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Ashmore

The RMB trade settlement effect

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RMB trade settlement is growing at a ferocious pace. As China moves towards a target of 50% RMB settlement of all its trade, this effect alone will turn China into a 'depletor' of reserves as early as 2017, regardless of what happens to its trade balance. This should concern the US, because it will begin to lose one of its largest clients for US treasuries. As US payrolls moved into line with other recent weak data, we review how the strong USD over the past three years impacted Emerging Markets (EM). The effect on investor sentiment was much greater than the effect on EM, which probably benefitted from weaker currencies. It seems that the US has been more adversely affected by the strong USD than EM, as indeed one would expect.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,005	–	3.18%
MSCI EM Small Cap	1,064	–	3.42%
MSCI FM	597	–	2.20%
GBI EM GD	6.25%	–	2.99%
EM FX spot	–	–	2.40%
ELMI+	4.20%	–	1.84%
EMBI GD	5.45%	352 bps	0.97%
EMBI GD IG	4.11%	212 bps	0.84%
EMBI GD HY	7.92%	612 bps	1.16%
CEMBI BD	5.33%	361 bps	0.60%
CEMBI BD HG	4.13%	240 bps	0.51%
CEMBI BD HY	7.71%	602 bps	0.78%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2081	-0.24%
VIX Index	14.74	1.59%
5 year UST	1.31%	-6 bps
7 year UST	1.66%	-5 bps
10 year UST	1.90%	-3 bps
US HY	6.55%	0.28%
European HY	4.54%	0.19%
EURUSD	1.0857	1.19%
USDJPY	119.88	-0.06%
Brent	57.87	1.58%
Copper	274.10	-4.05%
Gold	1208.20	2.01%

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

Emerging Markets

- **China:** Every year China exports about 25% of its GDP (about USD 2.4trn) and imports about 22% of GDP (USD 1.9trn). This makes China the world's greatest trading nation with a total annual trade volume equivalent to about 25% of US GDP. So far, however, China's currency, the Renminbi (RMB), has not been used nearly as prolifically as its products. But this is now changing rapidly. Last year the volume of trade settled in RMB doubled to 22%. Virtually no trade was settled in RMB as recently as 2009, according to data compiled by Morgan Stanley. China wants to settle 50% of its international trade in RMB by 2020 and this looks eminently feasible, in our view.

The implications of the RMB's rise as a trade settlement currency have yet to gain full recognition. One obvious implication is that China will increasingly engage in international trade without using foreign currency. Or to put it differently, the link between China's trade balance and its foreign exchange reserves is broken – in the same way that there is no relationship between the US trade balance and US FX reserves. Capital account liberalisation – which is progressing quickly – will further weaken the link between reserves and cross-border economic activity.

Suppose that China succeeds in settling 50% of its trade – imports and exports – in RMB by 2020. This implies that RMB settlement of export-related trade will advance more quickly in the coming years than settlement of imports in RMB (RMB settlement of imports is about twice as advanced as RMB export settlement). If China's trade with other countries grows at a constant rate from now to 2020, the result will be to turn China from a 'reserve accumulator' to a reserve 'depletor' by 2017, from the RMB trade settlement effect alone. The reason, of course, is that Chinese exporters are now paid in RMB instead of USD.

The effect will not operate in isolation. FX reserve valuation changes and portfolio flows will, of course, also matter to the level of reserves. Even so, it is clear that RMB trade settlement is already a major influence and it will only grow more prominent over time. China's trade surpluses will directly increase the volume of RMB in circulation inside China as exporters deposit their RMB proceeds in Chinese banks. This means that monetary policy must become more reliant on conventional monetary policies – such as interest rate management – rather than FX intervention. Indeed, that is why interest rate liberalisation and development of the bond market are progressing so quickly. In the US, China's transformation to a 'reserve depletor' will have adverse consequences for the Treasury market as well as providing direct competition from the RMB as a global reserve currency. China will obviously become a safer credit as it reduces its heavy exposure to US government bonds and to the USD itself.

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Emerging Markets

It is easy to see why the US so vehemently opposes China's aspirations to achieve global reserve currency status for RMB as early as December of this year. Ultimately, however, the US is fighting a losing battle. RMB trade settlement is a process that China can control unilaterally and bilaterally with its trading partners. China is opening up at a furious pace. Last week the China Insurance Regulatory Commission expanded the list of eligible countries and lowered ratings requirements for Chinese insurers wishing to invest abroad. At the same time, the State Council introduced a bank deposit insurance scheme, which will start on 1 May 2015. Deposit insurance will enable Chinese banks to set deposit rates freely without discouraging risk-averse savers from placing their money with them. This is a crucial step on the road to interest rate liberalisation.

