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WEEKLY INVESTOR RESEARCH

Ashmore

Colombian fireworks and the Fed's head fake

By Jan Dehn

Colombia's weighting in the GBI index expands sharply as access for foreign investors improves. Investors should expect more along similar lines from other Emerging Markets (EM) countries. We also discuss polls in Brazil, Russian economic data, the latest bout of hard landing fears in China, and financing issues in Argentina (in legalese). In developed markets, the Fed is being hawkish at a time of soft economic data in order to not to have to be hawkish when the data actually picks up. The forced U-turn on tapering last summer looms large in the Fed's decision last week to appear hawkish, but the removal of forward guidance was unashamedly dovish.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	955	–	1.34%
MSCI EM Small Cap	1,021	–	-0.05%
MSCI FM	616	–	1.94%
GBI-EM GD	7.08%	–	-0.44%
ELMI+	4.09%	–	-0.28%
EMBI GD	5.75%	298 bps	0.18%
EMBI GD IG	4.89%	206 bps	-0.11%
EMBI GD HY	7.87%	537 bps	0.77%
CEMBI BD	5.57%	318 bps	0.10%
CEMBI BD HG	4.65%	226 bps	0.02%
CEMBI BD HY	7.48%	509 bps	0.24%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1867	0.42%
VIX Index	15.00	-4.09%
5 year UST	1.75%	18 bps
10 year UST	2.77%	8 bps
US HY	5.42%	0.20%
European HY	4.45%	0.26%
EURUSD	1.3817	-0.76%
USDJPY	102.56	0.77%
Brent	106.45	0.10%
Copper	299.48	-0.67%
Gold	1323.31	-3.31%

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

Emerging Markets

- **Colombia:** Colombia's weighting in JP Morgan's GBI-EM-GD index will be increased from 3.25% to over 8% between the end of May and the end of September. The decision to increase Colombia's weighting is due to improved access to the local Colombian Bond, or TES market, for global investors. Weights in Russia, Turkey, Hungary, and Romania will be reduced to make room for more Colombian bonds in the index, but note that both Turkey and Russia are set to enter the Barclays Global Aggregate Index shortly, which should provide some offset. EM local currency government bonds are already the benchmark asset class in EM, but benchmark indices are hopelessly behind the curve. Local markets are far larger than index capitalisation would suggest, mainly, in our view, because the banks that produce indices tend to include only the bonds that they trade, either in New York or London, or in the countries, where they have local offices. Both have declined since the crisis due to regulatory measures imposed by developed countries in order to channel funding to their own bond markets. Despite these headwinds, Colombia's action to improve access to its local market is visionary. Its decision reflects an understanding alien to many myopic foreign investors, namely that the world will see significant inflation in developed economies in the next few years due to QE policies and excessive debt levels. We think the resulting appreciation pressure on EM currencies is an opportunity for EM countries: They will be able to borrow at much lower costs in the future as investors begin to flee the Dollar in favour of non-QE countries once inflation resurfaces in the US.
- **Russia:** Retail sales, real wages, unemployment, and investment all surprised to the upside in February. Russia's deep structural fundamentals remain extremely strong – 2% debt to GDP and around USD 450bn in FX reserves. Cyclical variables are weaker due to a poor business environment, which means that investment remains too low in Russia. But asset prices have recently been impacted far more adversely than justified by either structural or cyclical fundamentals by Russia's on-going conflict with the EU and US over Crimea. Last week this conflict continued with the imposition of further tit-for-tat sanctions on Russia by both EU and the US. However, we do not believe that these sanctions will extend to Russia's energy exports and financial flows, which are vital to European interests. In fact, we think the key turning point was reached last week when President Putin explicitly ruled out military adventures in Eastern Ukraine, while the government in Kiev downplayed prospects of joining NATO. As such, the recent fall in asset prices constitute an excellent buying opportunity, in our view.

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Emerging Markets

- **Argentina:** Holdout investors requested a delay in filing a reply to Argentina's appeal to the Supreme Court to review the decision of the second district court of New York to divert payments intended for performing bonds to holdout investors (that sentence was a bit of a mouthful, but such is the nature of legalese). Meanwhile, Mexico, France and possibly other sovereigns last week took the side of Argentina in the dispute by submitting amicus briefs to the court (amicus briefs are non-binding statements submitted to the Supreme Court on the grounds of an alleged interest in the outcome of the case). The support for Argentina is probably due to a variety of reasons, not just concern that a ruling against Argentina would set a nasty precedent in the event of future bond disputes. Argentina is trying to access international finance along two routes: Official sector money and market funding through a resolution to the holdout issue. Progress has been considerable on the former and last week the Paris Club formally extended an invitation to Argentina to begin negotiations on 26 May. The holdout issue remains hostage to decisions in the US courts. Meanwhile, Argentina has recently made significant changes to macroeconomic policy, which suggests that President Cristina Kirchner will be able to serve out her term without a credit event caused by poor macroeconomic policies.

