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Ashmore

The illusion of harmonious global economic policy coordination

By Jan Dehn

Indian Central Bank Chief, Raghuram Rajan, shatters the pleasant fiction of harmonious global economic policy coordination. In our view, his remarks are timely and important. The global imbalances have yet to be unwound and there will be important economic consequences for developed countries and Emerging Markets (EM) alike. Who will end up paying the bill? The sooner policy makers in EM realise that developed countries will strictly pursue their own self-interest the better. EM's best strategy in the face of self-serving policies in developed economies is to work together, not to go begging for leniency at the Fed.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	933		0.13%
MSCI EM Small Cap	977		0.47%
MSCI FM	597		-1.42%
GBI-GD	7.20%		-0.96%
ELMI+	4.63%		-0.14%
EMBI GD	6.06%	360 bps	-0.45%
EMBI GD IG	5.04%	241 bps	-0.10%
EMBI GD HY	8.43%	626 bps	-1.14%
CEMBI BD	5.73%	347 bps	-0.10%
CEMBI BD HG	4.79%	253 bps	0.04%
CEMBI BD HY	7.55%	533 bps	-0.23%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1783	0.07%
VIX Index	18.41	5.68%
5 year UST	1.51%	-6 bps
10 year UST	2.66%	-9 bps
DAX	9300	-0.52%
10 year Bund	1.66%	0 bps
EURUSD	1.3479	-1.44%
USDJPY	102.10	-0.44%
Brent	106.59	-1.76%
Copper	328.82	-1.95%
Gold	1242.89	-1.14%

Emerging Markets

Harmonious global economic policy coordination is an illusion. Always was, always will be. Yet, one could be forgiven for having thought otherwise in the last few years. After all, EM central banks actively supported developed economies in the early stages of the global crisis by financing their enormous fiscal deficits.

This week Indian central bank governor, Raghuram Rajan, former Chief Economist at the IMF, shattered the illusion of harmonious global economic policy coordination, when he openly criticised the US Fed's decision to taper for failing to take the plight of some EM countries into consideration.

Rajan is right to point out that the Fed does not care one iota about EM. Rajan's comment is above all a warning to those EM policy makers and investors who have still not faced up to the true nature of the economic relationship between developed countries and EM.

In our view, developed countries have always strictly pursued their own self-interest in their relations with EM countries. In the early stages of the crisis it was in the interest of developed countries to pay lip service to global coordination in order to secure financing. Today, as the fiscal needs of developed economies have become less acute, we are already beginning to see the outline of much bigger conflicts between developed countries and EM that lie ahead.

Why do we expect bigger conflicts? Because the global economy remains in a state of extreme disequilibrium.[1] The stocks of debt in developed economies have yet to be reduced. And EM central banks hold most of this debt. The unwinding of these imbalances is going to be intensely political. Will developed economies opt to repay their debts by inflicting austerity on current voters, or will they opt for a combination of inflation, financial repression, and devaluation, which will pass the cost onto future generations and foreigners?

In our view, developed economies will inflate, financially repress, and devalue their debts away, starting as soon as household deleveraging is over. Inflation and financial repression together produce negative real interest rates that in turn weaken home currencies. This cocktail of economic nationalism spares current voters the pain of austerity and passes the cost onto future generations and foreigners (neither of whom vote in current national elections).

Economic nationalism is particularly potent in the US, because of the Dollar's reserve status. Having the reserve currency is a great asset for the US, but a great liability for EM central banks. Financial repression and Dollar depreciation erodes the value of EM FX reserves, which remain overwhelmingly invested in US dollars.

[1] *"A Pleasant Fiction"*, The Emerging View, September 2013.

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Emerging Markets

Seen in this slightly longer-term context, the current weakness in EM currencies is clearly mainly technical in nature and strictly temporary. We are still in a world of low rates, low inflation, and low growth. Currencies move on good stories and changes in positioning rather than due to changes in fundamental currency drivers, such as relative growth and real rates. In a nutshell, having beaten up the EUR during the Eurozone debt crisis and then JPY as Japan launched its recent fiscal and monetary stimuli, the time has now come for the global currency markets to gang up on EM currencies.

However, given that there is little evidence of any major shift in EM fundamentals to justify this focus on EM currencies, we think the current EM currency weakness is likely to be reversed once positioning has moved far enough. Indeed, after a sell-off, which began in May last year EM currencies are already cheap, in our view. For example, the FX implied yield on JP Morgan's ELMI+ EM currency index is now 4.63% for around 56 days duration.

What does it take to turn sentiment around? Usually it is not just one thing that turns a market. Usually a number of ducks have to get into line, including valuations, technicals, fundamentals, policy actions in the more vulnerable EM credits, and sentiment in the non-EM world, notably sentiment about the US. We think we have made considerable progress in all these areas and investors should nibble into the current weakness.

