January 2015

Ashmore

ANNUAL OUTLOOK 2015

Market prospects

By Jan Dehn

Introduction

2015 kicks off with Emerging Markets (EM) asset prices at attractive levels after two tough years. Valuations notwithstanding, investors are likely to remain cautious towards EM in 2015. The global backdrop will be volatile as QE-soaked financial markets keep focussing on short-term fads and headlines rather than deeper or longer-term issues. The 'Dollar Delirium' looks set to continue in 2015 on the back of further easing in Japan and Europe, but will likely end with a mighty hangover. The fear of Fed hikes is bordering on the obsessive. Geopolitics will gain greater prominence – a net negative for the world. Commodities will dominate conversations at the start of 2015, if only because prices moved far and fast recently, but these should stabilise in 2015 because underlying demand and supply fundamentals have not changed nearly as much as prices would imply.

EM investors will be challenged to keep sight of the bigger picture amidst the global volatility, but the actual risks are overdone as far as EM is concerned, in our view. EM countries have generally responded to fickle investor sentiment with adjustment, reform or both and will continue to do so. EM is growing faster, is much less indebted and has stronger external balances than any of the heavily indebted developed economies. EM has better demographics and far more conservative policy makers. EM central banks are not printing money.

Even so, active management will gain in importance in 2015. Stories of self-inflicted pain and reform-induced successes co-exist across EM's increasingly diverse universe. Tighter global conditions and external shocks will accentuate the differences between credits but only at the margin; the quality of governance is by far the more important determinant of individual success or failure. The vast majority of EM credits remain solid going into 2015, but one differentiating facet to watch in 2015 is market access: smarter EM governments will open their markets to foreign money in a bid to maintain or even increase their share of a shrinking global financial pie.

Valuations notwithstanding, investors are likely to remain cautious towards EM in 2015. Cautious investor sentiment is not a bad thing: no need to fear bubbles, while yields, spreads and carry are attractive. Cautious sentiment also keeps EM policy makers on their toes. This helps to keep EM countries – for the most part – fundamentally healthy

The broader longer-term picture remains unchanged. The global imbalances – debt in developed economies and reserves in EM – have not gone away and EM local currency still offers the best way to protect the purchasing power of savings once the big inflation party kicks off in the developed economies, likely starting in the US in late 2016.

Attractive valuations

We enter 2015 with EM asset prices at attractive levels after two years of poor price action. EM now trades at valuations – in spread terms – that are better than before the Subprime Crisis in 2008/2009, consistent with tighter US monetary policies than we are likely to see in 2015, even taking into account US Fed hikes. With recent market weakness, forward looking equity valuations across EM and Frontier Markets do not appear stretched. A long list of EM countries with perceived weaknesses has been put through the wringer over the last couple of years. Most have responded with adjustment, reform or both, improving their credit worthiness. Only Argentina has defaulted.[1]

The contrast with developed economies is dramatic; most developed countries respond to weakness by easing fiscal and especially monetary policies. Indeed, they have squandered seven years of hyper-easy financial conditions without meaningfully deleveraging or reforming. Risks are priced in EM, but developed economies face a year of reckoning if monetary conditions genuinely tighten.

1 Even Argentina's default was odd; the country continues to service debt, but a US court has prevented the intermediary banks from forwarding the payments to bond holders.

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Fig 1: **Market valuations**

			Trailing PEs				Forward PE
Equities	**Index**	**Index level**	**5 year high**	**5 year low**	**5 yr average**	**Current level**	**Current level**
EM equities	MSCI EM	956	18.4	9.0	12.6	13.2	10.6
EM small cap	MSCI EM Small Cap	996	27.8	8.3	18.8	19.8	11.5
Frontier markets	MSCI FM	612	19.3	9.4	12.9	10.8	9.2

			Spread to US treasuries (bps)			
Bonds and FX fwds	**Index**	**Yield %**	**Start 2015**	**Start 2014**	**Start 2008**	**All-time low**
Local Government Debt	GBI-EM-GD	6.46	494	510	412	174
FX forwards	ELMI+	5.93	592	438	637	98
Local Corporate Debt	LOCL	8.89	764	654	NA	NA
External Sovereign	EMBI GD	5.75	370	288	271	169
External Sovereign IG	EMBI GD IG	4.49	240	195	163	88
External Sovereign HY	EMBI GD HY	8.46	651	518	325	203
External Corporate	CEMBI BD	5.59	368	311	300	147
External Corporate IG	CEMBI BD IG	4.49	257	226	237	124
External Corporate HY	CEMBI BD HY	8.10	621	489	549	270

Note: ELMI+ EX is the implied spread over 3-month US Treasury Bills

Source: Ashmore, Bloomberg, MSCI. Data as at 1 January 2015.

