

Declining inflation re-injects value into EM local bonds

By Jan Dehn

Despite strong performance in January, Emerging Markets (EM) local currency bonds retain their attractiveness due to the continuing decline in inflation in EM countries. Fears of pass-through from last year's currency weakness to inflation have proved, once again, to be unfounded except in a small number of countries, which have yet to learn the basics about macroeconomic management. In other developments, Thailand's political environment is suddenly a lot more interesting, OFAC rules that PDVSA 2020 bond holders can foreclose on CITGO, if required, and Russian growth significantly beats expectations. Also, the Brazilian government's draft pension reform proposal appears to be more ambitious than anticipated, Pakistan's credit rating is downgraded, Jokowi has a strong lead in polls in Indonesia and flows into China's domestic bond market look set to pick up significantly.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.5	–	-1.34%
MSCI EM Small Cap	9.6	–	-0.43%
MSCI Frontier	8.6	–	0.72%
MSCI Asia	11.2	–	-0.42%
Shanghai Composite	8.9	–	0.63%
Hong Kong Hang Seng	7.4	–	0.82%
MSCI EMEA	8.5	–	-2.88%
MSCI Latam	11.2	–	-3.35%
GBI-EM-GD	6.24%	–	-0.79%
ELMI+	5.39%	–	-0.43%
EM FX spot	–	–	-0.90%
EMBI GD	6.27%	362 bps	-0.05%
EMBI GD IG	4.57%	190 bps	0.20%
EMBI GD HY	8.06%	544 bps	-0.27%
CEMBI BD	5.89%	334 bps	0.25%
CEMBI BD IG	4.74%	219 bps	0.23%
CEMBI BD Non-IG	7.47%	491 bps	0.28%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.5	–	0.11%
1-3yr UST	2.48%	–	0.14%
3-5yr UST	2.46%	–	0.28%
7-10yr UST	2.65%	–	0.50%
10yr+ UST	2.99%	–	1.14%
10yr+ Germany	0.11%	–	1.20%
10yr+ Japan	-0.03%	–	0.22%
US HY	6.89%	422 bps	0.17%
European HY	4.91%	512 bps	0.17%
Barclays Ag	1.93%	-72 bps	-0.23%
VIX Index*	15.86	–	0.13%
DXY Index*	96.87	–	1.02%
EURUSD	1.1304	–	-1.17%
USDJPY	110.24	–	0.32%
CRY Index*	178.04	–	-2.51%
Brent	62.2	–	-0.53%
Gold spot	1307	–	-0.39%

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

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EM inflation remains extremely well behaved in spite of last year's 9% slide in EM currencies. EM CPI inflation, weighted by JP Morgan's GBI EM GD index, declined for the third month in a row to just 3.96% as of end-January 2019. However, this inflation rate is distorted by two unrepresentative high inflation EM countries, Argentina and Turkey. When Argentina and Turkey are excluded from the sample, EM index weighted inflation declined to just 2.69% in January, which is even lower than the already low inflation rate of 2.76% recorded in the same month of 2018.

