Issued: 2 February 2015

WEEKLY INVESTOR RESEARCH

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China moves ever closer to global reserve currency status

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The Chinese Renminbi has become the fifth most traded currency in the world and looks set to reach third place within the next three years. Brazil had a bad week. Russia cut rates. Saudi Arabia launched a major fiscal push. Dominican Republic went to town and Venezuela paid for the party. Sri Lanka's new government has launched an ambitious political reform program. Mexico is cutting spending pre-emptively. Poland and The Philippines grew strongly. Belarus had an 'Emerging Markets moment'. In the global backdrop, oil rose sharply on falling rig counts in the US, the US economy's growth rate halved in Q4, the FOMC indicated its patience and European sentiment declined over Greece.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	962	–	-2.72%
MSCI EM Small Cap	1,010	–	-0.51%
MSCI FM	587	–	-1.05%
GBI EM GD	5.90%	–	-1.23%
EM FX spot	–	–	-1.58%
ELMI+	4.79%	–	-1.31%
EMBI GD	5.59%	392 bps	0.21%
EMBI GD IG	4.27%	255 bps	0.38%
EMBI GD HY	8.54%	696 bps	-0.10%
CEMBI BD	5.48%	395 bps	0.15%
CEMBI BD HG	4.28%	274 bps	0.12%
CEMBI BD HY	8.28%	677 bps	0.22%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1995	-3.00%
VIX Index	20.97	35.12%
5 year UST	1.19%	-15 bps
7 year UST	1.49%	-15 bps
10 year UST	1.67%	-16 bps
US HY	6.98%	0.23%
European HY	5.07%	-0.12%
EURUSD	1.1335	0.86%
USDJPY	117.64	-0.70%
Brent	50.88	12.43%
Copper	145.50	1.75%
Gold	1275.11	-0.49%

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

Emerging Markets

- **China:** In 2014 the Chinese Renminbi (CNY) overtook both the Australian and Canadian dollars to become the fifth largest global payments currency in the world, according to new data from Swift, a global financial conduit agency. Two years ago CNY was only ranked 13th. At the current pace of growth, CNY will easily overtake JPY as the fourth most used payments currency next year and within three years challenge GBP for third place. Despite its rapidly growing importance in both financial and current account transactions, CNY is not yet a global reserve currency. However, the IMF is launching a review of CNY's status in October ahead of making a final decision in December of this year. The IMF only decides on currencies' reserve status every five years. We think China will strive to achieve global reserve currency status this year. The major obstacle is likely to come from developed economies that see the arrival of a new global reserve currency as a threat, because it would directly compete with their currencies for a share of global central bank reserves. Emerging Markets (EM) – which hold nearly 80% of all global FX reserves – have strong incentives to support China's bid for reserve currency status for a number of reasons. The most obvious reason is that the US, Europe, Japan and the UK have huge debt and fiscal liabilities and have printed huge quantities of paper money to re-inflate their bubbles instead of reforming or deleveraging.

In another Chinese development, the government has undertaken a major reform by incorporating 40 million public sector workers into the pension system along similar lines to those that apply to private sector employees. Prior to the reform, civil servants and other public sector employees were not required to make pension contributions, while their pensions were paid from the proceeds of direct taxation of the population. The pace of reform in China is quite dizzying – reforms that occur in Western economies only once in several decades are approved with barely a mention. This ability and willingness to reform is the main reason why China has a brighter future than perhaps any other country. As for this particular pension reform, it is supportive of another vital reform, namely the development of China's bond market. China's domestic bond market will soon become the main mechanism for transmitting monetary policy into the wider economy as part of China's transition to a domestic demand led economy.

