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WEEKLY INVESTOR RESEARCH

Ashmore

A nervous market shifts its attention from Ukraine to US treasuries

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Geopolitical risk occurs when domestic political dynamics extends beyond a country's borders and interacts with political dynamics in other countries. Geopolitical risk is complex, but ultimately entirely 'analysable', provided investors take research seriously. However, this week global sentiment was increasingly held hostage by the effect of financial tightening on US equity markets rather than the Russia-Ukraine situation. We think the more rational assessment of Russia-Ukraine is positive, but we do not expect the tightening of financial conditions in the US to become a major problem for Emerging Market (EM) countries.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,054	–	-3.64%
MSCI EM Small Cap	1,095	–	-2.35%
MSCI FM	703	–	0.51%
GBI EM GD	6.67%	–	-2.23%
ELMI+	3.38%	–	-1.04%
EMBI GD	5.26%	263 bps	-0.80%
EMBI GD IG	4.44%	176 bps	-1.19%
EMBI GD HY	7.09%	464 bps	-0.08%
CEMBI BD	5.19%	281 bps	-0.50%
CEMBI BD HG	4.35%	195 bps	-0.56%
CEMBI BD HY	7.03%	470 bps	-0.37%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1986	-0.76%
VIX Index	13.31	5.13%
5 year UST	1.81%	9 bps
10 year UST	2.60%	13 bps
US HY	5.94%	-0.58%
European HY	4.78%	-0.10%
EURUSD	1.2918	-0.12%
USDJPY	107.22	1.25%
Brent	96.39	-3.05%
Copper	316.43	-2.10%
Gold	1235.49	-1.38%

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

Emerging Markets

Geopolitical concerns have not gone away, but markets are becoming more rational about the situation in Russia-Ukraine and the Middle East, and shifting attention back to US markets, notably the Dollar and US treasury yields.

It is unsurprising that geopolitical concerns are fading a bit. It is the normal pattern for the complexities of geopolitical events initially to scare investors into selling all kinds of assets, even those with no direct connection whatsoever to the events in question, but then slowly for rationality to set in and eventually the risk is correctly priced.

Why does geopolitical risk initially spark so much asset price volatility? One reason is that geopolitical events are unambiguously more complex. When conventional domestic political risk extends beyond borders – that is, into the realm of foreign policy – it inevitably comes into contact with political dynamics in other countries.

There is also no doubt that geopolitical risk can be serious; the terrible conditions that prevailed in many EM countries during the Cold War owed much to the geopolitical risk arising from the quasi-imperialistic behaviour of the Superpowers at the time.

Today, geopolitical risk is fortunately less formidable, particularly in EM countries. Analysing geopolitics requires an understanding of the political dynamics of the countries involved – call them A and B – *as well as the interaction between them*. The additional complexity of geopolitical risk compared to single country political risk can be illustrated using a basic statistical formula:

$$\mathrm{Var}\,(A+B) = \mathrm{Var}\,(A) + \mathrm{Var}\,(B) + 2\mathrm{Cov}(A, B)$$

This formula says that the variance arising from the political dynamics in countries A and B are a function of *both* their individual political dynamics plus *twice* the covariance between them, whereas single-country political risk is only a function of the risk in that particular country. Obviously, if geopolitical events involve three or more parties the complexity only increases further.

The additional complexity of geopolitical events is often too much for the markets to handle. After all, large numbers of investors follow passive or quasi-passive strategies that ensure that their allocations to individual countries are based predominantly on how much debt those countries have issued, not how they are managed, either politically

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or economically. Passive investing saves money, but when geopolitical risks occur – which is inevitable – investors find that they may have underinvested in information. As a result, they feel poorly equipped to analyse the risk. Instead of getting on with the job of understanding the risk they simply adopt a simple rule of thumb, usually involving selling some assets in EM and buying something in America. Since so many other investors do the same thing each investor can always claim to be in good company and, in the short run, as nervousness prevails they are unlikely to be challenged. Running for cover at the first sight of geopolitical risk is hardly an optimal way to manage investments. First, the vast majority of political events (domestic as well as cross-border) end with no permanent impairment on asset prices. In other words, geopolitical *risk* is often quite different from the temporary *volatility* that such events can impart on asset prices; volatility is a nuisance but, provided the event goes away, asset prices can return to their previous levels with no permanent loss. At a bare minimum investment managers should be required to seriously analyse the risks they take. Geopolitical risk is part and parcel of human reality. Hence, it is part and parcel of managing risk in any country, at any time.

Second, herd-like behaviour in the face of geopolitical risks could put performance at risk over the full course of the geopolitical event in question. For example, when a herd rushes for the exit the bulk of them necessarily end up liquidating paper at unfavourable prices. And once the perception of risk begins to fade those same investors rush back in en masse to cover shorts or underweights only to fall for the fallacy of composition once again by buying long after prices have risen. Selling low and buying high is how to turn temporary losses into permanent losses.

