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The classic EM risk roll-down

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The classic EM risk roll-down is now on full display with Chinese stocks outperforming on the back of stronger than expected economic data. Elsewhere in EM, Ecuador announced a debt restructuring agreement with the majority of shareholders. In Indonesia, Bank Indonesia and the Ministry of Finance announced coordinated action akin to what is usually observed in developed countries. Argentinians took to the streets to ask for better economic conditions and in protest against planned nationalisations. In Ivory Coast, presidential candidate Amandou Gon Coulibaly passed away, which increases the odds that current President Alassane Ouattara will seek a third term in office. Chile's Congress approved a bill, which allows pensioners to withdraw up to 10% of their pension savings. In Brazil, President Jair Bolsonaro was diagnosed with coronavirus. Egyptian inflation surprised to the downside as the stock of foreign exchange reserves increased. The minutes from the most recent meeting of monetary policy committee in Mexico revealed a cautious approach to rate cuts.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	13.3	–	3.67%
MSCI EM Small Cap	11.5	–	2.42%
MSCI Frontier	12.5	–	0.07%
MSCI Asia	14.0	–	3.70%
Shanghai Composite	12.2	–	7.71%
Hong Kong Hang Seng	8.2	–	3.41%
MSCI EMEA	10.3	–	1.86%
MSCI Latam	12.3	–	0.97%
GBI-EM-GD	4.49%	–	0.75%
ELMI+	2.30%	–	0.22%
EM FX spot	–	–	0.48%
EMBI GD	5.41%	471 bps	0.10%
EMBI GD IG	3.02%	226 bps	0.35%
EMBI GD HY	8.83%	817 bps	-0.20%
CEMBI BD	4.84%	430 bps	0.45%
CEMBI BD IG	3.29%	275 bps	0.45%
CEMBI BD Non-IG	7.17%	663 bps	0.46%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	19.6	–	1.79%
1-3yr UST	0.15%	–	0.01%
3-5yr UST	0.29%	–	0.01%
7-10yr UST	0.63%	–	0.23%
10yr+ UST	1.33%	–	1.93%
10yr+ Germany	-0.47%	–	1.31%
10yr+ Japan	0.00%	–	0.56%
US HY	6.58%	597 bps	0.33%
European HY	5.50%	593 bps	0.22%
Barclays Ag	0.92%	29 bps	0.68%
VIX Index*	27.29	–	-0.39%
DXY Index*	96.46	–	-0.27%
EURUSD	1.1324	–	0.13%
USDJPY	106.84	–	-0.48%
CRY Index*	141.52	–	0.92%
Brent	42.9	–	-0.46%
Gold spot	1803	–	1.03%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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- **The classic EM risk roll down:** Two things are certain to happen when global shocks strike. One is that investors rapidly 'dumb down' the world into 'safe' and 'risky' assets, which invariably results in a sell-off in Emerging Markets (EM) asset classes, regardless of the nature of the shock or its importance to EM relative to developed markets (DMs). The second thing sure to happen is that investors eventually return as EM asset classes start to outperform. This outperformance is due to the fact that EM asset classes are usually sold during the initial reaction to the shock. During the recovery phase investor behaviour is typically as predictable as during the initial sell off. Specifically, they typically tip toe back into the EM space, first adding exposure in investment grade Dollar-denominated sovereign debt before graduating to higher yielding Dollar bonds and then finally partaking in the offerings available within the local currency space, including bonds and equities. We call this behaviour 'classic risk roll down' and it is now on full display.

After the sharp coronavirus-driven pullbacks across all EM asset classes in late February and early March, EM markets – bond, stocks, and currencies – bottomed out during the last fortnight of March and have been rallying ever since. Returns in sovereign and corporate Dollar-denominated investment grade credit are already positive for the year (4.20% and 2.52%, respectively), while EM stocks and local currency bonds are still modestly down for the year (-2.65% and -5.65%, respectively). However, the latter are catching up quickly with Asian equities now up 2.93% for the year and Chinese stocks leading the pack with a return of 12.68% in Dollar terms ytd. The strong, albeit belated, recovery in EM assets now underway is finally translating into positive flows.