- EM and the USD: The USD has recently been losing steam on the back of weaker data and valuations. Yet, the media is still full of fanciful stories about the alleged unravelling of EM on account of USD strength. It is an easy sell, because the notion of EM fragility appeals strongly to deep-seated prejudices about EM. But is it true? Leaving aside the fact that the stronger USD appears to have been quite bad for the US economy let us briefly review the evidence from EM. The USD is up 31% against EM currencies (including carry) since mid 2011, according to the JP Morgan EM spot FX index, so now seems a time to evaluate the impact.[1] Here are our observations:

1. EM asset prices, other than FX, have been adversely impacted, but not excessively. External debt is trading 80bps wider at 362bps, corporates 53bps wider at 357bps and local currency government bond yields, at 6.3%, are actually 58bps tighter than three years ago (at 6.3%). Sure, there has been plenty of volatility, in part because of premature reports about the demise of the asset class, but the fact that asset prices bounce back each time illustrates that fundamentals have largely been unaffected by these bouts of investor panic (otherwise asset prices would not have bounced back).
2. There is no evidence of systemic pass-through from weaker currencies to inflation in EM. Indeed, the Citibank inflation surprise index has fallen from +7.5 to -15.7 since 2011. IMF also predicts lower EM inflation going forward. Why? Credible inflation targeting central banks and much more diverse economies that can replace imports with domestically produced goods form parts of the answer.
3. The stronger USD has improved EM export competitiveness in most countries. Take the famous 'Fragile Five' EM countries, labelled thus by Morgan Stanley on account of their alleged vulnerabilities to outflows due to 'structural' external account problems.[2] In fact, four of the five countries have seen their external indicators improve, including their current account balances and their FX reserves. Only Brazil's situation has worsened, but for anyone following Brazil closely this is evidently due to entirely self-inflicted problems.
4. The stronger USD has created positive terms of trade shocks for 70% of EM countries due to falling commodity prices.[3]
5. The stronger USD has not exposed systematic FX mismatches on EM corporate balance sheets. To the contrary, after the 31% rally in the USD since 2011 the default rate for EM High Yield corporates actually more than halved from 2013 (3.7%) to end the year 2014 at just 1.8%. The long-term default rate for EM HY companies is 3.9%. EM corporates have not been as adversely affected by a stronger USD, because EM corporates are generally not managed recklessly. CEOs care about their companies, so they often hedge FX mismatches, whereas others have actually been able to reduce their FX mismatches by borrowing in USD, particularly if they have revenues in USD).
6. Retail investor outflows from local markets have not derailed EM economies. We estimate that as much as half of all US and European mutual fund money left EM local markets over the past two years. Did this destroy EM? Hardly. EM yields rose 200bps in just nine months in 2013, but the impact on growth was relatively modest at 0.5%. This resilience is due to the fact that foreign investors simply do not matter as much as they did before – as about 80% of local bonds are held by locals.
7. Each time a USD rally puts an EM country 'through the wringer' the countries usually take quick and decisive measures to address the vulnerability (unlike developed countries that just print money).

- Nigeria: Muhammadu Buhari won the Nigerian election and vanquished President Jonathan conceded defeat along with a statement urging his supporters to accept the result. As we outlined recently, Buhari must now complete the remaining macroeconomic adjustment that was neglected due to the election.[4] Even so, the election of Buhari is good news, in our view. During his previous stint at the helm, he reformed the economy and fought corruption. Buhari also appears to be pragmatic. In the 1980s when the path to power in Nigeria required the support of the military, Buhari used this avenue. Since the end of the Cold War, however, Buhari has contested several elections and lost but accepted the result. Now he has finally made it to the top by legitimate democratic means. As such, his experience echoes that of Africa as a whole.

[1] Three years is arguably enough to see the effect on both portfolio flows and EM's fundamentals.
[2] South Africa, Brazil, India, Indonesia and Turkey.
[3] See *"Falling commodity prices, rising terms of trade"*, Weekly Investor Research, 12 January 2015.
[4] See *"Nigeria: After the election"*, Market Commentary, March 2015.

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Emerging Markets

- **Brazil:** President Dilma Rousseff announced that Petrobras, the scandal-hit national oil company, will produce final audited accounts by the end of April. Business confidence continued to slide in March and the public finances remain poor (January's BRL 10.5bn surplus had turned into a BRL 7.4bn deficit by February). The reason for fiscal weakness is an inflexible structure of government payments, many of which are statutory. Inflexibility in the spending program is now forcing the government to cut capital spending in a downturn, thus making it even harder to return to positive growth and limiting the upside once the cycle turns.

