Ashmore

Market Prospects 2012

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Jerome Booth & Jan Dehn **January 2012**

Big Picture

The world in 2012 will continue to be divided into deleveraging G10 economies and EM economies without excessive debt. The US and Europe will continue to experience sub-trend growth, with the main risk still a return to recession or even depression. Most of the EM economies will grow close to trend, with the main risks being country specific, most commonly inflation. G10 and EM economies will continue to experience broadly synchronised intra-year inventory cycles due to the increasingly globalised nature of the manufacturing supply chain, but the underlying growth stories and the demand side conditions in particular will continue to differ markedly for the next 12 months and beyond in favour of EM. Indeed, EM fundamentals are likely to be even stronger relative to G10 than last year.

We believe it most likely that global monetary conditions will be eased further in G10 economies via fresh rounds of QE, which will tend to keep asset prices elevated and interest rates low. 2012 will therefore be another year with QE-inflated asset prices coexisting alongside weak underlying G10 fundamentals to produce higher than normal levels of asset price volatility.

Volatility is not risk. Yet, markets are mainly driven by risk perception, not risk directly, which is only observable through an investment process, which pays careful and continuous attention to credit fundamentals. 2012 is likely to see more confusion in markets as previously stable mental constructs and views of the world are found lacking, and then gradually replaced. Shifts in perception can be radical for the individual, yet the overall cumulative effect is gradual. Greatest actual risk - that is, the risk of not being repaid on an invested amount - is in those asset classes where a triple cocktail exists: a homogenous investor base; a major under-perception of risk, which is likely to reverse; and leverage. All the main candidates are in the developed world. Rating agency shortcomings and the speed of downgrades may come as revelations to some, though they should not.

We expect tail risks in Europe to reduce further as awareness of the depth of the problems rises among electorates and politicians. EM assets are currently attractively priced due to the high levels of risk aversion due to Europe. We therefore see particularly strong return potential in EM over the coming 12 months.

Eurozone: 3 Scenarios, 6 Conditions for Success, 2 Outliers

The most likely scenario in the Eurozone is for greater fiscal discipline, in combination with structural reform, and the promise of more sovereign bond purchases by the ECB, to lead to a return of market confidence and private sector sovereign bond purchases. Countries will go through extensive structural reforms, for which there is plenty of scope, with public sector cuts taking the brunt of fiscal adjustments. This need not lead to recession, depending on the effectiveness of reforms, but will require strong political leadership not clearly apparent in a number of countries. Recapitalisation and de-levering of banks will continue, possibly exacerbated by the EBA's current pace of implementation of Basel III. Greece is expected to reduce sovereign debt repayments substantially, most likely through default. The knock-on effect on EU banks will probably be reacted to rather than fully prepared for, and may lead to several (non-Greek) bank nationalisations. Greece's exit from the Euro is a distinct possibility, though more likely is further EU funding for Greece post default, possibly on condition of preferential treatment for official lenders.

The second scenario differs from the first through ECB purchases of sovereign debt gradually rising, not being funded, and not being replaced by private buyers - because structural reform does not lead to returns of sovereign creditworthiness. In time this leads to sufficient inflation and currency weakness to erode indebtedness denominated in Euros across the whole region; but nominal debts are not defaulted on.

In the third, least likely scenario, a sovereign default causes an EU banking crisis and precipitates other defaults and a break-down of the Euro project.

Six conditions to avoid contagion, and to prevent the second and third scenarios are: 1) fiscal consolidation; 2) bank bail-out funds or nationalisation; 3) Bank liquidity lines (LTRO); 4) contingent lines of credit for sovereigns (QE from the ECB); 5) longer term fiscal credibility (the new treaty); and 6) structural reforms to promote growth.

Two outliers are Greece (whose debt burden cannot be reduced to sustainable levels without substantial debt forgiveness or default) and the UK which did not sign up to the new treaty to address future fiscal credibility - but negotiations can reopen any time. Portugal and Ireland remain at risk due to significant challenges in generating growth and overcoming enormous debt burdens, respectively.

US and Global Markets

The US continues to de-lever and experience volatility in growth expectations as the inventory cycle overshoots. In an election year little is expected from fiscal policy. The economy remains fragile and low growth is still likely until the consumer stops de-levering - so another 4 years or so. Exporters could do with a cheaper Dollar, but this will be determined by emerging market central banks, who generally favour a gradual and orderly appreciation of their currencies in the interest of maintaining stability. With fiscal policy and its design not likely to provide further stimulus, indeed with a reduction of fiscal stimulus likely, more quantitative easing is expected, possibly targeting mortgage assets. US equity markets are expected to be buoyed by more quantitative easing, as are credit markets, but should EU woes yield to catharsis, this may be followed by more bearish Dollar sentiment. In any event Dollar weakness may start to erode the real value of US assets for non-US investors sometime in 2012.