Cautious sentiment towards EM

Valuations notwithstanding, investors are likely to remain cautious towards EM in 2015 due to the uncertainty that surrounds the precise timing, pace and size of Fed hikes rather than the effects of the hikes per se, in our view. Cautious investor sentiment is not a bad thing: no need to fear bubbles, while yields, spreads and carry are attractive, in our view. More momentum-oriented investors will stay on the side-lines, but institutional investors are likely in the main to maintain their allocations to EM, at least in line with the overall growth of their assets under management.

Keep a close eye on the ball

Cautious sentiment also keeps EM policy makers on their toes. This helps to keep EM countries – for the most part – fundamentally healthy. EM is fundamentally far less risky than developed economies; EM countries have only issued 12.5% of the world's government and corporate debt compared to 87.5% in developed economies. EM is 56% of global GDP, so EM debt dynamics are superior to those in developed economies.

Welcome return to positive Fed rates

Fed hikes will dominate headlines in 2015. It is by no means certain that the Fed will hike. US growth is erratic and most US markets are in bubble territory. The Fed probably wants to chalk up a few hikes to mark progress on the long road to recovery, but hikes will be slow in coming and start from a low base. The underlying US growth momentum is still unimpressive, while overall indebtedness, lack of capacity in Congress to deal with long-term structural challenges and rock-bottom inflation expectations obviate the need for draconian Fed tightening. We would strongly welcome a return to non-zero policy rates in the US as an important first step towards more rational market behaviour, but the risk is that the Fed delivers less than expected in the way of hikes.

Fed fears overdone

Fears over Fed hikes are overdone as far as EM is concerned. Falling inflation has already pushed real yields in EM local markets well into positive territory. The 'Taper Tantrum' of 2013 saw EM yield curves re-price in real terms by a full 200bps with little fundamental damage or loss of growth momentum across EM, underlining economic resilience. Japan, Europe or the US would not have fared quite so well had their yield curves re-priced by 200bps in such a short period. Indeed, QE features prominently in both Europe and Japan because both regions are ill-prepared for tighter financial conditions. The fact that Fed hike fears are overdone in EM should not surprise; EM markets are notoriously inefficient with endless examples of asset prices and fundamental risks parting ways. This will not change in 2015 as febrile, risk-averse markets over-state risks in troubled EM countries – such as Russia – and dramatically under-state risks in developed economies. The silver-lining is that EM offers excellent opportunities for value-oriented active managers. The exodus of weak hands from the asset class since May 2013 suggests strong technicals.

The importance of policy

EM countries will continue to display very different performances in 2015. The most important determinant by far of the success or otherwise of any EM country is the quality of its government. EM countries that find themselves in trouble can usually blame themselves, while the successful countries do well because of intelligent and far-sighted government policies. External shocks or 'immutable' structural characteristics of individual EM countries matter relatively little. The vast majority of EM countries are run well, diversified and stable, able to perform in spite of whatever challenges the global environment throws in their direction. When countries do experience serious shocks, their fate owes far more to how they respond to such shocks than to the shocks themselves.

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Structural factors that matter at the margin

Some EM countries are obviously more structurally challenged than others. A few struggle with external interference, such as Ukraine, which tends to erode domestic political legitimacy, though they can still thrive as Georgia, Azerbaijan and the Baltic States have shown. A few others are saddled with deep internal political divisions, which tend to lead to populism. They too can make compelling investment opportunities; Argentina defaulted in 2014 (under peculiar circumstances), but Argentina's debt spread declined by nearly 400bps in the course of 2014 to make it one of the best performing debt markets last year. Commodity-dependent countries are naturally more prone to external shocks, but their populations are often used to volatile macroeconomic conditions. Recall that when Venezuelan oil production fell to zero in 2003 Venezuela favoured debt service over paying civil servant salaries and bonds staged a spectacular recovery.

