Ashmore

Market Commentary

29 September 2011

Engage that First Bullet now

Global markets seem to have entered a stage of heightened uncertainty with investors paying little regard to fundamentals. In our view, valuations of Emerging Market ("EM") assets are sharply at odds with underlying risks and we now see considerable value across the EM complex.

EM assets have sold off due to significant growth and fiscal challenges in G10 economies. While these difficulties will take years to play out, we believe the end-game is now in sight for the most serious tail risks in G10. The current global sell-off is likely to be over in the coming weeks.

We urge investors to consider beginning to scale into EM assets using a three-bullet approach, because it is difficult to pinpoint the precise bottom. We recommend investing the first bullet here.

The outlook for EM remains solid in our view. EM economies are increasingly insulated from G10 developments due to solid domestic demand, strong reserve cushions, and domestic financing sources. We expect EM central bank reserves to exceed $8.5trn over the next 12 months. We believe that EM will continue to grow 3 times as fast as G10 while carrying less than 1/3 of the public debt levels of G10 economies. EM fiscal balances are more than twice as good as those in G10.

EM assets are now cheap at current levels in our view:

- EM currencies are around 10% off their peak, but selected currencies, such as BRL, have fallen circa. 20% versus the dollar.
- EM external debt spreads have risen to 437bps versus previous lows of 170bps and 2010 lows of 220bps.
- EM Corporate High Yield spreads over treasuries have almost doubled, largely due to worries over European crossover. EM corporates remain generally healthy.

We believe EM external debt offers compelling risk-adjusted value at these levels:

- If 10 year treasury yields rise to 2.25% and EM spreads normalise to 250bps over the next 12 months EM external debt would return 18%.
- EM external debt is rated investment grade, highly diversified and liquid.
- EM external debt trades with the same volatility as US treasuries and is less volatile than US IG.

Corporate debt could generate the highest absolute return of all EM asset classes over the next 12 months, particularly in the sub-investment grade segment:

- Sub-investment grade corporate spreads are now 937bps over treasuries compared to 497bp over in April 2011 and an average of less than 400bps prior to the 2008/2009 crisis.
- Corporate High Yield now yields more than 10.7% and would return 26% over the next 12 months within a scenario of modest spread compression to 600bps over treasuries from current levels.
- Typically, Developed Market High Yield credit has the problem of too much leverage.

EM currencies now offer strong short-term upside potential plus long-term outperformance versus G10 currencies. In our view:

- EM FX has 10%-15% upside potential when current G10 tail risks dissipate.
- EM central banks have begun to intervene to stabilise their currencies.
- We then expect EM FX to resume a 5% p.a. trend appreciation vs. USD once markets normalise.

EM rates offer value in selective markets and in specific curve plays:

- Many EM curves now price neutral policy rate outlook in a benign inflation scenario with slower global growth, but policy diversity means country choice is key.
- Tactically, the first bullet can wait a bit, but we believe substantial value can quickly emerge in rates markets.
- Local rates are likely to offer attractive alpha opportunities on a permanent basis in the context of improving liquidity.

During the 2008/2009 crisis, we advised our clients to buy into EM currencies and EM corporate debt, which were trading at severely distressed prices. For the period 1 Apr 09—30 Jun 11 our broad EM local currency strategy has returned 47.8% and our EM corporate strategy has returned 108.7%. (Data as at 29/09/11)

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