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Ashmore

More money illusion on display

By Jan Dehn

The ECB eased monetary policy due to fears of the effects of US monetary policy normalisation and general economic weakness at home. When this causes markets to rally they are displaying a kind of money illusion, which is likely to continue until the costs manifest themselves. Before discussing the latest easing in developed economies we offer our interpretation of Rafael Ramirez's demise in Venezuela and review the latest changes in the Russia-Ukraine situation. We touch on the Argentine debt saga, Mexico's manufacturing cycle, Brazil's latest polls and Hungarian growth.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,099	–	0.87%
MSCI EM Small Cap	1,124	–	0.83%
MSCI FM	700	–	0.70%
GBI EM GD	6.48%	–	-0.01%
ELMI+	2.99%	–	-0.23%
EMBI GD	5.11%	262 bps	-0.05%
EMBI GD IG	4.28%	175 bps	-0.17%
EMBI GD HY	6.96%	466 bps	0.17%
CEMBI BD	5.08%	284 bps	0.05%
CEMBI BD HG	4.24%	198 bps	-0.03%
CEMBI BD HY	6.92%	473 bps	0.22%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2008	0.26%
VIX Index	12.09	0.92%
5 year UST	1.67%	5 bps
10 year UST	2.44%	9 bps
US HY	5.63%	-0.18%
European HY	4.71%	-0.39%
EURUSD	1.2946	-1.43%
USDJPY	105.19	0.87%
Brent	99.14	-2.20%
Copper	322.93	-0.39%
Gold	1264.86	-1.76%

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

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- **Venezuela:** In a noteworthy demonstration of political power Venezuelan President, Nicolas Maduro, last week removed Rafael Ramirez from the position of Head of Venezuela's state oil company, PDVSA, and minister in overall charge of economic policy. Ramirez was for many years the single most powerful political operator in Venezuela, second only to Maduro himself and, before Maduro, former president Hugo Chavez. Ramirez's demotion was brutal – he was relegated from a position where he controlled the oil sector and exchange rates and hence the life-blood of Venezuela's official and parallel economy into the lowly job of foreign minister, which in Venezuela basically means peddling mindless political rhetoric on the foreign stage, especially during times when conditions at home deteriorate so badly that political distractions abroad become convenient. In a classic 'better the devil you know' moment, the market greeted the news of Ramirez's demise as a negative development. This is because Ramirez was widely perceived as a reasonable pragmatist, although in our view the negative market reaction says far more about the paucity of good Venezuelan policy-makers than about the quality of Ramirez himself who was, after all, able to deliver next to nothing in terms of actual economic policy improvements. Ramirez's replacements at PDVSA and in overall charge of the economy are political appointees from the military with strong ties to Maduro. In other words this reshuffle was largely an exercise in political consolidation rather than anything to do with the economy. For those that wish to discover a silver-lining in the reshuffle we might point out that a politically stronger Maduro would in theory be better placed to undertake pragmatic changes in economic policy, though it is by no means clear that this particular leopard has changed its spots.
- **Russia:** Pro-Russian separatist rebels and the Ukraine government entered a temporary cease-fire, but whether this holds largely depends on buy-in from both Russia and the West. So far the odds of a permanent cease-fire look poor. Europe has decided to go ahead with fresh sanctions on Russian state-owned banks and defence companies. The lack of support from the West increases the incentives for one or both of the warring parties to exploit tactical opportunities to better their positions on the ground. Over the weekend there were already indications that the cease-fire had been broken in places. Statements from Western leaders that sanctions could be unwound if there is progress on the ground may not be sufficient. Details of the new sanctions are to be unveiled this week, according to officials. We expect a broadening of sanctions to new individuals and companies rather than a deepening of sanctions to already sanctioned names. Russia has also hinted that it would retaliate in the event of new Western sanctions. Its response could include renewed support for rebels in

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Eastern Ukraine and further bans on access to Russian markets for Western goods and services. If yet another chance for peace goes begging the economic pain in both Europe and Russia will only increase. Markets are already paying less attention to this conflict as it becomes increasingly apparent that it has no major impact on third parties, though this could change in the event of a major re-escalation. We expect a peaceful resolution to this conflict, but a resolution looks set only to materialise once the mindless diplomatic and proxy military tit-for-tat retaliations have inflicted sufficient misery, loss of life, and economic pain on both sides to focus the minds of politicians on a solution.

