role as defender of the EUR – so if the currency gets very strong the ECB is willing to reduce the return it offers to those who hold the currency. EURUSD has traded in a 1.20-1.50 range for the past six years, held in place by low growth, low inflation, and low policy rates in Europe and the other heavily indebted developed countries. Last year the EUR completed a return-trip to 1.20 following the launch of ECB's OMT program in the summer of 2012.

ECB's bank lending survey showed that loans to the private sector are still falling, down 2.0% in the 12 months to February 2013. Bank lending to businesses (down 3.1% yoy) is critical to a strong economic recovery due to the heavy dependence of European companies on bank financing (as opposed to bond financing). Banks are not lending due to unresolved bad asset problems.

Speculation is mounting that Japan may launch a further stimulus to accompany the corporate tax changes billed as the 'third arrow' of 'Abenomics'. We are sceptical about the ability to address Japan's deep structural problems with corporate tax changes and fiscal and monetary stimulus.

US manufacturing slowed in March. Markit's PMI declined to 55.5 in March from 57.1 in February. Durable goods output and pending home sales also weakened, but claims for unemployment declined. The US economy has disappointed in Q1 due to an inventory correction. We think final demand will remain sluggish until households have concluded their deleveraging process, which will probably take another couple of years. On that note, the Federal Reserve released fresh estimates of US household financial accounts on 6 March 2014. The data shows that the ratio of US household debt to income declined by just 0.1% to USD 1.0trn in Q4 2013 as households' disposable income rose to USD 12.6trn, while debts rose to USD 13.1trn. On a qoq basis, the ratio of household debt to income rose by 0.16%, which is the first increase in the debt to income ratio of households recorded since Q3 2009. Our view is that the US household debt to income ratio still needs to decline by some 10% to about 90% (the pre-Greenspan Bubble level). The still high level of household debt will place a major drag on the economy if interest rates rise materially in the US.

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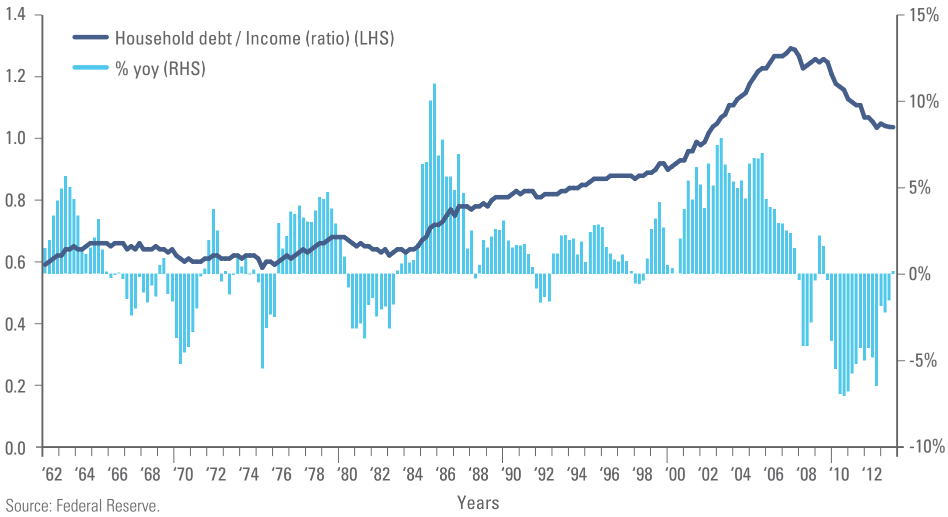
Global backdrop

Fig 2: **US household debt to income and year on year change**



Source: Federal Reserve.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	2.1%	-1.5%	-1.9%	-1.9%	13.8%
MSCI EM Small Cap	1.3%	2.6%	0.2%	-0.6%	19.4%
MSCI FM	2.8%	6.8%	24.5%	7.9%	13.9%
S&P 500	0.05%	1.00%	20.88%	14.80%	20.39%
GBI EM GD	1.96%	1.05%	-7.90%	1.07%	9.46%
ELMI+	0.98%	0.17%	-1.91%	-0.92%	4.13%
EMBI GD	1.17%	3.53%	0.36%	7.08%	11.61%
EMBI GD IG	0.53%	3.45%	-1.84%	5.69%	9.06%
EMBI GD HY	2.47%	3.71%	4.48%	9.53%	15.24%
5 year UST	-0.99%	0.63%	-1.95%	2.88%	2.85%
7 year UST	-0.97%	1.97%	-3.26%	4.39%	3.70%
10 year UST	-0.02%	4.24%	-2.86%	6.38%	4.00%
CEMBI BD	0.54%	2.66%	1.11%	5.80%	12.04%
CEMBI BD HG	0.44%	2.92%	1.07%	6.19%	10.27%
CEMBI BD HY	0.76%	2.10%	1.20%	5.34%	18.22%
Barclays Agg	-0.13%	2.34%	1.80%	2.71%	5.07%

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