Smart policy makers in EM already understand the temporary nature of the current EM currency sell-off. They are using the current EM weakness to diversify away from the Dollar at attractive levels, while aggressively reforming their economies to help them withstand future EM currency appreciation. Those who continue to let themselves be hoodwinked by lip service in developed countries will ultimately pick up their tab.

It is in the best interest of EM central banks to work with other EM central banks, not to beg the Fed for lenience. Together they control more than USD 9trn of FX reserves (80% of the world's total stock of reserves). This gives them considerable power to determine the direction of global currencies, including the Dollar as well as their own currencies. But to do so they have to act as a group. Can they? EM policy coordination is not easy. Many EM policy makers still maintain an almost religious faith in the Dollar and US treasuries. Many still look to developed markets for leadership rather than taking the lead themselves. It remains unclear if EM can seize this bigger prize.

Back to the present: Do EM countries really need the Fed to be more lenient? We see three reasons why tapering is not nearly as threatening to EM as implied by Rajan and recent price action:

Firstly, the vast bulk of QE money went to developed markets, not to EM. This is why EM corporate and sovereign bonds are trading at spreads to US bonds that are twice as wide as they were before the crisis. Only a moment's sober reflection should be enough to conclude that tapering will ultimately hurt developed countries more because QE pushed their asset prices far higher and raised their debt levels far more than those in EM;

Secondly, EM countries obtain the bulk of their financing in local markets, where yields have already adjusted to 7.2%, where they last traded when US 10 year treasury were 4.5%. Neither the futures market nor we believe that 10 year treasuries will hit 4.5% this year. This means that EM yields have likely already overshot and that much of the current price action is due mainly to momentum trading and selling by those who confuse price volatility with riskiness;

Thirdly, the troubles observed in a few EM countries are largely self-inflicted, not the consequence of Fed policies. Argentina, Venezuela, and Ukraine have been dysfunctional for years, long before the Fed began to taper. Positioning by international investors is light. Turkish and Brazilian policymakers broke away from economic orthodoxy years ago, for political reasons or due to sheer ineptitude. Their policy mistakes are directly to blame for the macroeconomic imbalances and business confidence problems in these two countries, though, sadly, at the moment their mistakes are now also helping to fuel a broader, irrational hysteria against EM as a whole.

Still, the economic problems in Brazil and Turkey are relatively modest. They can easily be solved 'at home'. All it takes is political leadership. We believe that the bulk of the more than 50 other EM countries are easily capable of riding out the current storm. In short, EM does not need a compassionate Fed.

In other developments:

- **Turkey:** The central bank last week raised all policy rates sharply in a bid to stabilise the currency. Overnight lending and borrowing rates were raised from 7.75% and 3.5% to 12% and 8%, respectively. The one-week repo rate was also raised from 4.5% to 10% and the rate on the late liquidity window was increased from 10.25% to 15%. Turkey has been resisting rate hikes for a number of reasons, including political pressures from Prime Minister Erdogan and concerns about the sensitivity of the housing sector to higher rates after years of excessive domestic credit growth. The central bank's failure to raise rates has left Turkey with a large external deficit (December's trade deficit was a wide USD 9.1bn). Going forward, however, the combination of higher

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rates and a weaker TRY should help to improve external balances as they have in India and Indonesia (see comment on India below). We think the decision of the Turkish central bank to raise rates despite political pressures and concerns about the economy illustrates an important general point about policy-making in EM: Governments are ultimately willing to do almost anything to avoid instability, especially in the lead-up to elections. Turkey goes to the polls in March (local elections). A poll last week showed that support for Erdogan's AK party remains solid. The AK party is supported by 43% of voters polled, compared to 28% for the CHP and 15% for MHP. A failure to raise rates could have unleashed greater instability in Turkey that would undoubtedly have eroded support for the AK party more than last week's rate hikes.

- **India:** The central bank raised rates by 25bps and signalled the end of the hiking cycle. As a result of the RBI's adjustment measures, India's current account deficit has shrunk to 2.8% of GDP after a massive 5.4% of GDP improvement last year. Reserves now stand at 7.6 months of imports and foreigners hold just 1.7% of local bonds.

- **South Africa:** The South African Reserve Bank (SARB) raised rates by 50bps in a split decision. The SARB's rationale for raising rates was pass-through to core inflation rates from a weaker currency. The SARB indicated that future decisions would be highly data dependent meaning, in our view, that they are tied to the general sentiment towards EM. South Africa's current political leaders have been unable to address the country's underlying growth challenges. We expect no significant change in the political outlook following elections scheduled to take place later this year.