Meanwhile, one of the predicted economic consequences of the conflict for Russia is inflation. Russian inflation did indeed push higher in August, though not beyond what was already expected. Core inflation in August was 8%, bang in line with consensus and up from 7.8% in July. Meat and fish prices rose most strongly, but agricultural goods prices declined due to prospects of a good Russian harvest this year. The ban on food imports into Russia from the West is likely to continue to put upwards pressure on prices, but a solid Russian harvest could significantly ameliorate the effects. A loss of control of inflation is very unlikely, in our view. The Central Bank of Russia has not been afraid to hike rates, and may do so again, while the economy is not showing strong upwards cyclical momentum. The central bank's rate setting meeting is this coming Friday.

- Argentina: In Argentina, the Senate approved a law to replace Bank of New York as payment agent and to offer holders of exchange bonds to swap their securities into local law bonds. In a sign of the fickle nature of Argentine politics, opposition leader Sergio Massa, who previously opposed a swap of exchange bonds to local law bonds now supports the swap on the proviso that payments can be made in Uruguay or France. This is an innovation, which may offer Argentina a way to increase participation. The law approved by the Senate would allow settlement of exchange bonds in a jurisdiction governed by French Law, but final details are still unclear. They may not be known until the Lower House has passed the final version of the bill (possibly this week).

For further details about the challenges of implementing a swap in practice see *'The road less travelled'*, Ashmore's Weekly Investor Research, 26 August 2014 – click here.

Meanwhile, press reports indicated last week that China has affirmed its commitment to lending Argentina USD 2bn towards infrastructure despite doubts arising from the July default. Local newspaper La Nacion also reports that Argentina and China have cleared the way for a first payment under a USD 11bn swap agreement with China's central bank. Argentina's economy continues to bleed, however, as the government continues to tackle the symptoms rather than causes of its predicament. Thus, last week the government tightened capital controls further by requiring Argentine banks to cap their foreign currency holdings at 20% of liquid assets, down from 30% previously. Just a few months ago the cap was 70%. This latest tightening move has forced banks to sell approximately USD 1.3 - 1.7bn to the central bank, which has about USD 28.5bn of FX reserves, but clearly such measures cannot be repeated indefinitely. Finally, we note that holders of bonds and writers of CDS contracts that were triggered by the late July default settled at a price of 39.5 in an auction last week. Substantial volumes of very cheap-to-deliver JPY denominated Par bonds were submitted, pushing the final settlement price lower than the market had expected. We note however that the low settlement price is largely a consequence of technical factors rather than a meaningful indication of the recovery value on the currently defaulted securities, in our view.

- Mexico: Cyclical indicators in Mexico began to show signs of a life again after a three months hiatus. Purchasing manager's indices and producer confidence rose in August. Over the past two years, Mexico has undertaken important reforms that should enable the economy to expand more rapidly without creating inflation, but the cyclical recovery itself has been hampered by softer US growth in Q1, uncertainty about the timing of the passage of important secondary legislation to support reforms, a housing downturn and slow execution of investment projects by the government (all temporary drags).

- Brazil: In Brazil, the COPOM – the committee that sets interest rates at the central bank – decided to leave rates unchanged at 11% last week, although the committee's bias changed from hawkish to neutral. The central bank has raised rates significantly over the past two years, but inflation has remained sticky, while the economy has gone into recession. The uncomfortable combination of recession and sticky inflation is however secondary to the much more exciting developments on the political front. As Brazil heads inexorably toward elections next month the early momentum of opposition presidential candidate Marina Silva has shown signs of waning. An IBOPE poll published last week showed that President Dilma Rousseff is now once again leading in the first round, though the poll still predicts that Marina will win the second round. Specifically, the poll predicted a 7% Marina win margin compared to 10% in a similar poll last week. Nevertheless, Marina's campaign could now receive a boost from Dilma's own camp. A fresh political scandal has hit Brazil in the past few days. Paulo Roberto da Costa, a former (now imprisoned) director at Petrobras, the state owned oil company, has named a long list of government officials – people close to President Dilma Rousseff and former President Lula – that allegedly were embroiled in corrupt activities. So far, the mud has not stuck to Marina in spite of the fact that her former running mate, Governor Eduardo Campos, was one of the names mentioned by Mr Costa in his plea bargain.