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Emerging Markets

- **Brazil:** It was a bad week for Brazil. Firstly, Petrobras has issued its much-delayed Q3 2014 non-audited accounts, but without providing explicit information on a USD 20bn suspected write-off attributed to alleged corruption involving senior members of the administration of President Dilma Rousseff and the PT party. According to the company, it was impossible to specify the precise write-off, because it is not possible yet to be sure how and where the money went, probably because shedding light on these facts would broaden the political fall-out. While the release of the non-audited statement strictly satisfies Petrobras' commitments under the bond covenants, the continued lack of full transparency has wider ramifications. For example, Moody's downgraded the company's credit rating to Baa3, while maintaining a negative outlook. This will drive up borrowing costs. Also, as more information becomes available about where the money went, tensions could rise between Brazil's political parties and undermine support for the current effort to rectify the fiscal situation. On that count, last week was also bad, because it transpired that Brazil racked up a primary deficit of 0.6% of GDP in 2014. This means that Finance Minister Joaquim Levy must inflict 1.8% of GDP worth of fiscal austerity on Brazilians this year in order to meet his 1.2% of GDP primary surplus target. At the same time, it is clear from the central bank minutes released in the past week that there are more interest rate hikes coming. Needless to say, this prospect is causing business confidence in Brazil to decline (down 6.1% in January). Credit numbers for 2014 also showed bank loan growth slowing to 11.3% from 14.7% in 2013. In a nutshell, Brazil is heading into a tough fiscal adjustment, the need for which was self-inflicted – due to the poor economic management of former finance minister Guido Mantega. On the other hand, the corrective measures currently underway will return Brazil to good economic health over the next two years, in our view. Consistent with this view, the government last week established GTAG, a body comprising the planning and finance ministries plus the audit office and the cabinet chief's office to oversee execution and implementation of the budget objectives and to improve the quality of public spending and policies more broadly.

- **Russia:** USDRUB rose sharply following the Russian central bank's (CBR) decision to cut the policy rate from 17% to 15%, but the currency later returned to near the levels before the cut. The CBR cited already slowing inflation momentum and expressed confidence that inflation expectations will remain anchored, particularly as growth begins to slow more decisively in the course of 2015 and inflation begins to decline towards its 10% target by this time next year. This reasoning seems reasonable. Real interest rates are still north of 3.5% following the CBR's surprise cut. So far the economy has been showing resilience. Industrial production rose 3.9% in December versus 0.8% expected, while retail sales rose 5.3% yoy, also substantially better than anticipated. Ironically, Russia's economic resilience now looks more threatening to Russia's balance of payments outlook than sanctions or low oil prices per se. We estimate that Russia's FX reserves are likely to remain at extremely comfortable levels in 2015 provided that the Russian economy shrinks considerably this year. A less than expected shrinkage would however enable Russian consumers to sustain a higher demand for imports and therefore result in a larger drain on reserves. Despite strong retail spending in December, however, we think the slowdown is coming. Real wages declined 4.7% yoy, so retail spending is likely to decline going forward. In general, we see the economy decelerating in the course of 2015 due to the recent rise in real interest rates and the impact of the weakening RUB on the cost of imported goods and hence real income and spending. In other Russian news, the EU extended its current sanctions regime by another six months following the recent upsurge in fighting in Eastern Ukraine. The old sanctions regime would otherwise have expired in March. An initiative to introduce new and tougher sanctions was blocked by Greece. By now, most analyses of Russia's balance of payments, including our own, assume the indefinite maintenance of the current sanctions regime, so the effect of this news on the market was minimal.

- **Saudi Arabia:** In less than a week after King Salman's enthronement, some 30 royal decrees were issued, from ministerial post changes to extra salary hand outs and additional infrastructure spending. We estimate the total cost of the extra spending amounts to USD 32.3bn of which 80% is current spending and another USD 5.3bn is capital expenditure over several years. The measures comprise 4.4% of our estimated 2015 GDP of USD 732bn. The majority of the measures are consumption-driven and would have a direct one-off impact. The payments are expected to be made over the course of the next four weeks. Such measures are not atypical at the outset of a new monarch's tenure. They are considered good politics and always positively received by society as a gesture of goodwill by the new monarch. Three weeks after King Abdullah ascended to the throne (in August 2005) a 15% salary increase for public sector employees was announced. Basic salaries at that time had not increased for quite some time. Just like in previous times, the private sector reacted to such measures and many have instituted basic salary increases or parallel monthly basic salary hand outs. This will have an impact for more than two million private sector Saudi employees as well as many expatriates. Caps have been placed as private sector wages are many times over public sector salaries. We estimate the total effect to add 0.78% to real GDP.

The measures included payment of two months of additional basic salary or similar rewards to a wider range of state and military employees, retired government and private sector workers, public sector students (in Saudi or abroad) and social security beneficiaries. There were also grants to professional associations and sports and literary clubs around the country and SR 20bn in spending to improve electricity (SR 14bn) and water services (SR 6bn).