- **Argentina:** After a 15% depreciation of the Peso the government last week allowed the de facto policy interest rate (the rate on 70-day notes) to rise by 600bps to 25.5%, while the wholesale deposit rate (Badlar) was allowed to rise by 90bps to 22.9%. However, inflation rates are running at more than 30%, so real interest rates remain negative. Moreover, the underlying cause of Argentina's macroeconomic imbalances – loose fiscal policy – has not been addressed. Supply side policies also need to become far more investor friendly.

- **Ukraine:** Prime Minister Azarov resigned and the government dismantled various laws intended to crush widespread anti-government protests. Ukraine's zero-sum political conflict is intense and results in the neglect of longer-term economic issues. These issues have now become acute, rendering the government extremely vulnerable to domestic and foreign political pressures. Last week Russia stepped up the outside pressure by putting a recently agreed bailout on hold pending further clarity about the direction of domestic policy in Ukraine. At the same time, the EU, also seeking to influence events in Ukraine, is once again making overtures with offers of financial assistance that may not hinge on an IMF agreement. Due to elections scheduled for next year, EU's insistence that its aid is tied to an IMF agreement has been an obstacle to a deal with Ukraine in the past, 'forcing' Ukraine into the arms of the Russians.

- **China:** HSBC and official PMI data softened in the month of January. The decline was relatively modest and probably due to early Chinese New Year celebrations compared to last year. The lead-up to the Chinese New Year is usually associated with a slowdown in economic activity.

- **Mexico:** IHS Automotive, an auto-industry consultant, says that Mexico will overtake both Canada and Japan as the largest exporter of cars to the US by 2015. Mexican car exports to the US are expected to rise to 1.7 m this year, overtaking Japan (1.51m). Next year Mexican exports are expected to rise to 1.9m at which point Mexico will overtake Canada (1.87m) as the largest exporter of cars to the US.

- **Korea and Taiwan:** Both countries released strong economic data last week. Industrial production in Korea rose 3.4% mom, much higher than the 1.0% mom expected. Taiwan Q4 GDP growth was 2.9% yoy versus 1.7% yoy in Q3.

- **Brazil:** Unemployment dropped to the lowest ever rate of 4.3% of the labour force in December, down from 4.6% in November. Real wages are rising at a pace of 2.7% yoy. Brazil's central bank has raised policy rates north of 10%. Real GDP growth is running at around 2.0%. Inflation is just south of 6%.

Global backdrop

The single most commonly held consensus view going into 2014 was a bullish US outlook. Expectations of stronger growth and tapering from the Fed fuelled expectations of a strong Dollar. The strong US dollar view was further supported by the fact that the Dollar had lost 15% of its value against the EUR since June 2012; that Japan was shooting monetary and fiscal arrows; that the Eurozone would enter deflation; and that EM was going to implode.

One problem with this view is that all these alleged reasons to be bullish the Dollar were largely priced in by the end of 2013. The Fed had already announced tapering; US data had already performed strongly in Q4 2013; the US stock market had already rallied more than 25%; Japan's currency had already weakened 20%; and EM had already been beaten up.

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Global backdrop

This past week saw US durable goods, new homes sales, and pending home sales disappoint relative to expectations. Claims for unemployment also rose. University of Michigan consumer confidence declined relative to December albeit still at a high level. US Q4 GDP growth was confirmed at 3.2% in Q4, but the details raised questions about future growth. In particular, inventories increased again, consumption disappointed, investment in structures declined, and government spending dropped significantly. We also note that the US stock market has performed poorly so far this year, possibly because QE policies have begun to be scaled back (the FOMC reduced the pace of QE by USD 10bn to USD65bn per month). QE has undoubtedly boosted valuations in the US stock market over the last few years, in our view.

Meanwhile, in Europe there were signs of weakening retail sales and inflation dropped sharply to 0.7% in January versus 0.9% expected. On the other hand, German labour markets improved sharply and IFO, a measure of business confidence, also beat expectations.

In our view, the direction of the Dollar this year is far less clear than implied by the consensus. EURUSD has returned to 1.35, which is in the middle of the range of the past 6 years, and its direction from here is more likely to be determined by surprises to the consensus in the US and Europe rather than the consensus itself. The two currencies that stand out are JPY and EM FX as a group. Both have been pushed far from recent ranges.

The most notable development in Japan was that consumer price deflation returned in December, where prices fell 0.1%. This follows a period of about six months where consumer prices have risen sharply due to the temporary impact of strong fiscal and monetary stimulus from the government (but wages never rose to the same extent). We think the danger in Japan is that fiscal and monetary measures are largely temporary, while Japan's economic problems are mainly structural in nature. If the government fails to address structural problems with structural measures it is likely that deflation and bearishness eventually return. That in turn should gradually cause USDJPY to fall back towards 80.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE
T: +44 (0)20 3077 6000
@AshmoreEM
www.ashmoregroup.com

Beijing
T: +86 10 5764 2601

Bogota
T: +57 1 347 0649

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Sao Paulo
T: +55 11 3556 8900

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

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