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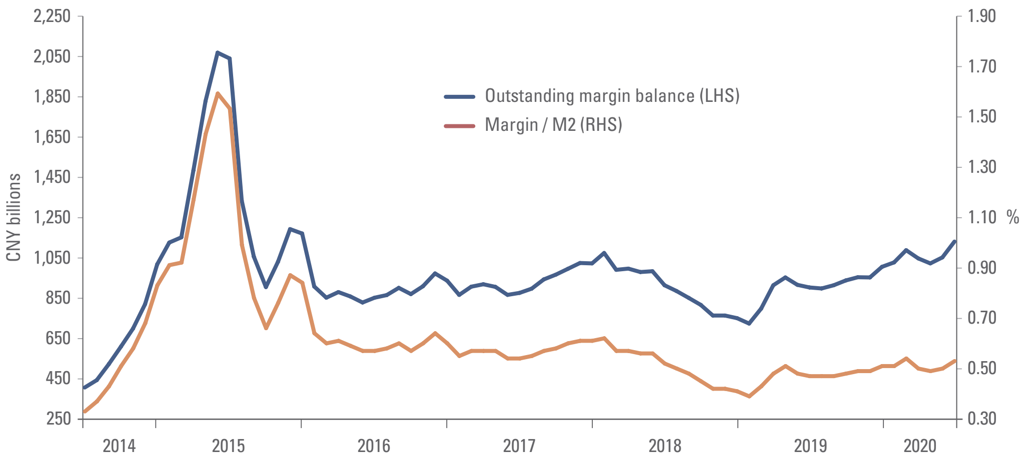
Proxy data on EM inflows collected by EPFR shows USD 5.7bn of inflows into EM equities last week, driven by flows into Asia ex-Japan. EM bonds also received inflows of USD 1.6bn last week.[1] The classic risk roll down now underway is identical to dozens of examples from previous risk-off episodes. Clearly, the best time to buy is when the crisis is at its most intense, yet most investors never do so. Instead, they only return to the asset class after a long delay.[2] Do investors never learn? Regardless of the reasons for this type of irrationality, one thing is clear: the fact that investors only return to EM very slowly means that the asset class remains 'too cheap' for 'too long' in both absolute terms and relative terms. This is lovely, of course, because bond investors in particular are paid more than the risk they take as long as this is the case.

- China: Chinese stocks have recently outperformed strongly on the back of strong data from credit markets and the broader economy. As always, detractors have been quick to label the rally a 'mini-bubble' similar to 2015. However, the situation today is very different, in our view. Valuations are more attractive and positioning is very light as foreign investors have been selling Chinese equities almost constantly for many months. Local leverage does not seem to be excessive either. Based on data from China Securities Finance Corporation and People's Bank of China, margin trading in 2015 reached CNY 2.3trn, which is equivalent of 1.7% of the Chinese money supply as measured by M2 (Figure 1). In comparison, as of the end of June, margin trading stood at a far more manageable CNY 1.1tn, or just 0.5% of monthly M2. In fact, this is at the low end of the range of margins to M2 over the past five years (the ratio has been between 0.5% and 0.7% for 80% of the time over the last five years). We believe that the main reason for Chinese equity outperformance is China's faster than expected economic recovery (consistent with the First-in, First-out thesis).[3]

High frequency data suggests that GDP growth has been recovering more rapidly than expected as targeted funding had fed the recovery. Total social financing accelerated to CNY 3.4bn in June after CNY 3.2bn in May, mainly due to an acceleration in corporate lending and a slowdown in the contraction in shadow bank loans. In other Chinese news, consumer prices index (CPI) inflation inched higher to 2.5% on a yoy basis in June from 2.4% yoy in May, while producer prices index (PPI) inflation rose to -3.0% yoy in June from -3.7% yoy in May.

Fig 1: **Equity margin balances versus M2**



Sources: China Securities Finance Corporation, PBoC, Bloomberg, Ashmore. Data as at 30 June 2020.

- Ecuador: The government announced that a USD 17.4bn debt restructuring deal was agreed with the largest group of bondholders.[4] The agreement extends principal repayments, reduces coupons to an average of around 5%, and introduces a nominal haircut of 9%, thereby achieving USD 10bn in debt relief over the next four years and another USD 6bn in relief between 2025 and 2030. If finalised, the agreement would significantly reduce the risk of a hard default around the presidential election in 2021 and a subsequent lengthy conflict with bond holders. In other news, Vice-President Otto Sonnenholzner resigned in order, we suspect, to announce his candidacy in next year's presidential election. Under current legislation, former President Rafael Correa, a defaulter, will not be allowed to run.