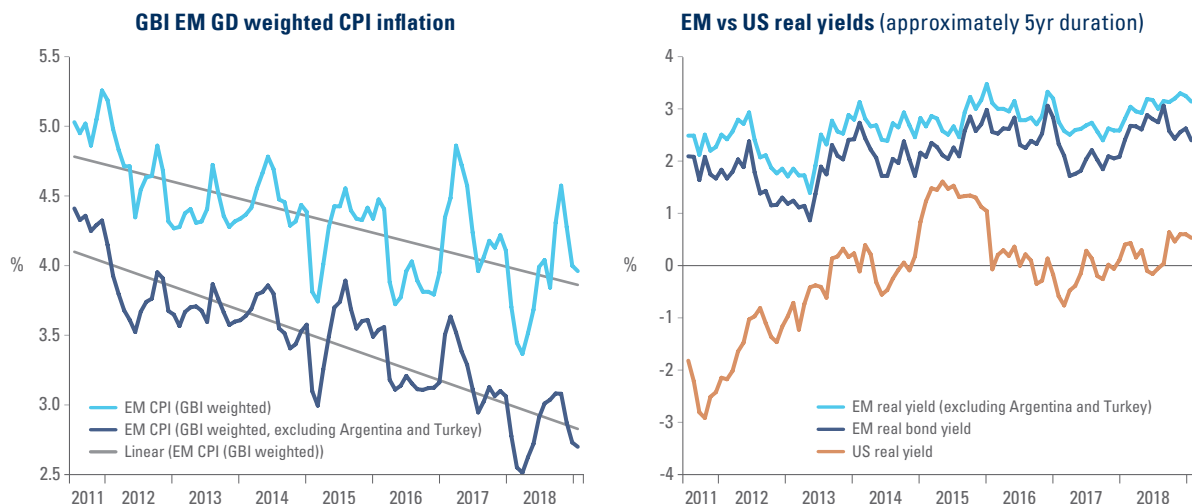
Benign inflation following EM currency weakness in 2018 confirms that the risk of higher inflation due to weaker currencies – a commonly cited risk to EM bond holders - is generally not a problem in most EM countries. While a drop in the currency does push up import prices mechanically, declining non-tradable prices tend to offset the rise in import prices to keep the overall index in check. Even more importantly, most EM central banks are now very credible inflation fighters, so inflation expectations do not unravel regardless of what happens to FX. Pass-through from currencies to inflation only tends to be an issue in a few countries, which have not managed to establish monetary policy credibility, such as Argentina and Turkey.

The other implication of low EM inflation is that the rally in EM local currency bonds in January has not materially lowered real rates, so bonds remains very attractive in absolute terms as well as relative to developed market bonds. Specifically, the nominal GBI EM GD yield declined from 7.04% in October last year to 6.40% as of the end of January, but the real yield only declined by 6bps from 3.24% to 3.18% over the same period due to declining inflation. The real yield on EM bonds is high compared to historical yields, but

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also compared to similar duration US government bonds. As of end-January, the US 5-year bonds yield only 54bps in real terms, while core European real bond yields were negative. Needless to say, high real yields mean that EM central banks also have room to cut rates in case global growth slows further.

Fig 1: EM inflation and real bond yields



Source: Ashmore, JP Morgan, Bloomberg.