Smarter EM governments recognise that they can maintain or increase their share of a shrinking global financial pie if they open their domestic markets to foreign investors. We expect to see more frontier economies issue sovereign external debt for the first time, while China, India and Saudi Arabia will take further strides towards opening their domestic markets

Opening markets

Smarter EM governments recognise that they can maintain or even increase their share of a shrinking global financial pie if they open their domestic markets to foreign investors. The mere act of joining an index increases available funding because so many investors are passive. In 2015, we expect to see more frontier economies issue sovereign external debt for the first time, while China, India and Saudi Arabia will take further strides towards opening their domestic markets. Will the main index providers – Wall Street banks – follow suit by expanding their index coverage? We doubt it. A strong case exists for a public sector international financial institution – such as the BRICS bank – to step in where markets fail to provide a full set of representative EM benchmark indices.

More currency volatility

The opportunity cost of investing in currencies has fallen sharply as bond yields have declined due to hyper easy monetary policies. G3 currencies are extremely liquid and trade on clearly understood 'themes' (alternatively they could be called fads or obsessions), such as the Eurozone debt crisis, 'Abenomics', the Taper Tantrum and now ECB QE. This is why currency markets have come to dominate not just FX markets, but all other markets too. The rise of currency markets is symptomatic of a myopic financial industry with too much money, too much herd instinct and too little vision, but this state of the world is unlikely to change in 2015. Instead, we expect flows to fuel the bubble in developed markets, where they are genuinely at risk of tighter financial conditions, the loss of central bank support or economic shocks. Nervous markets will become ever more prone to media and investment bank manipulation as investment horizons shorten. The resulting volatility in developed economies will frighten EM investors despite the fact that bouts of volatility in developed markets demonstrably turn out to be excellent EM buying opportunities.

EM FX amidst the Dollar Delirium

Since 2011, the common currency theme has been a stronger Dollar. The Greenback first tore through the EUR during the First Eurozone Debt Crisis, then demolished the JPY during 'Abenomics I' in 2012. EM currencies were beaten up during the Taper Tantrum of 2013 and the JPY was targeted for a second time in 2014 as the market began to front-run Japanese pension fund re-allocations. In late 2014 and early 2015 the Dollar gobbled up commodities, thus setting the stage for a second leg down in EM currencies (even though most EM countries are net importers of commodities). Aided by events in Europe the Dollar Delirium looks set to continue in early 2015. EM currencies are merely the tail on that particular dog, but few EM investors are likely to steadily add to EM currencies in this environment. For this reason, rather than fundamental reasons, we remain tactically cautious on EM currencies at the start of 2015.

EM currencies beyond 2015

The Greenback Binge will end with a mighty hangover. The missing variable in the global currency story is still inflation. Enormous amounts of money have been printed, but money does not go shopping on its own. Drags from deleveraging, unemployment, and negative housing equity are keeping a lid on inflation, but the drags should fade further over the next two years, specifically in the US. Inflation should slowly return by late 2016. But in conditions of still slow trend growth and high overall debt levels the Fed will be prevented from meaningfully tightening monetary policy even after inflation begins to rise. The resulting Dollar hangover starts in earnest after markets realise that the US government – like its counterparties in Europe and Japan – intends to fix the debt problem by inflating it away. By then, most investors will be 'limit-long' Dollars.

Protecting purchasing power

The imbalances in the global economy are alive and well, pitting big debtors in developed economies against big reserve holders in EM. Developed economies have issued more than 80% of the world's debt, while EM countries control nearly 80% of the world's FX reserves. When developed economies solve their debt problems via inflation and currency debasements – as we think they will – EM currencies will offer perhaps the only way to protect the purchasing power of savings. After all, policies right across developed countries are geared specifically at turning debt into inflation – an effort that continues to this day. Inflation is good for developed economies, because it erodes their debt and helps to claw back productivity via currency weakness, but it is bad for assets denominated in their currencies. In EM, the opposite is true. EM economies will be challenged economically as their currencies appreciate, but the purchasing power of assets denominated in their currencies will be enhanced.