- Indonesia: Bank Indonesia (BI) agreed to purchase bonds with a total value of IDR 400trn (USD 28bn) with the interest cost entirely absorbed by the central bank. Finance Minister Sri Mulyani confirmed that this operation is equivalent to a one-off debt monetisation, but one that will not be repeated in the future. In addition, BI will buy another IDR 329tn (USD 23bn) where the government share in the cost and another IDR 123tn (USD 9bn)

[1] EPFR data is incomplete. It does not measure flows by many official sector institutions, segregated accounts, and many local investors.

[2] Ashmore provided investors with a reminder to get ready to buy as early as 28 February 2020, that is, within a month of the absolute best entry point in this crisis. See: *'It is here again - the VIX spike!'*, Market Commentary, 28 February 2020.

[3] See: *'The triple shock and EM equities: First-in first-out?'*, The Emerging View, 2 April 2020.

[4] https://www.prnewswire.com/news-releases/the-republic-of-ecuador-reaches-an-agreement-in-principle-with-a-group-of-substantial-international-investors-of-its-international-bonds-301088475.html

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where the cost is to be shared with other institutions. If these types of debt operations are restricted to extreme scenarios, such as the ongoing coronavirus shock then they should not lead to escalating inflation, in our view. Rather, they are a mechanism for bringing yields down to lower levels further out on the yield curve, which is entirely appropriate during periods of extreme economic uncertainty and economic weakness. This has been demonstrated amply in many DMs, where central banks have been purchasing trillions of Dollars of debt at close to 0% nominal interest rates. The main risk of inflation arises when aggregate demand picks up to exceed supply and if central banks are not able to reverse their actions at that time.

- Argentina: Protesters took to the streets during Argentina's Independence Day to demand better economic conditions and to protest against the nationalisation of Vincentin, an agro-industrial group. The Andean Development Fund (CAF) approved a loan of USD 300m to the government to help to combat hunger. In other news, tax collection declined by 15.5% in real terms on a yoy basis, which was an improvement from the 21.5% yoy contraction recorded in May. Both auto production and cement sales showed signs of recovery.

- Ivory Coast: Prime Minister Amandou Gon Coulibaly passed away in Abidijan after two months of treatment for a heart condition in Paris. Coulibaly was the presidential candidate of the ruling Rally des Republicans (RDR) party ahead of October's presidential election. His demise means that President Alassane Ouattara may consider a controversial third term in office unless RDR finds an alternative candidate prior to the 31 July deadline for nomination.

- Chile: Congress approved a bill, which allows workers to withdraw up to 10% of their private pension savings. Before becoming law, the bill needs to receive a super-majority of three fifths in the Senate. The government is strongly opposed to the bill, which, if approved, could lead to up to USD 20bn of outflows from Chilean pension funds. Peru has enacted similar measures in response to the coronavirus crisis. Pension funds are the single most important financial innovation in EM in the past three decades. They have led to financial independence for many countries with resulting greater stability. As such, the gutting of pension systems in some EM countries should be viewed with great concern, in our view. In other news, CPI inflation surprised to the downside at -0.1% in June, which took the yoy inflation rate down to 2.6% from 2.8% in May.

- Brazil: President Jair Bolsonaro tested positive for coronavirus, but so far has not displayed serious symptoms. This is consistent with the observation that the majority of infected people are either asymptomatic or show very mild symptoms. In other news, Brazilian CPI inflation surprised to the downside in June at 0.26%, which took the yoy rate to 2.13% from 1.88% yoy in May. Retail sales were stronger than expected, bouncing 13.9% in May after a 16.3% decline in April. The May reading means that retail sales are 7.2% lower than in the same month of 2019.

- Egypt: CPI inflation rose to a yoy rate of 5.6% in June from 4.7% yoy in May. June was the third consecutive month with inflation below the central bank's 6%-12% target inflation band. The rate of core CPI inflation declined to 1.0% on a yoy basis from 1.5% yoy at the same time last year. Foreign exchange reserves rose to USD 38.2bn in June from USD 36.0bn in May as the International Monetary Fund (IMF) disbursed the first tranche and gold prices went up.

- Mexico: The minutes of the monetary policy committee of the Mexican Central Bank revealed a cautious attitude towards further easing due to (a) MXN volatility; (b) sticky core CPI inflation despite the existence of an output gap; and (c) risks to the public finances, including Pemex. In economic news, industrial production (IP) declined by 1.8% in the month of May, which marked a strong improvement from 25.1% mom decline in April, although the consensus expectations were even stronger at 4.0% mom growth. The rate of CPI inflation surprised to the upside at 0.55% in June, which took the yoy inflation rate to 3.3% from 2.8% in May.