- **Brazil:** A poll issued by IBOPE, a reputable Brazilian pollster, last week deflated a rapidly spreading perception that President Dilma Rousseff's popularity is declining fast. IBOPE's poll showed that Dilma will obtain 43% of the total votes cast, or three times more than Aecio Neves and seven times more than Eduardo Campos, her two main competitors. Based on these poll numbers, Dilma would retake the presidency in the first round. Our view has been and remains that Dilma wins a second term. This bodes poorly for business confidence and therefore points to a longer period of tepid growth in Brazil. On the other hand, Brazil's deeper structural fundamentals remain healthy and the economy should not have a crisis. Indeed, last week saw much stronger than expected formal job creation for the month of February (+260k versus +116k consensus). Brazil, like other EM countries, has strong demographic drivers of growth, including rapid labour force growth and rapid formalisation of labour markets. This ensures decent growth even if conditions for capital are less than optimal under the current economic management of Brazil.

- **China:** The latest bout of 'hard landing' fears continued unabated, aided by another weak manufacturing print this morning. We think these fears are exaggerated. China is slowing due to the ferocious pace of its reforms. China has an abundance of means to manage its business cycle: The country's debt stock is low, its savings rate is high, its banking system leverage is modest (deposits are 160% of GDP against total credit to GDP of 230%), and the shadow finance system is tiny (16% of GDP with low default rates). Moreover, the State Administration of Foreign Exchange sits on USD 3.8trn of FX reserves. China has enormous capacity to stimulate. But most importantly, China's reforms today mean that China will be better prepared for the world of tomorrow than perhaps any other country.

- **Policy action:** Mexico's central bank left rates unchanged at 3.5%. Colombia's central bank left policy rates unchanged at 3.25%.

Global backdrop

The major change in the global backdrop in the past week came from the US Fed. Chairwoman Janet Yellen indicated that the Fed could hike rates by Q2 2015 and FOMC members shifted forward their individual (anonymous) projections for the timing of rate hikes. Both developments were hawkish relative to expectations and under the current conditions of low stable US inflation drove real rates higher and caused the Dollar to strengthen.

One could also argue that the removal of explicit forward guidance increases uncertainty about rates, although we think this move was actually dovish. By removing forward guidance the Fed gains flexibility not to raise rates even when cyclical indicators, such as unemployment improve further.

Indeed, we think the market's initial interpretation of the Fed's position as unambiguously hawkish to be far too simplistic. Rather, we think the Fed 'head fake' has been more tactical than strategic, deliberately signaling hawkishness at a time of relatively weak economic data in order to buy itself room to be less hawkish later when the data is likely to be stronger.

Central bankers know that the best way to establish credibility is to tighten (or signal tightening) at a time of relative economic weakness, because it scares the market into thinking "if the Fed is this tough when the economy is weak it surely must be super tough when the economy picks up".

Indeed, this is why the Fed is tapering during soft patches – it can reduce its purchases without blowing up the bond market because others step in to replace its purchases when the data is weak. Recall that the Fed had to U-turn on tapering last summer when the data was stronger after bond vigilantes pushed long rates higher.

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Global backdrop

It makes sense for the Fed to build up a reputation for hawkishness now because its ability to hike is actually rather modest, in our view. We do not think the Fed can drive real interest very high due to the US economy's very considerable stock of debt (it is nearly 400% of GDP and the Fed euphemistically refers to it as 'headwinds'). If the Fed manages to hoodwink the market into believing that it is hawkish then it will be able to manage expectations with mere verbal guidance rather than actually pushing up rates, thereby avoiding a repeat of last summer's debacle the next time the data picks up. Or that appears to be the plan at least.

Much has been made of the alleged inconsistency between the Fed's (generally positive) forecasts for the cyclical variables in the economy – such as unemployment, inflation, and growth – and its own (generally dovish) projections for the Fed funds. The Fed has now reduced the discrepancy somewhat, although it is still excessively dovish relative to its own economic forecasts. In our view, this 'excess dovishness' exists because of the debt and the other structural drags on the economy. We do not see these structural drags disappearing anytime soon so we think that the Fed's dovishness will remain in spite of the apparent hawkish tilt last week. Indeed, we think Fed dovishness will prove quasi-permanent, because easy monetary policy is the only realistic way to erode the considerable 'headwinds'.