Growing opportunity set

We anticipate that EM financial markets will more than double in size by 2020. They will grow in line with nominal GDP – say 8-10% per year – plus a bit due to financial deepening. There are more than 60 countries in EM fixed income indices – three times as many as ten years ago – while EM corporate indices have

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more than 1,600 names. The number of eligible countries is likely to rise to at least 80 by 2020, the number of corporate names by far more. Local markets will completely dominate EM, while the corporate bond market will continue to grow faster than sovereign markets. We expect about USD 340-360bn in total corporate issuance in 2015 with Asia the main contributor, while supply from Eastern Europe and Russia could decline due to temporary regional troubles.

EM credit – offers decent value

EM credit is cheap on a historical basis and against developed market peers, especially vs. US credit. EM IG and HY credit spreads over the US equivalents are wider at the start of 2015 than at any time since the first Eurozone debt crisis, despite a fall in default rates in EM credit in 2014 to 1.7% from 3.3% in 2013 (the long-term average is 1.95%). The risk-averse environment gives rise to a number of attractive value opportunities for credit selectors. Speculation about FX mismatches are rife, but after a 20% fall in EM FX in the two years since significant media speculation of an imminent collapse there is still no sign of an EM credit collapse caused by FX mismatches. Why? Outstanding EM dollar debt does not equate to FX mismatches. Many EM corporates have revenues and assets denominated in Dollars. Others hedge or swap FX liabilities into local currency. As a general rule, owners of EM companies do not gamble their companies on the currency markets. EM debt markets can grow without eroding their capacity to pay because nominal GDP and nominal EBITDA grow too. Besides, local borrowing accounts for more than 80% of corporate funding. FX risks tend to be company specific rather than systemic.

EM equities outlook

The spread between price returns and earnings expectations is at the widest it has been since the global financial crisis and the dispersion in valuations across EM is at record highs. We are bullish on China on valuation grounds and more cautiously optimistic on Korea as we expect a gradual recovery in consumption. We see India and Indonesia continuing to deliver as these so-called ‘fragile five’ economies continue to benefit from a low oil price environment and positive sentiment following their respective elections. Russia, while the cheapest market in EM, faces severe headwinds in the face of lower oil prices and declining currency. There is deep value in Brazil, but a recession to overcome before the reward materialises. In the meantime, exporters and banks look more resilient in the face of weakened currency and threat of inflation, though balance sheet quality will be a factor to monitor. Equity markets in oil producing countries have been oversold in our view, and offer value at the start of 2015. The big event of H1 2015 will be the much anticipated opening of the Saudi Arabian market to foreign investors; the market trades at a 30-40% discount to its EM peers.

Geopolitics – nothing positive on the horizon

Geopolitics will continue to be a negative for the world in 2015. Populations in developed countries are complacent, while in EM they are lean and hungry. Huge structural weaknesses were exposed in developed economies after 2008/2009, while EM countries have never before been able to realise their economic potential to the extent we have seen since the turn of the century. As a result, the global power balance is in a state of extreme flux. Lame duck developed market governments ruling over populations with falling voter participation are shying away from undertaking economic surgery that could save them in favour of populism. Nationalism, xenophobia and foreign policy activism are on the rise. Religion is being deliberately politicised in a bid to mobilise mass support. Populations are sleepwalking into mass surveillance and the media has never been this complacent in the face of rising state power. At root, the key fault-line between nations remains energy, despite temporarily low oil prices. But the battles now also embrace a bewildering array of other issues, such as information technology, financial regulation, currency manipulation, new institutions to challenge the Bretton Woods institutions, FDI flows and direction of trade, not to mention the conventional ‘hot Cold War’ confrontations in the Middle East and borderlands around Russia. One thing seems certain: geopolitics will get more economic in nature in the future. The biggest economic battle of them all – how to distribute the cost of unwinding the global imbalances – still lies ahead of us. Both EM and developed economies will defend their perceived national interests vigorously – and what is in the national interest may not be in the interest of investors.