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Emerging Markets

On the fiscal side, these measures can be sustained given Saudi Arabia's reserve position. The government's current account with SAMA has declined by USD 32.6bn between September-December 2014. Although our view is that oil prices will pick up later this year, even at USD 50 per barrel, coupled with elevated spending would lead to a manageable decline in reserve assets.

On the cabinet front, of the eight ministers appointed by King Abdullah less than two months ago, only one kept his position – Abdullah Al Muqbil (Transportation). All others were replaced.

Of particular importance are the institutional changes announced which are geared to increase efficiency and effectiveness. The Ministry of Higher Education and Ministry of Education were merged into one super Ministry. In total, twelve committees and councils were abolished. We expect that additional initiatives could be announced as well as additional projects that have a positive trickledown effect for the larger economy.

- Dominican Republic: One man's gain is another man's pain. The Dominican Republic (Dom Rep) announced last week that it has used part of the proceeds of a USD 2.5bn bond issue to buy back more than USD 4bn of debt it owes to Venezuela. DomRep bought back the debt at a discount of 52% of original face value, reducing the value of its outstanding debt by a massive 3.3% of GDP. The fall in oil prices has cheapened Venezuelan debt, but has presented great opportunities for countries such as DomRep to profit from Venezuela's problems. In addition to lowering its debt stock in both face value and net present value terms, DomRep also extended the average life if its debt stock considerably.

- Venezuela: Venezuela is paying dearly for its past profligacy, but right now what matters for Venezuela is to raise enough cash to stay current on its debt. To that end, the transaction with DomRep (see above) was good news. The deal generated an inflow of USD 1.9bn to Venezuela, which caused FX reserves to rise from USD 20.6bn to USD 22.4bn last week. There is scope for Venezuela to undertake other similar transactions with other countries such as Jamaica and Paraguay. Venezuela has yet to undertake the same decisive macroeconomic adjustment as other oil-exporting countries, but the government is unlikely to opt for default on the grounds that the fall-out from a default could be the worse of two unpleasant options. A default could render PDVSA, the state-owned oil company, unable to produce oil due to the loss of working capital credit lines. The political fallout from a collapse in oil production would likely exceed the political cost of undertaking the unpleasant adjustment required to continue to service debt. Moreover, we estimate that if oil prices average USD 60 per barrel for the year then Venezuela will accumulate rather than lose reserves in 2015.

- Mexico: Luis Videgaray, finance minister, announced 0.7% of GDP worth of spending cuts for 2015, citing lower oil prices. Mexico has hedged its oil sales at USD 76 bp this year, but is mindful that export prices have not been hedged for 2016. The decision to cut spending is therefore a very prudent one, typical of the high quality of fiscal management at central government in Mexico. Meanwhile, Mexican economic expansion continued in November, when the economy grew by 0.5% relative to the previous month, where the economy expanded 0.7% mom. In its monetary policy meeting, the central bank left rates unchanged at 3%.

- Sri Lanka: The program for the first 100 days of the Sirisena administration has been published. The program is ambitious. It aims to shift power from the Executive branch to parliament. It also aims to increase transparency via improvement in the Rights to Information Act. The accountability of government agencies will be improved and there will be reforms to drugs policy. After the 100 days are up the parliament will be dissolved and a fresh general election held.

- Poland: The economy expanded 3.3% yoy in 2014, according to official government data, mainly due to strong domestic demand-led growth. Poland's growth performance shows that proximity to Western Europe is not necessarily a major constraint on EM growth. The tendency to overstate the importance of external factors to the performance of EM countries is rooted in prejudices that were shaped a quarter of a century ago when EM countries suffered under the yoke of Superpower abuses. Poland did not even suffer a recession in the 2008/2009 financial crisis.

- The Philippines: The economy continues to perform extremely strongly. In Q4 2014, the economy racked up 6.4% yoy growth (vs 6.2% expected). Real GDP growth as a whole for 2014 was 6.1%. The Philippines is firing on all cylinders – government spending, investment, consumption and exports. The recent fall in oil prices has been very beneficial too.