The tendency for managers to behave in this way only increases when geopolitical risk involves far-away EM countries. The motivations of political leaders in EM are even more poorly understood in the finance industry than those in rich countries, thus making it all the more difficult to quantify the two last terms in the equation above. And the cost of trading with the herd is greater, because liquidity in EM assets is often far more pro-cyclical than for developed market assets.

Rather than knee jerk selling, the better strategy is to pick managers that are willing and able to form views about these complex events. The key is always to identify the actual risk. After all, someone who buys into weakness with actual knowledge is taking far less risk than someone who buys merely on faith. As we suggested in this publication last week, Europe and the US went ahead with the imposition of sanctions on Russia over its alleged involvement in the Eastern Ukraine conflict despite the establishment of a cease-fire between the Ukraine government and the separatist rebels. The sanctions were mainly broadened to new individuals and companies in the defence, finance and energy sectors. These companies will see access to Western capital markets restricted to very short-term financing. However, the sanctions skirt the key gas, space and nuclear sectors, and Europe and Ukraine continue to buy gas from Russia. Russia has so far not responded to the new sanctions and the cease-fire in Eastern Ukraine continues to hold, albeit with smaller occasional breaches. Our view is that both Europe and Russia are feeling the pinch. For Russia the pain is mainly via a weaker RUB, which in turn pushes up inflation, which then requires higher domestic interest rates that slow growth. In fact, at current levels of interest rates, growth is slowing down so much that the central bank of Russia decided to leave rates unchanged at 8% last week. But Russia's fundamentals are strong and we see little risk from a credit perspective. We think a solution is close, because the costs to both sides have now reached a level where they begin to matter more than what is at stake in Ukraine. Throughout this conflict both sides have been extending olive branches, but so far both sides in this mini-Cold War have failed to display the courage required to fix this relatively simple geopolitical conflict. Minds are likely to become more focused as winter draws closer and once the Ukrainian elections are out of the way.

Turning to other EM specific events, we highlight the following:

- China: China's economic data releases over the past week point towards moderating growth. Industrial production, retail sales and fixed asset investment rose significantly yoy, but at a slower rate than expected. Earlier in the week, new loans data had bounced back. The fact that CPI inflation in China also came lower than expected at just 2.0% yoy means that there is certainly scope for further stimulus from the central bank if the authorities deem the 7.5% target growth rate to be at risk. We do not expect broad-based easing measures, but rather targeted interventions to support particularly vulnerable sectors. China is in the process of a structural transformation of its economy, which inevitably leads to a period of slower growth (so-called 'crossing the desert' problem familiar to students of the structural adjustment literature of the 1980s).

- Mexico: Mexican industrial production picked up in July, rising 2.1% yoy mainly due to strong manufacturing output. The 0.3% mom pickup in industrial production more than offsets a blip in July and restores the upwards trend of the past five months.

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- **Brazil:** Economic activity in Brazil rose 1.5% mom in July, above the expectation of the market, but the improvement does not appear to have a broad basis, because retail sales slowed by a larger than expected 4.9% yoy in July. Net net, this puts Brazil on track for flat growth in Q3 after two quarters of negative growth in Q1 and Q2. Moody's placed Brazil's foreign currency debt ratings on negative outlook, but we note that Moody's has Brazil on an investment grade, Baa2 rating. Fitch and S&P also rate Brazil at investment grade (BBB and BBB-, respectively). We do not expect Brazil to lose investment grade status anytime soon. The other development in Brazil pertains to the upcoming election. Opposition challenger Marina Silva saw her support decline to the point where she is now level pegged with President Dilma Rousseff in the second round. Marina's popularity spiked following the death of Eduardo Campos, her election partner, but Dilma has access to more TV time and a bigger pot of money, so the narrowing of the poll gap should not surprise. A rumour that former central bank governor Henrique Meirelles would join the Dilma administration was not substantiated, but caused a brief rally.
- **Argentina:** Argentina's lower house passed a bill that allows the government to swap exchange bondholders' securities into identical securities issued under local law. The law also allows the government to use a domestic institution to replace Bank of New York as payment agent for the bonds. It remains to be seen if Argentina can find a way to overcome the logistical challenges involved in getting the money to bond holders. The government further tightened capital controls by requiring banks to obtain government permission for FX purchase in excess of USD 150K, from USD 300K previously.
- **Mongolia:** After a protracted stand-off, Mongolia may have taken an important step towards reaching agreement in a tax dispute with Rio Tinto Group, a major miner. Mongolia agreed to cut the tax claim on Rio Tinto. The dispute has frozen a USD 4bn development of Oyu Tolgoi, a copper and gold mine.
- **Chile:** Chile's central bank cut rates by 25bps to 3.25% while hinting that the bias towards easing is becoming less strong.
- **South Africa:** South Africa's current account deficit widened to 6.2% of GDP in Q2, higher than the average EM current account deficit and wider than the 4.5% deficit recorded in Q1. South Africa's external balances fluctuate considerably and we expect lower domestic demand to gradually reduce the external deficit (but not eliminate it) over the next 6-12 months.
- **Philippines:** Philippines exports rose strongly in July, up 12.4% yoy, which was enough to secure another consecutive rise in the 3-month rolling average of exports. Exports are mainly to Japan and the US.
- **Venezuela:** Venezuela's bond markets became witness to a fine piece of entirely meaningless political theatre last week following the publication of an article by Ricardo Hausmann, a flamboyant Harvard academic with a talent for drama wherein he argued that Venezuela has accumulated such arrears with foreign suppliers and created such shortages of essential goods for its own citizens that the country may be better-off defaulting on its external debt. Amazingly, some traders took this as a sign that Venezuela was about to default, despite the fact that Hausmann and the Maduro administration could not be further apart from one another. As for the substance of Hausmann's argument, we think it is extremely weak. First, default on the external debt would not solve anything unless the broader economic backdrop changed. Second, the issuance of external debt into a Dollar-starved economy confers enormous rents onto the political establishment. Why kill the goose that lays the golden eggs? In another amazing twist, President Maduro of Venezuela actually felt compelled to publicly denounce Hausmann's article and to restate the government's intention to service all debt. The bonds then rallied. Venezuela is a very poorly managed country, but we think the larger risk is that debt issuance eventually becomes so large that the overall debt level becomes unsustainable. But that is not an imminent risk.
- **India:** India's inflation declined by 0.2% in the month of August to 7.8% yoy. Inflation is declining due to a combination of vigilance in the part of the Reserve Bank of India, much improved rains (which should push down food prices) and lower oil prices.