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- **Hungary:** Hungary's economy grew substantially faster in Q2 than expected. The economy clocked up 3.9% yoy real GDP growth with investment being the main driving force, up a whopping 18.7% yoy and 4.5% on the last quarter. The surge in investment happened in spite of softer government spending and still sluggish demand from households burdened by mortgage debt (although over the next twelve months various measures by the government will shift a significant part of this burden back to the banks that issued the mortgages). Hungary also showed few signs of suffering from European sluggishness as exports held up well.

Other developments:

- **South Africa:** After a seemingly endless stream of poor economic data, South Africa last week recorded a big bounce in its manufacturing PMI numbers as the August PMI rose from 46.4 in July to 51.1 in August.
- **Qatar:** Qatar National Bank is buying a 12.5% stake in Ecobank, a pan-African bank with a large presence across the African continent.
- **Turkey:** Turkish core inflation was unchanged at 9.7%, while headline inflation ticked higher to reach 9.5% in August. The economy has softened in response to rate hikes at the start of this year, but given the unashamedly dovish central bank's proclivity to cut rates at the slightest provocation it may prove tough to break expectations of generally high inflation. The central bank in turn is constrained by the political agenda defined by President Erdogan.
- **China:** China's services PMI rose to a seven-month high of 54.1 in August. Also, China racked up a much stronger than expected trade surplus of USD 50bn in August versus USD 40bn expected. This was due to both higher than expected exports and lower than anticipated imports. We do not think the data should be seen as signs of some impending significant acceleration of the Chinese economy. After all, the government is undertaking many reforms and liberalising interest rates. These are good policies, but they will depress growth for some time.
- **Saudi Arabia:** Saudi Arabia's PMI hit the highest level in three years last week – 61 (50 usually denotes the difference between an expanding and a contracting economy though manufacturing sector often fails to mirror the broader economy). Output, exports and new orders performed strongly. Saudi Arabia is preparing to open its domestic equity market to foreign investors, a process that is likely to be accompanied by IPOs and other exciting market events.

Global backdrop

The economic backdrop in developed economies worsened last week as the ECB was forced into further easing on account of poor credit market conditions and fears of rising interest rates, while the US labour markets were softer than expected. Ironically, these very same weak conditions caused financial markets to improve. Clearly, money printing by central banks in response to rotten underlying economic conditions drives up real asset prices - probably more than actual good economic data would - or would a normalisation of monetary policies. This is a type of money illusion, neither healthy nor sustainable. But policies are unlikely to change until the true costs of money illusion – inflation in all its manifestations including currency realignments – make themselves felt. After all, it is the world's largest central banks that are the main sponsors of money illusion.

As for the ECB's decision to cut interest rates, the 10bps cut was largely an economically meaningless measure undertaken in part because of difficulties in pursuing alternative policies. A more important element in the ECB's strategy was the announcement that substantial asset backed loans will be extended by the ECB to the non-financial private sector starting in October. This is the ECB's band-aid for the ulcer that is the dysfunctional credits markets in Europe. The European banking system is insolvent, a fact that poses all kinds of challenges going forward. For example, with inadequate financial intermediation it will be difficult for Europe to produce enough growth and inflation to soften the blow of higher US interest rates as the Fed commences rate tightening next year. The broader economic backdrop also weighed on the ECB. Europe's recovery from the debt crisis in 2011-2012 has been extremely tepid with recent signs of weakness, including soft PMIs and negative Q2 German growth. Sadly, there is no guarantee that ECB's measures will actually solve Europe's growth problem. After all, even if corporates get access to cheap and plentiful financing from the ECB is it not certain that they would choose to make productive investments in the real economy. They might simply hoard the funds, anticipating deflation. Europe's debt problem is also formidable, which will place a dampener on any cyclical response in the broader economy. A more intelligent strategy would involve a permanent fix for European banks, but this requires political will, leadership, and boldness neither of which is in great supply. So far, the ECB does not deem the deflation risk in Europe to be significant enough to warrant purchases of government bonds. In other European developments, new polls showed that the number of voters in favour of Scottish independence has overtaken those in favour of maintaining the union with the rest of Great Britain.