- Belarus: In a classic EM moment, last week Belarus's President Lukashenko inadvertently caused a short-lived panic in the market for his country's bonds, when in the course of a seven-hour address to the people of Belarus he stated that he would 'restructure' his country's debt. In fact, as he clarified later he had meant to say that he would 'refinance' the debt. After a violent round-trip Belarus's bonds returned to the prices they traded at before Lukashenko's comment. These situations arise frequently in EM. The extreme sensitivity of EM bonds to such simple misunderstandings illustrate how strong prejudices still are about EM. Regardless of strong records of debt service, better macroeconomic conditions backed by disclosure of solid economic data,

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repeated reconfirmations about willingness and ability to pay, etc. the market is still ready at a moment's notice to ditch all its knowledge of a credit in favour of reverting to a prejudice that EM governments are untrustworthy. This perception couldn't be more wrong: Most EM governments are in fact highly respectful of markets and will do almost anything to avoid upsetting them.

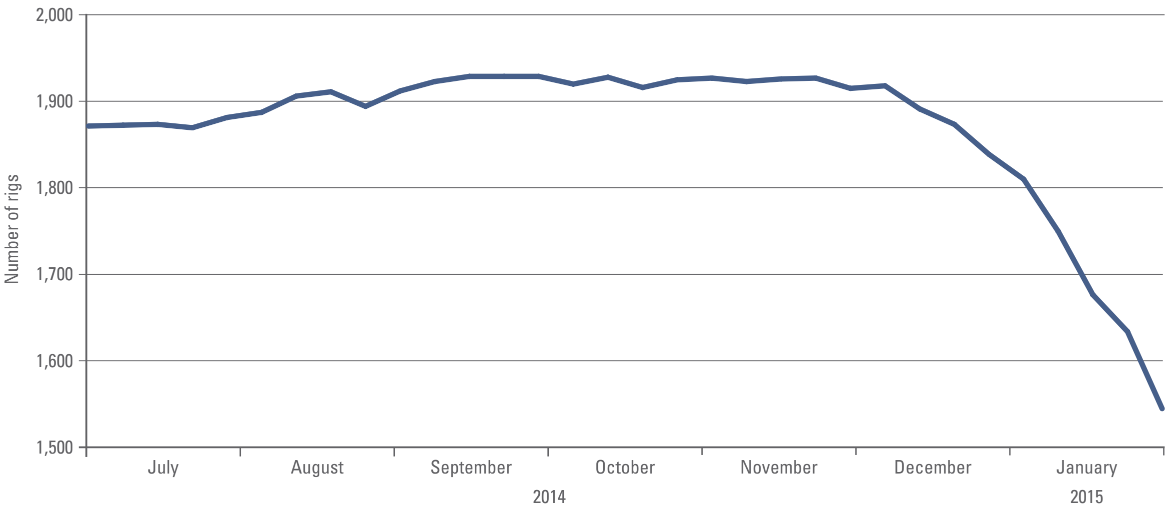
Snippets:

- Costa Rica: The fiscal balance deteriorated by 0.2% to reach -5.6% of GDP in 2014. Costa Rica needs to cut spending, not just raise additional revenues, but the government is not willing to pay the political cost. Yet.
- Peru: Bank's reserve requirements for deposits in Peruvian sol have been cut by 50bps to 8.5%. The central bank also eased by 50bps banks' minimum deposit requirement at the central bank. The measure will enable banks to lend more money.
- Hungary: The central bank left policy rates unchanged at 2.1% with a dovish outlook.
- Colombia: The central bank left rates unchanged at 4.5%.
- South Africa: The central bank left rates unchanged at 5.75%, while sharply lowering its inflation expectations. If the SARB's inflation forecasts are correct then its policy of keeping rates unchanged is consistent with higher real rates, reflecting the relatively hawkish stance of Governor Lesetja Kganyago.
- Singapore: The Monetary Authority of Singapore will slow the pace of appreciation of the SGD following a decline in inflation in the country. Inflation is declining both due to lower oil prices and softer wage pressures.
- Thailand: The central bank left rates unchanged at 2%. The trade surplus in December rose to USD 1.6bn versus USD 1bn expected and –USD 0.1bn in November.
- Malaysia: Bank Negara, Malaysia's central bank, left rates unchanged at 3.25%. Moody's affirmed the country's A3 credit rating with positive outlook.
- South Korea: Industrial production rose 3.0% mom, significantly better than consensus expectations of a 0.9% mom gain.