Global backdrop

Sentiment in global markets deteriorated last week due to events mainly in developed countries. Two academic papers, one arguing that the market was complacent with respect to rate hikes, the other arguing for tighter labour market conditions, helped to push US treasury yields higher. 10-year yields have now risen by 30bps from 2.30% in early August to 2.61% at the close on Friday (16bps move in the past 5 days). At the same time, the US dollar has strengthened particularly against the JPY and EUR over the same period due to very weak growth and renewed optimism about the effectiveness of Abenomics and QE from the ECB, respectively. Both a strong Dollar and higher US treasury yields tighten financial conditions. At this early stage in the hiking cycle, the prospect of hikes usually stimulates a stock market rally, because the Fed's willingness to tighten policy is regarded as a sign that the economy is healing. Sadly, we believe this cycle is different. QE policies have pushed US asset prices far higher than what is justified by fundamentals. In other words, valuations owe more

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Global backdrop

to easy money than to the economy per se. As such, even modest financial tightening – such as higher UST yields and a stronger Dollar – can actually hurt stocks quite a lot. And falling stocks becomes a so-called 'risk off' event, which then causes some investors to sell EM assets. MSCI EM was down 2.9%, but EM Frontier Markets rose 0.3%. EMBI spreads narrowed by 2bps, but yields rose overall due to the move in the US treasury curve.

One thing to watch is the technical position in US bonds. Yields were pushed too low earlier this year, which means there are now many investors with long positions acquired expensively. Some position unwinding might now happen. Still, in our view US rates are not going very far, at least not far enough to pose any material threat to any EM country. Last year EM fundamentals stood up extremely well in the face of 200bps re-pricing of EM government borrowing costs from 5.25% to 7.25% (imagine for just one second how badly Western economies would have fared if THEIR bond market yields had risen 200bps!). Net net, the sentiment has turned more negative but world has not really changed very much. We also think EM is more insulated from a 'mini-taper tantrum' this year due to cheaper valuations, better technicals, less irrational fear about EM fundamentals (EM real yields are markedly higher than last year following a credible policy response), and a more cautious Fed.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.9%	8.2%	10.2%	6.0%	6.4%
MSCI EM Small Cap	-1.4%	11.4%	14.6%	6.8%	8.4%
MSCI FM	1.0%	22.1%	33.6%	16.7%	9.2%
S&P 500	-0.80%	9.00%	20.39%	22.15%	16.14%
GBI EM GD	-2.54%	2.70%	2.78%	0.92%	5.22%
ELMI+	-1.28%	0.05%	0.63%	0.11%	1.38%
EMBI GD	-1.04%	8.88%	12.75%	6.73%	8.74%
EMBI GD IG	-1.36%	8.69%	11.80%	5.13%	7.34%
EMBI GD HY	-0.43%	9.28%	14.76%	9.49%	10.93%
5 year UST	-0.87%	1.63%	2.35%	0.62%	3.27%
7 year UST	-1.48%	3.78%	4.17%	1.03%	4.61%
10 year UST	-2.29%	6.88%	6.94%	1.73%	5.37%
CEMBI BD	-0.40%	6.73%	10.24%	6.40%	7.91%
CEMBI BD HG	-0.54%	7.06%	10.31%	5.91%	7.31%
CEMBI BD HY	-0.13%	5.99%	10.09%	7.77%	9.71%
US HY	-0.98%	4.94%	9.71%	10.69%	12.19%
European HY	-0.49%	5.87%	11.44%	16.06%	14.32%
Barclays Agg	-2.17%	2.28%	3.92%	1.03%	2.90%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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