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Global backdrop

This is the first time the polls have shown a majority in favour of Scottish independence and offers an intriguing prospect for the world's markets to flog the Great British Pound for a while. Finally, we note that among the higher frequency data German industrial production, factory orders, and manufacturing all picked up more strongly than expected in July after a soft patch in Q2.

In the US, non-farm payrolls rose by only 142K, which was significantly weaker than expected. This followed a small miss in ADP's private sector payroll data issued prior the release of the main payroll print. The market dismissed the print as the product of August labour market noise, though the US labour market data has become somewhat softer since peaking in May of this year. The manufacturing cycle, however, appears to be going strong in the US. Auto sales rose to their highest level in eight years and the ISM number for August printed 59 versus 57 expected. We warn, however, that every single swing in the manufacturing cycle since 2008/2009 has failed to accurately forecast 'exit velocity'. We think the economy's households will continue to hold back on spending due to labour market slack, negative home equity and household debt to income ratios above 100%. Within a couple of years, however, these constraints will have eased sufficiently that inflation can resurface to help speed up the debt reduction process.

Japan's Q2 growth rate was revised lower to -7.1% qoq annualised rate from -6.8% initially reported. The collapse in demand triggered by the consumption tax increase illustrates just how difficult it will be for Japan – and other heavily indebted economies – to solve their debt problems by fiscal means. Growth rates are likely to improve going forward, but a large build-up in inventories in Q2 suggests that the recovery will be gradual. Imports slowed for obvious reasons, helping the current account to once again return to surplus after a deficit earlier in the year. Unsurprisingly, therefore, the Bank of Japan maintained its current policy of increasing the monetary base by JPY 60-70trn per year. Sadly, this policy does very little to fix Japan's deeper structural problems. Even so, the JPY has been able to weaken towards the edge of the recent ranges against the US Dollar on account of a sharp rise in Japan's workers' cash earnings in July (up 2.6% versus 0.9% expected). This increase in earnings was not due to some miraculous change in inflation expectations; rather it was due to the special summer bonuses paid at this time of year (and not far from expectations in terms of size).

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.1%	11.7%	19.0%	6.5%	8.1%
MSCI EM Small Cap	1.1%	13.4%	20.4%	6.6%	9.5%
MSCI FM	0.5%	21.6%	36.7%	16.1%	9.3%
S&P 500	0.26%	10.15%	23.83%	22.12%	16.99%
GBI EM GD	-0.13%	5.24%	9.03%	0.91%	6.12%
ELMI+	-0.25%	1.09%	3.27%	-0.61%	1.85%
EMBI GD	-0.05%	9.96%	15.29%	6.92%	9.30%
EMBI GD IG	-0.17%	10.01%	14.73%	5.43%	7.93%
EMBI GD HY	0.17%	9.94%	16.50%	9.50%	11.41%
5 year UST	-0.25%	2.27%	3.71%	0.82%	3.45%
7 year UST	-0.56%	4.75%	6.07%	1.40%	4.95%
10 year UST	-0.97%	8.33%	9.27%	2.46%	5.80%
CEMBI BD	0.05%	7.22%	11.78%	6.44%	8.26%
CEMBI BD HG	-0.03%	7.61%	11.88%	6.05%	7.60%
CEMBI BD HY	0.22%	6.36%	11.57%	7.59%	10.32%
US HY	-0.18%	5.79%	10.71%	10.88%	12.74%
European HY	-0.39%	5.98%	11.94%	15.65%	14.80%
Barclays Agg	-1.02%	3.49%	6.45%	1.02%	3.54%

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

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