- Thailand:** Politics is getting a bit un-Thai-dy, so to speak. In a move without precedence, Princess Ubolratana Rajakanya last week entered the political fray, when she announced her candidature for Prime Minister for the Thai Raksa Chart Party. Thai Raksa Chart is controlled by former Prime Minister Thaksin Shinawatra, a populist. Princess Rajakanya's brother, King Maha Vajiralongkorn, then publicly opposed his sister's decision to enter politics (the royal family has traditionally not participated in politics, but this may now be changing following the death of former King Bhumibol Adulyadej in October 2016). Following King Maha Vajiralongkorn's intervention against his sister's ambitions, it is now quite possible that the Electoral Commission intervenes. If this results in the dissolution of Thai Raksa Chart then Thailand will face a mini-political crisis of sorts. It is possible that the United States gets involved too (the US has traditionally been opposed to the Thai military). Political uncertainty is not entirely novel in Thailand, which has a rather unique political business cycle. Typically, the cycle starts with the election of a populist government, usually with the backing of Thailand's rural poor, who form the majority of the electorate. The populist government then mismanages the economy and gets embroiled in serious corruption scandals. When these problems assume sufficient gravity, the wealthy elite of Bangkok and urban populations in general begin to stage street protests, which escalate until the country becomes ungovernable. At that point, the military traditionally steps in to restore order. Eventually, the military calls fresh elections. The next election is scheduled for 24 March 2019. In other news, Bank of Thailand left the policy rate unchanged at 1.75%.
- Venezuela:** OFAC, an office within the US Treasury, which has been extremely busy of late slapping sanctions on people, companies and countries all over the world. Last week, it clarified that holders of PDVSA 2020 bonds will be able to foreclose on CITGO, a Venezuelan-owned chain of petrol stations on the eastern seaboard of the United States, in case the Venezuelan government does not service the bonds. PDVSA is the national oil company of Venezuela. The access to CITGO collateral in the event of default is reassuring for bond holders. CITGO is currently worth more than the outstanding of the PDVSA 2020 bond. In other news, humanitarian aid from the United States has arrived at the Colombian side of the border with Venezuela. The Venezuelan government has banned the aid from entering the country. A stand off now exists. There is now speculation in many quarters that the United States may exploit the Venezuelan government's refusal to let the much-needed aid enter the country as a pretext for military intervention to remove President Nicholas Maduro from power.
- Russia:** Russian real GDP growth was far stronger than expected in 2018. The economy expanded 2.3% in 2018 versus 1.9% expected. While domestic demand was modest, Russian exports were particularly strong alongside construction, mining and financial services. In its policy meeting last week, the Central Bank of Russia left the policy rate unchanged at 7.75% with a clear hawkish bias. Headline inflation increased to 5.0% in January from 4.3% in December, but the increase in inflation is due to an increase in the rate of VAT, the effect of which soon fade from prices. The market had expected inflation to be even higher (5.1% yoy). Core inflation was in fact far lower than expected (4.1% yoy versus the 4.6% yoy consensus). In other news, Moody's upgraded Russia's local currency and external debt ratings to investment grade with a stable outlook, and Standard & Poor's raised the credit rating of Rosneft, a state-owned oil company, to investment grade with stable outlook.

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- Brazil:** The latest version of the government's pension reform proposal appears to be more ambitious than previously anticipated. The reform proposal raises the retirement age to 65 years of age for both men and women and extends the minimum contribution period. Under the proposal, a minimum of 40 years of contributions will be required for civil servants to achieve a full pension upon retirement. Military personnel, teachers and politicians are included. While it is likely that some of the provisions will be watered down in the parliamentary process, it is nevertheless positive news that the government has adopted a more aggressive starting point. Brazil's public finances – and especially pensions – remain the main obstacle to a strong cyclical bounce and a surge in foreign investor flows to the country, in our view. In other news, consumer prices inflation was 0.32% in the month of January, below the market expectation of 0.37% mom inflation. The monthly inflation print implies yoy inflation of 3.78%. The central bank maintained the policy rate unchanged at 6.50% in January. The combination of low inflation and a high policy interest rate is an important reason why Brazilian bonds are attractive, especially at a time when the government is also pursuing broadly sound economic policies on the fiscal side, which may help drive long yields lower too.
- Pakistan:** Standard & Poor's cut Pakistan's sovereign credit rating to B- from B, citing a diminishing likelihood of rapid improvement in the fiscal balances. The downgrade follows recent news that Pakistan has secured USD 30bn in fresh funding from Saudi Arabia and China, which may even obviate the need for IMF financing, although Pakistan may yet opt to enter an IMF programme. IMF Managing Director Christine Lagarde, who met with Pakistani President Imran Khan over the weekend, said that the "IMF stands ready to support Pakistan". The timing of rating decisions is often odd. As a general rule, we strongly advise investors never, ever to base their investment decisions on the ratings decisions of credit rating agencies.
- Indonesia:** President Jokowi maintains a solid lead in polls ahead of the presidential election scheduled for 17 April 2019. Two out of the three polls point to a growing Jokowi lead of 20-30%, while a third poll has Jokowi leading by 10% over his main rival, Prabowo. In economic news, the balance payments recorded a strong surplus of USD 5.4bn in Q4 2018. A 5.18% yoy, the rate of real GDP growth was also strong in the final quarter of last year. Growth was 5.17% yoy in Q3 2018. The growth rate achieved in Q4 2018 was the fastest in five years.
- China:** JP Morgan, the investment bank, estimates that USD 250-300bn will flow into the Chinese bond market, when Chinese government bonds enter Barclays Bloomberg Aggregate Index and other benchmark indices. To put this flow into some context, it is equivalent in size to approximately one quarter to one third of the total outstanding stock of sovereign Dollar bonds issued by all the EM sovereigns in the world (approximately USD 1.1trn). JP Morgan is consulting with market participants about including Chinese bonds in the GBI EM GD index in Q2 and Q3 of this year. In other news, senior government officials from the United States and China are due to meet this week to continue negotiations towards a trade deal. Our view is that both sides are keen to strike a deal. China never wanted a trade war, while the US must now end the trade war it instigated less than a year ago in order to avoid triggering the next US recession, in our view.