Global backdrop

Oil prices rose sharply last week. Brent 1st futures spiked to USD 53 pb after briefly touching a low of USD 46.7 on 13 January. This followed news that the US rig count fell sharply in January. As the chart below shows, the US rig count has declined by nearly 20% since oil prices began to fall in June 2014. Amidst many 'after the fact' structural explanations for the sudden fall in oil prices, we tend to believe that the explanation is more cyclical in nature. Firstly, we think the rise in the Dollar explains a decent proportion of the fall in oil prices. Secondly, we think the balance is due to a build up in inventories. Lower prices will have the effect of gradually increasing demand as users switch to thermal energy from less economic sources, while supply should gradually decline as less efficient producers are priced out of the market. In addition, the lower price of oil is already discouraging investment in the oil sector, a fact that could potentially tighten conditions in the oil market further out.

Fig 1: **US oil rig count**



Source: Baker Hughes.

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Global backdrop

According to the FOMC minutes, the Fed is 'patient', which means that it will not raise rates in April, in spite of 'solid' economic growth. The chance of an early hike is likely to decline further since as it has since transpired that the rate of growth in Q4 2014 effectively halved relative to the pace in Q3 2014 – due mainly to a 1% drag coming through from the trade balance – perhaps a consequence of Dollar strength. Imports rose, exports fell and investment declined, while inventories increased, which may not be such a good thing if demand continues to weaken. Falling oil prices poses another risk for growth in the US due to the dominant role oil producing states have played in driving the recent expansion. Weekly initial claims for unemployment benefit declined a lot, but mainly due to a holiday-shortened week. Durable goods orders were weak, but housing is still broadly strong and consumers still appear chirpy. The Fed would dearly like to get a few hikes on the books, if only to demonstrate progress, but amidst falling inflation expectations and now slowing growth the hikes are not going to be dramatic. Besides, over the longer-term we think the Fed will choose to protect growth rather than fight inflation aggressively. Sadly, a choice between growth and inflation seems inevitable, because of the crippling debt stock of 644% of GDP (including unfunded medical liabilities), which the market happily continues to completely ignore. Modest hikes, implemented slowly from a low base pose no fundamental threat to EM, where rates and spreads are already consistent with far tighter conditions.

By contrast, it has escaped no one's attention that the Eurozone crisis is back. The question of how to deal with Greece's populist new government is now weighing on sentiment globally. The handling of Tsipras and co is worth watching closely as a precedent for how the Eurozone will deal with Spain's Podemos Party later this year. Podemos too is a populist party opposed to austerity, which this weekend pledged to restructure Spain's USD 1.1trn debt.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.6%	0.6%	5.5%	0.9%	3.4%
MSCI EM Small Cap	1.4%	1.4%	5.3%	4.8%	4.3%
MSCI FM	-4.1%	-4.1%	1.5%	11.6%	7.3%
S&P 500	-3.00%	-3.00%	14.22%	17.46%	15.57%
GBI EM GD	0.34%	0.34%	-0.81%	-2.18%	2.65%
ELMI+	-2.77%	-2.77%	-7.54%	-3.01%	-0.88%
EM spot FX	-3.00%	-3.00%	-12.25%	NA	NA
EMBI GD	0.93%	0.93%	9.17%	5.90%	7.68%
EMBI GD IG	1.80%	1.80%	11.56%	5.41%	7.19%
EMBI GD HY	-0.65%	-0.65%	5.13%	6.59%	8.34%
5 year UST	2.48%	2.48%	4.39%	1.48%	3.79%
7 year UST	3.59%	3.59%	8.11%	2.52%	5.74%
10 year UST	4.80%	4.80%	13.41%	4.18%	7.47%
CEMBI BD	0.68%	0.68%	5.25%	5.63%	6.52%
CEMBI BD HG	1.46%	1.46%	7.93%	5.96%	6.81%
CEMBI BD HY	-1.02%	-1.02%	-0.25%	5.23%	6.16%
US HY	0.45%	0.45%	1.79%	7.62%	9.17%
European HY	1.15%	1.15%	6.18%	13.45%	11.81%
Barclays Agg	-0.16%	-0.16%	-0.62%	0.12%	2.53%

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

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