- **India:** The Reserve Bank of India (RBI) left rates unchanged at 7.5%. The RBI noted that the transmission mechanism from policy rates (cuts) to lending rates has not taken place at the speed it hoped. Hence, the bias is for further cuts, in our view. We also believe that the government could dramatically improve the transmission mechanism by allowing foreign investors into India's bond market. This would have the additional advantage that the average interest rate in India would fall, because inflows from investors would support the currency and therefore allow the RBI to achieve a lower average policy rate, assuming that the solid overall policy framework and focus on supply-side reforms continues.

Snippets:

- **Russia:** Headline inflation appears to be stabilising around 17%. The March print was 16.9% yoy compared to 16.7% in February. The slowdown in the pace of acceleration – which was triggered by Russia's dramatic RUB devaluation between June 2014 and February 2015 – should allow the central bank to gradually reduce interest rates. USDRUB has declined from 70 to 55 since early February.

- **The Philippines:** March inflation was 2.4% yoy compared to 2.6% yoy expected. The Philippines has been able to sustain strong growth for several years without inflation, which reflects a credible central bank and continuous efforts by the government to ease supply-side constraints.

- **Ecuador:** The government has settled with a major holdout investor from the 2008/2009 default. At the time most of the bonds were bought back by the government at very low prices after the government pre-emptively announced that it would no longer service them. Holdout investors failed to prevent Ecuador from coming to market subsequently.

- **Thailand:** Inflation in March was flat and down 0.6% yoy. Core inflation declined 0.1% on the month to take the yoy rate to 1.3% from 1.4% in February. Core inflation has averaged about 1.5% over the last three years.

- **South Korea:** Industrial production was 4.7% lower in February than in the year before.

Global backdrop

The weak payroll number in the US was obviously the most important event of the past week as far as global sentiment is concerned. It is easy to make a meal out of the weak number, but it is merely the latest of a number of weaker indicators that point to sluggish growth in the US that began in late 2014 and has continued into 2015. Our view is that this is actually not a dramatic change from the past. The average real GDP growth rate for the US economy from 2011-2014 has been 2.1%. This is a remarkably low level of growth, taking into account the depth of the collapse in 2008/2009 plus the extraordinary level of fiscal and especially monetary stimulus over the entire period. The much touted and annually recurring prediction of Q1 'exit velocity' has once again failed to materialise. The question investors should ask themselves is this: Why is there no dynamism in the US economy? What variables are the ever-bullish forecasters repeatedly failing to acknowledge? Our view is that debt plays a big part in this story. A pre-occupation with asset price inflation rather than fixing underlying structural economic problems is another part. Meanwhile, over in Europe things aren't that hot either, although the economy is experiencing a cyclical bounce. Greece and its Eurozone neighbours have still not reached agreement on an acceptable list of reforms so, with major repayments on Greek debt due almost immediately after the Easter vacation, the market will pay attention to this matter. US ISM weakened, but the factory orders and a smaller than expected trade deficit due to weak imports should provide a boost to GDP in what is turning out to be a much weaker Q1 than any analyst had predicted (notice a pattern here? Q1 growth disappointments are becoming a regular event). European PMIs were stronger than expected. Unemployment declined 0.1%, but remains extremely high at 11.3%.

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Market data	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.24%	5.54%	3.16%	1.87%	2.16%
MSCI EM Small Cap	3.41%	7.13%	3.05%	5.24%	3.24%
MSCI FM	2.95%	-0.71%	-3.26%	11.82%	4.93%
S&P 500	0.63%	1.59%	13.84%	16.60%	14.20%
GBI EM GD	2.99%	-1.09%	-8.79%	-2.77%	1.19%
ELMI+	1.84%	-0.61%	-8.12%	-2.60%	-0.85%
EM spot FX	2.40%	-4.08%	-16.59%	NA	NA
EMBI GD	0.97%	3.01%	6.09%	5.70%	7.26%
EMBI GD IG	0.84%	3.46%	9.15%	5.24%	6.82%
EMBI GD HY	1.16%	2.14%	0.71%	6.46%	7.91%
5 year UST	0.10%	1.97%	4.53%	1.78%	3.87%
7 year UST	0.15%	2.54%	7.60%	2.77%	5.78%
10 year UST	0.19%	3.00%	11.04%	4.58%	7.68%
CEMBI BD	0.60%	2.97%	4.86%	5.56%	6.31%
CEMBI BD HG	0.51%	2.90%	6.80%	5.80%	6.60%
CEMBI BD HY	0.78%	3.09%	0.87%	5.29%	5.85%
US HY	0.28%	2.70%	1.37%	7.59%	8.94%
European HY	0.19%	3.61%	5.39%	12.54%	11.28%
Barclays Agg	0.68%	-1.26%	-2.88%	0.17%	2.58%

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

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