Snippets:

- Argentina:** Industrial production declined at a yoy rate of 14.7% in December (-1.7% mom) as the government continues to try to re-establish policy credibility. The return to orthodox economic policies are enabling inflation and the 7-day Leliq rate to decline. The Leliq rate is down 9% so far this year, but remains high at 50%.
- Chile:** The economy contracted 0.7% in the month of December, according to the monthly GDP proxy. However, retail sales were 2.4% higher in December 2018 than in the same month of 2017.
- Colombia:** At 3.1% yoy, CPI inflation was lower than expected in January. Also, the government released fiscal numbers, which show that it likely achieved its 3.1% of GDP fiscal deficit target in 2019. The government also expects to meet the tighter fiscal deficit target of 2.4% of GDP in 2019, according to the finance ministry.
- Czech Republic:** The Czech National Bank left the policy rate unchanged at 1.75%. Industrial production declined at a yoy rate of 1.4% in December and retail sales slowed too.
- India:** The Reserve Bank of India cut the policy rate by 25bps to 6.25%. At the same time that the central bank is cutting rates, the federal government is stimulating fiscal policy ahead of the general election scheduled for Q2 2019.
- Kazakhstan:** The central bank cut the policy rate by 50bps to 9.25%.
- Mexico:** CPI inflation declined substantially to 4.37% yoy in January from 4.83% yoy in December. Gross fixed investment dropped faster than anticipated in November (-3.2% yoy versus -2.4% yoy expected). Mexico's central bank left the policy rate unchanged at 8.25%. President Andres Manuel Lopez Obrador announced that he will provide additional government support for PEMEX, the state oil company.
- Peru:** The central bank left the policy rate unchanged at 2.75% as inflation declined to 2.13% yoy in January from 2.19% in December. The central bank's inflation target is 2% +/- 1%. The governor of Peru's central bank, Mr Julio Velarde, one of the grand old men of Latin American central banking, has a good aim!

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- **Philippines:** The central bank left the policy rate unchanged at 4.75% in line with expectations as inflation slowed sharply to 4.4% yoy in January from 5.1% yoy in December.
- **Poland:** The central bank left the policy rate unchanged at 1.5%.
- **Serbia:** The economy racked up a solid real GDP growth rate of 4.2% in 2018, the fastest growth rate in ten years.
- **Turkey:** The government is taking over shares in Isbank controlled by the opposition CHP party. The government is also keeping food prices artificially low in order to give an impression of lower than actual inflation.
- **Ukraine:** The National Bank of Ukraine left the policy rate unchanged at 18%.