The market is of course largely ignoring the 'headwinds'. This is why the Treasury market reacted to the Fed's pronouncements by bear flattening (short end sells off). Yet, in our view it is extremely unlikely that thirty years of fiscal profligacy, accompanied by rapid credit expansion, followed by rampant money printing will give way to a smooth return to trend growth without an intervening period of major business cycle volatility. And that in turn means that the US yield curve should eventually bear steepen with the long end selling off and becoming far more volatile in the coming years. But we do not expect this to happen in a meaningful way until inflation shows clear signs of returning, probably in the second half of 2016.

The initial negative reaction of EM assets to the Fed decision was unsurprisingly negative, but neither excessive nor sustained. The market's sentiment about EM is still based on the basic premise that tighter global financial conditions are more damaging to EM than to developed economies. We profoundly disagree with this view. Fundamentally, EM countries are far more resilient to rising rates than developed economies due to lower debt, fewer structural drags, and stronger growth. Indeed, it is worth remembering that EM countries already obtain 80% of their funding in local markets at an average yield of 7% while growing comfortably at about 5% real GDP. By contrast, developed economies are struggling to eke out 2% growth under conditions of zero interest rates. EM has so far defied shrill prediction of crises in two sell-offs (June 2013 and January 2014). The sell-offs have instead sharply improved technicals and valuations, which are now attractive. We see clear value.

Having said that, the market is heavily influenced by fads. The Eurozone break-up story was a fad. The idea that Japan could escape its structural problems simply through monetary and fiscal stimulus was a fad. And the idea that EM countries are fundamentally more vulnerable than developed economies to global financial tightening is the latest fad. Just like the previous fad, this latest incarnation is proving resilient. This means that the risk of further asset price volatility in EM remains. For example, barring a softening of the Fed's stance (which we do not rule out at all) the most obvious risk to EM asset prices is now that stronger US data will trigger significant increases in real US bond yields by inviting bond vigilantes to aggressively sell Treasuries. If this happens, it is likely to be followed by a change in tack from the Fed.

Our view is that US treasury yields rise further this year. The silver-lining is that EM offers significantly higher yields, stronger fundamentals, and now increasingly healthy technicals. After two big sell-offs, we believe the odds of positive returns in EM fixed income in the next 12 months are strong, indeed almost as strong as the odds that investors will make outright losses in developed market fixed over the same period.

The other notable development on the global stage last week was the agreement among EU members on the future of banking union. Under the agreement, oversight of banks will be transferred to the ECB, while resolution (of banking crises) will be transferred to a yet to be defined supranational institution. These are extremely important developments, which mark a very important further step forward towards a Federal Europe. In particular, these measures will break the link between sovereigns and their own banks, a link that in the past has led to ludicrous assessments of banks' health by national regulators acting under pressure from their respective paymasters. The banking union will encompass the 130 largest banks in Europe (meeting a German demand to not include all the smaller banks). What is missing? There is still no resolution to the question of 'legacy assets' – that is, toxic assets from the 2008/2009 crisis still sitting on European banks' balance sheets. An asset quality review and stress test of banks scheduled for later this year may provide an updated picture of the size of this problem.

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.0%	-5.6%	-4.9%	-2.5%	14.4%
MSCI EM Small Cap	0.3%	1.7%	0.2%	-0.2%	20.8%
MSCI FM	1.1%	5.0%	22.2%	7.6%	14.1%
GBI-EM GD	-0.26%	-1.15%	-9.71%	0.55%	8.85%
ELMI+	-0.06%	-0.87%	-2.96%	-1.12%	3.75%
EMBI GD	-0.10%	2.23%	-1.03%	6.67%	11.55%
EMBI GD IG	-0.50%	2.39%	-2.64%	5.31%	8.99%
EMBI GD HY	0.72%	1.94%	2.07%	9.03%	15.16%
CEMBI BD	-0.20%	1.90%	0.41%	5.57%	12.34%
CEMBI BD HG	-0.17%	2.29%	0.51%	5.93%	10.44%
CEMBI BD HY	-0.27%	1.06%	0.24%	5.17%	19.09%
S&P 500	0.49%	1.45%	23.31%	15.32%	21.96%
US HY	0.01%	2.93%	8.25%	9.80%	19.28%
European HY	0.60%	3.05%	12.90%	13.32%	22.62%

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