The spread between equity price returns and earnings expectations is at the widest it has been since the global financial crisis and the dispersion in valuations across EM is at record highs. Active management to determine the winners and the losers is key

Commodity prices stabilise

A plethora of ‘Monday morning quarterbacks’ now cite structural reasons for the sudden and spectacular fall in commodity prices, notably oil. But we do not think the dynamics of global commodity demand and supply have changed nearly as much as the fall in prices since June 2014 would imply. Inventory and currency dynamics play a part, but a 50%+ fall in prices itself changes things: demand will rise and supply will decline, so inventories will fall and prices will stabilise. The stabilisation of oil prices will be supportive for oil producers, but removes an important temporary tail wind for most other EM countries. The broader disinflationary effects of falling oil prices will turn into adverse base effects in H2 2015 just as the Fed prepares to hike, at least on current market expectations. Looking further ahead, the return of inflation and the gradual recovery in developed economies as their debt burdens decline should be supportive for commodity prices.

View on the US

For now, the US is ‘winning the ugly contest’ with Europe and Japan. Early recapitalisation of banks and government-aided household deleveraging has proven effective. The US can realistically hope to generate inflation on the back of the recovery in consumer demand starting in H2 2016. During 2015 inflation will still be low. The Fed will try to hike mainly as a symbol of the progress made in the recovery process, but risks are high. Growth is erratic. We see no prospects for major infrastructure or welfare reforms in 2015; only foreign policy is set to assume a more prominent role in the twilight years of the Obama administration. The Dollar is supported by expectations of bear flattening of the Treasury curve, but increasingly long positioning both in the Dollar and in the US bond curve makes these trades ever more risky.

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View on Europe

Banking sector problems, excessive debts and inability to reform destine the Eurozone for slow growth, deflationary risks and serious vulnerability to higher US rates. This is why the ECB will likely adopt sovereign QE in 2015. Periphery economies are not out of the woods. Greece goes to the voters on 25 January, Spain towards the end of 2015. Printing money and buying bonds seem to be Europe's only defence. Even so, the EUR will survive as each crisis brings greater not lesser integration. Perhaps the greatest threat to Europe is from its own people, the most tribalistic population in the world. The protracted slump is fertile ground for divisive policies. The referendum on EU membership in the UK after the general election in 2015 will provide an important gauge of the strength of such feelings, because the UK is still one of the most pluralistic countries in Europe.

View on Japan

You could be forgiven for thinking that Prime Minister Shinzo Abe's quiver only holds two arrows – monetary and fiscal stimuli. They deliver one-off moves in JPY and the stock market, but can they resolve Japan's major underlying problems of debt and demographics? We think not. We think 'Abenomics' will only provide temporary relief. In the absence of much more ambitious reforms – unlikely in our view – we think JPY is ultimately destined to strengthen again, while stocks are destined to sink.

As we often highlight, EM is far from a homogenous region. In fact these 60-plus countries offer a very wide spread of opportunities and each faces its own challenges – and their individual responses to those challenges will shape their progress and determine their performance in 2015 and beyond. We predict wider variations between individual countries than we have seen before. Here we review around 40 key markets and consider some of the issues they will face and how they might react.

Fig 2: **A journey across EM. What 2015 holds in store for some of its many countries.**

EM country	Market moving issues	Comments
Argentina	**General Election**	All candidates are considerably more market friendly than President Cristina Kirchner
	Holdouts	RUFO or not RUFO? The lady is not for turning
	Macroeconomic situation	Major fiscal and monetary adjustment required, but debt levels are low and the economy can bounce back sharply
Brazil	**Fiscal adjustment**	A credible fiscal adjustment will be implemented
	Recession	We expect a recession in 2015
	Ratings	Ratings agencies are behind the curve and may well downgrade Brazil as growth slows
Chile	**Third generation reforms**	Greater spending on education and other distributional policies as Chile develops
China	**Financial and capital account liberalisation**	Reforms will continue at a very high pace, including development of domestic bond markets
	Reserve currency status for CNY	China will try to achieve global reserve currency status in 2015
	Gradual slowdown	Growth is slowing due to forward-looking reforms; supportive fiscal and monetary backdrop
Colombia	**FARC peace talks**	Peace will further enhance Colombia's reputation for prudent economic management and reforms
Costa Rica	**Fiscal**	Fiscal balances look set to worsen from a strong base with increasing downgrade risks
Croatia	**Lack of reforms**	Presidential elections in January will not change much until the balance of power changes in parliament (February 2016)
Dominican Republic	**Growth, debt and deficits to improve**	'Cruise control' amidst strong growth and no elections until 2016
Ecuador	**Back to the market**	Likely to tap Dollar sovereign markets in 2015 regardless of a small number of holdout investors
Egypt	**Parliamentary elections**	Elections in Q1 will slowly restore institutional stability and pave the way for new IMF program