Global backdrop

EM countries continue to be the strongest economies in the world, while developed countries continue to supply most of the worries. The UK continues along the tragicomic trajectory towards Brexit on 29 March, while Yellow Vests make life a misery for the government in France. The economic data in Germany is weak and Italy has plunged headlong into recession under the stewardship of a populist government, which will struggle to produce the reforms and the boost to business confidence required to get back in black. In the United States, imports surprised sharply to the downside, reflecting, perhaps, softer domestic demand, since services ISM is softening and the expected meaningful decline in the number of people claiming unemployment benefit failed to materialise. The ten-year old stock market rally in the United States is to all intents and purposes over, because costs have begun to eat into company earnings. This means that the large capital gains, which drove so much money into stocks during the period of hyper-easy monetary policies, may well be at an end. Meanwhile, dividend yields are unattractive too. This all adds up to one simple conclusion: the search for yield will switch to EM.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.32%	7.32%	7.32%	-8.47%	15.22%	4.84%
MSCI EM Small Cap	-0.34%	5.03%	5.03%	-13.62%	8.54%	2.52%
MSCI Frontier	0.88%	5.68%	5.68%	-12.69%	7.78%	1.45%
MSCI Asia	-0.32%	6.97%	6.97%	-8.02%	14.61%	6.95%
Shanghai Composite	1.30%	4.99%	4.99%	-22.19%	1.29%	7.59%
Hong Kong Hang Seng	-0.72%	8.22%	8.22%	-7.88%	15.31%	6.62%
MSCI EMEA	-3.55%	6.88%	6.88%	-9.22%	13.46%	0.07%
MSCI Latam	-3.25%	11.23%	11.23%	-1.12%	21.51%	2.44%
GBI EM GD	-0.79%	4.46%	4.62%	-5.03%	6.96%	0.47%
ELMI+	-0.63%	1.98%	2.07%	-3.28%	4.64%	-0.17%
EM FX Spot	-1.10%	2.49%	2.49%	-8.29%	0.03%	-6.07%
EMBI GD	0.04%	4.45%	4.45%	1.72%	6.92%	5.59%
EMBI GD IG	0.33%	3.21%	3.21%	3.03%	5.38%	4.73%
EMBI GD HY	-0.24%	5.77%	5.77%	0.38%	8.68%	6.46%
CEMBI BD	0.35%	3.07%	3.07%	1.74%	6.25%	4.84%
CEMBI BD IG	0.34%	2.32%	2.32%	2.68%	4.45%	4.20%
CEMBI BD Non-IG	0.36%	4.07%	4.07%	1.20%	9.33%	5.66%

Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	0.21%	8.24%	8.24%	7.04%	15.80%	10.79%
1-3yr UST	0.05%	0.32%	0.32%	2.18%	0.77%	0.82%
3-5yr UST	0.03%	0.44%	0.44%	3.03%	0.62%	1.39%
7-10yr UST	0.05%	0.79%	0.79%	4.89%	0.20%	2.51%
10yr+ UST	0.60%	1.27%	1.27%	6.14%	0.29%	5.15%
10yr+ Germany	0.93%	3.11%	3.11%	12.74%	2.41%	7.28%
10yr+ Japan	0.81%	1.90%	1.90%	4.20%	2.90%	4.47%
US HY	0.29%	4.83%	4.83%	3.24%	10.37%	4.61%
European HY	0.20%	2.67%	2.67%	-1.21%	5.36%	4.15%
Barclays Ag	-0.48%	1.03%	1.03%	-0.16%	2.05%	0.99%
VIX Index*	-4.28%	-37.61%	-37.61%	-45.42%	-43.64%	9.30%
DXY Index*	1.35%	0.72%	0.72%	7.11%	1.37%	20.13%
CRY Index*	-0.89%	4.85%	4.85%	-5.56%	14.86%	-38.65%
EURUSD	-1.26%	-1.42%	-1.42%	-8.04%	-0.17%	-17.11%
USDJPY	1.24%	0.50%	0.50%	1.45%	-1.94%	7.42%
Brent	0.47%	15.58%	15.58%	-0.97%	106.85%	-42.79%
Gold spot	-1.07%	1.92%	1.92%	-1.18%	4.84%	1.22%

*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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