Snippets:

- Czech Republic: Czech CPI inflation was 3.3% on yoy basis in June compared to 2.9% yoy in May. The consensus expectation was lower at 2.9% yoy.
- Gabon: Ratings agency Moody's kept Gabon's sovereign rating unchanged at Caa1 with a positive outlook based on the expectation that the country will return to a primary surplus next year and that the IMF programme will be renewed at the end of Q3 2020.
- Hungary: The yoy rate of CPI inflation increased to 2.9% in June from 2.2% in May, which was in line with the consensus expectation.
- India: IP declined at a yoy rate of 34.7% in May after declining 57.6% yoy in April. This was in line with consensus expectations. Capital goods and consumer durable goods were the most affected items.
- Malaysia: Bank Negara Malaysia cut the overnight policy rate by 25bps to 1.75% in line with consensus expectations. IP declined by a yoy rate of 22.1% in May after -32.0% yoy in April. This was stronger than analysts had expected.

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- **Morocco:** The Central Bank of Morocco said that it expects the economy to contract by 5.2% in 2020 leading to a 7.6% of GDP budget deficit.
- **Peru:** President Martin Vizcarra signed a decree confirming that a general election will be held on 11 April 2021. In other news, the Central Bank of Peru kept the policy rate unchanged at 0.25%.
- **Philippines:** The trade deficit widened to USD 1.9bn in May after a USD 0.5bn deficit in April. Imports rebounded by 78% while exports rebounded by 'only' 41%. The rate of CPI inflation increased to 2.5% on a yoy basis in June from 2.1% yoy in May.
- **Poland:** President Andrzej Sebastian Duda won a second presidential term with 51.2 per cent of the vote according to the election commission. Polish CPI inflation beat expectations by rising to 3.3% yoy in June from 2.9% yoy in May. The market was only expecting 2.8% yoy inflation.
- **Russia:** The rate of CPI inflation inched up to 3.2% on a yoy basis in June from 3.0% yoy in May. This was in line with consensus expectations.
- **Senegal:** The yoy rate of CPI inflation declined to 2.0% in June from 2.7% yoy in May.
- **Singapore:** The ruling PAP won the general election on 10 July but lost some ground to the opposition Workers' Party. The election result is now fuelling expectation of more government spending and higher taxes to pay for it.
- **Sri Lanka:** The Sri Lankan central bank cut both policy rates by 100bps, which means that the deposit rate is now at 4.5%, while the lending rate is 5.5%.
- **Taiwan:** Exports declined by 3.8% on a yoy basis in June, which was in line with consensus expectations. Tech exports rose at a yoy rate of 18.7%, while non-tech contracted at a yoy rate of 24.6%. Exports to China and Hong Kong picked up the most.
- **Ukraine:** National Bank of Ukraine Deputy Governors Oleg Churiy and Dmytro Sologub urged President Volodymir Zelenski to appoint a credible governor to secure the policy continuity required to allow for continued cooperation with the IMF and access to markets.
- **Uruguay:** The yoy rate of CPI inflation declined to 10.5% in June from 11.1% in May.
- **Suriname:** Fitch downgraded Surinam's sovereign credit rating to C from CCC as the government entered the grace period for the 2023 bond and issued a consent solicitation to bondholders.
- **Venezuela:** The rate of CPI inflation was 19.5% in the month of June (equivalent to 3,524% rise on a yoy basis), according to the opposition controlled National Assembly.
- **Vietnam:** The real economy expanded by 0.4% on a yoy basis in Q2 2020, which puts the economy on track for an expansion of about 2.5% in 2020.

Global backdrop

- **US:** The US government formally quit the World Health Organisation (WHO) giving one-years notice. Democrat Presidential candidate Joe Biden pledged to reverse the decision to leave the WHO if he is elected in November. Biden also unveiled some details of his economic plan, including USD 400bn of government procurement of US-based goods and services in the next four years and USD 300bn in new spending on US-based technology R&D. There was no detail on who will pay for all this spending. Biden also reiterated a pledge to reverse part of the tax cuts implemented by the Trump Administration, including an increase in the corporate tax rate from 21% to 28%, but Biden shied away from the proposal from the far left of the Democratic Party to introduce a wealth tax. In economic news, initial jobless claims declined by 100k to 1.3m in the week ending in 4 July from 1.4m in the previous week, while continuing claims declined to 18m in the week ending in 27 June from 18.8m in the previous week. The ISM non-manufacturing survey surprised on the upside rising to 57.1 in June from 45.4 in May. PPI inflation was -0.2% mom in June. Finally, we note that Florida smashed previous records in coronavirus cases on Sunday with more than 15,000 new cases.