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EM country	Market moving issues	Comments
Ghana	Fiscal pain before gain	Fixing the world's largest political business cycle problem will be painful
Hungary	Conversion of remaining household FX loans	Private consumption and inflation are set to rise as the remaining FX loans are converted to HUF loans
India	Rate cuts amidst falling inflation	Fiscal prudence has finally provided room for rate cuts
	Growth	Growth looks set to continue
	Reforms	Modi rules by executive order until elections in 2016 break the Senate deadlock
	Capital account liberalisation	Greater likelihood that India opens its bond markets as yields decline
Indonesia	Infrastructure investment	Major fuel subsidy reform paves the way for more infrastructure spending
Iraq	ISIS and Iraqi oil production	May they never meet – stay long Iraqi debt
Ivory Coast	October presidential election	Elections pose greater than expected risk due to Ouattarra's waning health
Kenya	Stable politics	No major political events until 2017 suggests steady economic performance in 2015
Lithuania	EUR membership	Lithuania's economy will continue to rotate from Russia to Europe after Lithuania joined the EUR
Malaysia	Public investment program	The government's investment drive insulates Malaysia from external growth shocks
Mexico	Growth	Growth should double in 2015 relative to 2014
	Oil sector	The first major auctions of oil fields gets underway
	Gubernatorial and lower house elections	President Peña Nieto faces a tougher time as opposition looks set to make gains
Myanmar	General election	Potentially the first time a civilian government takes power in half a century
Nigeria	Presidential election	President Jonathan is re-elected
	Living with lower oil prices	Nigeria successfully adjusts at the expense of the NGN, oil stabilisation funds and President Jonathan's popularity
Panama	Fiscal adjustment	The government will moderate fiscal deficits after the 2014 as construction on the Panama Canal expansion supports growth
Paraguay	Infrastructure	Paraguay will realise significant growth dividends by addressing its massive infrastructure deficit
Peru	Lame duck	A quiet year lies ahead of the 2016 Presidential election; the investment cycle slowly winds down
Philippines	Goldilocks	Infrastructure led investment and falling inflation makes for sustained performance of the Philippine economy
Poland	Parliamentary election in October 2015	The odds of major political change are low; the odds of economic policy change even lower
Romania	New political blood	Solid growth and low inflation but rising political uncertainty as President Johannis shifts the focus to judicial and political reform
Russia	Recession and inflation	Russia adjusts to lower oil prices by passing the cost to citizens via inflation and slower growth
	Public finances	Robust due to flexible RUB
	Relations with the West	Remain tense, but odds now favour resolution over Ukraine question
	Ratings	A downgrade is a distinct possibility

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EM country	Market moving issues	Comments
Saudi Arabia	**Opening the stock market**	Recent oil price induced price falls offer attractive entry point to one of the world's largest stock markets
Serbia	**Post-IMF hangover**	A year of fiscal retrenchment and recession
South Africa	**Better growth and inflation**	Business cycle looks set to pick up, but long-term growth is threatened by major structural challenges
South Korea	**Policy response to Japan**	Watch Korea's response to a weak JPY closely; it foretells the wider EM response to eventual inflation in developed economies
Sri Lanka	**Post-election momentum**	Positive outlook for the economy as the January election uncertainty fades
Thailand	**Faster growth**	Growth set to quadruple in 2015 on the back of greater fiscal stimulus
Turkey	**June 2015 parliamentary elections**	The promise of economic reforms is entirely hostage to the outcome of the June parliamentary elections
Ukraine	**Peace agreement in Donbass**	The fortunes of the government now hinge on the economy; incentives to find a political solution in Donbass has increased
	IMF	Additional foreign support is increasingly linked to a political solution in Eastern Ukraine
Uruguay	**Infrastructure challenge**	A new Frente Popular mandate increases odds of a major infrastructure push
Venezuela	**Macroeconomic adjustment**	What reaches zero first? Maduro's approval rating or the central bank's FX reserves? A currency adjustment offers an exit from the horns of the dilemma
Zambia	**Presidential election**	A peaceful presidential election in Q1 will pave the way for a new IMF program

Source: Ashmore.

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