Longer term inflationary concerns may also build in 2012, as market perceptions of the Administration and the Federal Reserve's incentives change: a realisation of the convenience over structural reform of using

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inflation to erode debts. Gradualism in policy will continue, with the biggest risk to the US economy coming from a major drop in investor confidence. Whilst this could come from a Dollar crisis, an oil shock is more likely should there be substantial prolonged supply disruption.

Global Rebalancing

Until a year ago there was little inflation in the emerging markets, hence no urgent need to appreciate currencies. Then followed a period of central bank inertia as uncertainty in Europe trumped the desire to diversify from the Dollar. At the end of 2011 inflation pressure has again subsided. In 2012, we expect the drift in events in Europe to lead to a more definitive resumption of confidence or crisis followed by recovery. This should lead in due course to Dollar weakness (including probably but not necessarily against the Euro). A sudden Yen appreciation, announcement by a major Central Bank of substantial Dollar holding reduction, or an oil price shock could all precipitate more acute Dollar weakness. Most likely though is a more gradual diversification and reduction of EM Central Bank reserves.

The most likely path for unwinding global imbalances over the medium term is through appreciation of EM currencies versus G10 currencies. We expect this process to be only temporarily interrupted by bouts of risk aversion, which in turn will generally offer opportunities to add to long EM currency positions. Over the medium term as their currencies appreciate, EM economies will gradually come to rely more on domestic demand. In order for this shift to be non-inflationary, there will be a greater focus on addressing supply-side constraints within EM economies, particularly through reforms, the development of corporate bonds markets, and a major push into infrastructure investment.

Protracted weakness in G10 demand will also spur South-South investment and trade. Countries will make further efforts to shift trade patterns more to emerging markets. Emerging market banks will take more market share from developed market peers, possibly including through acquisitions. Policy-makers may take the initiative in persuading more companies to invoice in non-Dollar currencies. We will also see further diversification into EM assets by EM central banks, a process which is still in its infancy.

EM Prospects

As the unwind of global imbalances slowly takes hold via dollar weakness and EM currency appreciation then we expect countries increasingly having to turn to domestic led growth instead of export led growth. This requires supply side measures to ensure that domestic led growth is not inflationary. Such supply side measures fall into three broad categories: development of corporate bond markets, structural reforms to relieve growth constraints, and infrastructure investment. We expect more heterogeneity across EM countries as some cope better with these challenges than others and as their growth constraints become more binding over the next few years. This will require specialist fund manager expertise to navigate.

2012 and 2011 may not be very different in terms of fundamentals (G10 still deleveraging, EM relatively stronger), but 2012 is vastly different in terms of valuations. Whereas we started 2011 with the market already pricing in an unrealistically bullish view of G10, especially in the US, this year we are starting the year in the midst of a more modestly bullish view on the US and a very pessimistic view of Europe. The result is that EM asset price valuations at the start of 2012 are far more attractive than they were at the start of 2011.

We expect a gradual normalisation of risk appetite as Europe slowly comes to terms with its sovereign debt problems. We expect further QE to lead to US Treasury yields rising somewhat, but for them to remain within their 30 year downward trend. We expect the recovery in risk appetite to trigger a reversal of recent fear-induced Dollar strength.

Based on these assumptions, and with a significant margin of error, in our main scenario we see the 10yr US treasury yield 2.25% by year end, and EM sovereign debt spreads narrowing to 250bps from current distressed levels (the rally could be more pronounced, remembering the spread was 170bp before Lehman collapsed). The net effect should be a 12 month return of approximately 14% plus alpha.

Corporate high yield offers the best fixed income risk reward, following a tough year in 2011 due to the widening of European corporate and sovereign debt spreads. Again applying a conservative assumption of a narrowing of spreads to 600bps this leads to a return of about 19% in corporate high yield over the next year. Note that this spread compares to the post-2008/2009 lows of 471bps.

Equities start 2012 with p/e ratios below 10 and extreme value incompatible with the still strong growth and sound prospects facing emerging markets. Volatility may remain linked to that in US stocks, but outperformance is highly likely in bearish, but also highly bullish, US scenarios.

EM currencies also offer a very attractive entry point. Even without any major global rebalancing starting in the year, we think EM currencies are about 5% undervalued. We can also assume a further 5% upside potential in 2012 (China 's annual trend appreciation) and as longer-term structural Dollar weakness resumes - most likely to commence as European fears slowly fade. Investing local currency exposure in local currency bonds should impart some 5% in carry for a total return of about 15%, net of alpha.

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