- **UK:** Chancellor Rishi Sunak announced a GBP 30bn stimulus programme to support the economic recovery and jobs, thereby taking the total direct government support for the economy to GBP 190bn and the budget deficit above 15% of GDP, according to the Office for Budget Responsibility.

- **EU:** Euro area IP rebounded 13.6% in May after a 29% cumulative contraction in the prior two months as many economies lifted lockdowns. Retail sales bounced 17.8% in May after a cumulative decline of 22.7% in the previous two months.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	7.81%	7.81%	-2.65%	4.77%	4.79%	5.65%
MSCI EM Small Cap	6.02%	6.02%	-7.42%	-3.13%	-0.74%	0.98%
MSCI Frontier	0.72%	0.72%	-15.13%	-12.53%	-1.59%	0.26%
MSCI Asia	7.98%	7.98%	2.93%	11.20%	6.60%	7.24%
Shanghai Composite	13.83%	13.83%	12.68%	18.75%	4.28%	-0.56%
Hong Kong Hang Seng	9.41%	9.41%	-2.47%	2.47%	5.00%	1.55%
MSCI EMEA	3.84%	3.84%	-18.24%	-16.74%	-1.31%	-0.75%
MSCI Latam	5.63%	5.63%	-31.48%	-31.13%	-5.79%	-1.38%
GBI EM GD	1.34%	1.34%	-5.65%	-1.77%	1.89%	2.65%
ELMI+	0.72%	0.72%	-4.66%	-2.94%	0.39%	0.99%
EM FX Spot	1.10%	1.10%	-9.96%	-10.35%	-5.58%	-4.75%
EMBI GD	0.94%	0.94%	-1.85%	1.11%	4.11%	5.41%
EMBI GD IG	1.04%	1.04%	4.20%	9.17%	7.15%	6.31%
EMBI GD HY	0.82%	0.82%	-8.85%	-7.76%	0.62%	4.32%
CEMBI BD	0.65%	0.65%	0.50%	4.04%	4.81%	5.24%
CEMBI BD IG	0.58%	0.58%	2.52%	6.02%	5.42%	5.02%
CEMBI BD Non-IG	0.76%	0.76%	-2.33%	1.25%	3.99%	5.61%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	2.79%	2.79%	-0.38%	8.52%	11.64%	11.16%
1-3yr UST	0.00%	0.00%	3.01%	4.25%	2.69%	1.85%
3-5yr UST	-0.03%	-0.03%	6.00%	7.48%	4.18%	3.04%
7-10yr UST	0.09%	0.09%	11.24%	13.33%	7.00%	5.12%
10yr+ UST	1.58%	1.58%	23.12%	28.29%	13.12%	9.82%
10yr+ Germany	0.59%	0.59%	6.50%	5.62%	8.22%	6.58%
10yr+ Japan	0.35%	0.35%	-1.77%	-2.42%	2.14%	3.49%
US HY	1.07%	1.07%	-2.77%	0.86%	3.76%	5.03%
European HY	0.45%	0.45%	-5.50%	-2.81%	1.22%	2.97%
Barclays Ag	0.84%	0.84%	3.85%	5.66%	4.30%	3.80%
VIX Index*	-10.32%	-10.32%	98.04%	120.26%	175.66%	96.33%
DXY Index*	-0.96%	-0.96%	0.07%	-0.36%	0.76%	-0.41%
CRY Index*	2.57%	2.57%	-23.83%	-23.24%	-18.83%	-35.24%
EURUSD	0.80%	0.80%	0.98%	0.59%	-0.65%	2.93%
USDJPY	-1.01%	-1.01%	-1.63%	-0.99%	-5.69%	-13.43%
Brent	4.25%	4.25%	-35.00%	-35.70%	-11.40%	-25.84%
Gold spot	1.24%	1.24%	18.83%	27.50%	48.08%	55.70%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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