Issued: 9 February 2015

Global imbalances alive and well

By Jan Dehn

China racks up another record trade surplus – this time USD 60bn – just weeks after the US recorded a trade deficit of USD 47bn. Why the imbalance? Because the US has replaced decades of debt-fuelled stimulus with years of hyper-easing by the Fed. This is keeping spending going, but it is against the backdrop of low productivity and still enormous debt burdens that will make it hard to materially tighten policies. By contrast, China's demand for imports is waning because the country is engaging so seriously in reforms. The continued accumulation of trade imbalances is unsustainable and will end in the time-honoured fashion – with inflation and currency realignments. We discuss the Petrobras scandal in Brazil, Ukraine's devaluation, India's macro numbers and the new diplomatic push in Eastern Ukraine. We end by putting the latest US employment numbers into context.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	970	–	0.69%
MSCI EM Small Cap	1,003	–	-0.40%
MSCI FM	590	–	-0.08%
GBI EM GD	6.04%	–	-0.51%
EM FX spot	–	–	0.14%
ELMI+	4.54%	–	0.56%
EMBI GD	5.57%	361 bps	0.01%
EMBI GD IG	4.31%	231 bps	-0.57%
EMBI GD HY	8.35%	648 bps	1.10%
CEMBI BD	5.45%	363 bps	0.36%
CEMBI BD HG	4.29%	246 bps	0.05%
CEMBI BD HY	8.13%	632 bps	1.06%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2055	1.80%
VIX Index	17.29	-11.01%
5 year UST	1.44%	26 bps
7 year UST	1.74%	25 bps
10 year UST	1.90%	24 bps
US HY	6.74%	0.96%
European HY	4.97%	0.45%
EURUSD	1.1301	-0.28%
USDJPY	118.55	1.05%
Brent	57.45	7.01%
Gold	1238.95	-3.14%

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

Emerging Markets

- **China:** China's January trade surplus of USD 60bn was the largest on record and occurred despite weaker than expected exports. The main driver of the strong trade balance number was therefore weaker imports. The recent decline in oil prices was an important contributor and Chinese New Year effects may also be playing a part, but interest rate liberalisation and the rapid pace of other structural reforms are almost certainly the most important reasons for the softer import number. Experience from other countries engaged in serious structural reforms point to a phenomenon that economists call 'crossing the desert' – a phase of slower domestic demand during the reforms, which then give way to stronger growth after the adjustment (stronger than would have been possible without the reforms).

  China has the means to support the economy during the adjustment – the PBOC's decision to cut reserve requirements for financial sector institutions by 50bps last week is an example of this capacity for support. Technically, of course, the larger than expected trade surplus should also result in a stronger than expected real GDP growth number as lower imports drive net exports higher.

  It is important to place the Chinese trade surplus in a global context. The Chinese trade surplus contrasts with a US trade deficit of USD 47bn in December. Clearly, the global imbalances remain intact. The US ultimately needs to reduce demand to bring it more closely into line with its lower level of productivity and higher debt burdens, but is instead continuing to stimulate demand with extremely easy monetary policies, while not undertaking any productivity enhancing reforms. On the other hand, China with its already large FX reserves continues to build external surpluses. The global imbalances are unsustainable. In the absence of serious supply-side reforms, the US will ultimately end up with an inflation problem due to the constant stimulus of aggregate demand, which is of course why China is reforming so much – China knows that in just a few years it will have to find a way to grow with a much stronger currency as the Dollar is debased by inflation. In the meantime, we believe that investors can profit from China's reform-induced slowdown and declining inflation pressures by investing in Chinese government bonds.

Continued overleaf

Emerging Markets

China's breathtaking pace of reform will put the country in a strong position to grow in the future while countries that are not reforming with such determination – or not at all as is the case in most developed economies – will struggle.

Talking of reforms, the Chinese government announced proposals to further decentralise spending decisions from central to local governments. This reform will not only increase the quality of fiscal spending, but also help to raise consumption levels in China. The reform re-defines the specific roles of central and local governments by giving local governments more room to allocate spending in accordance with their own priorities and increases overall the level of spending that local governments can exclusively manage to 60% of total central government transfers. This is likely to be accompanied by another reform to increase auditing of local government spending. Experience from many other countries shows that priorities for spending at local and national level often differ substantially and often results in misallocation of resources relative to intended budget destinations and moral hazard issues.[1] Under the new framework, local government administrations will have greater flexibility to establish pension and medical healthcare provision. This is particularly critical to raising consumption levels in China.

- Brazil: The Brazilian government appointed Aldemir Bendine, former CEO of state-run Banco do Brasil, to run Petrobras, the scandal-hit, state-run oil giant. This follows the downgrade of the company to BBB- with negative outlook by Fitch. Bendine's appointment was a disappointment to the market, because many had hoped for a proper reformer at Petrobras instead of a political appointee and Dilma's 'Yes Man'. Yet, a more careful analysis of the political situation in Brazil should have led investors to suspect this. After all, the importance of the Petrobras scandal extends far beyond Petrobras itself. It has the potential not just to threaten Dilma's presidency, but also to push Brazil from being a 'troubled' country into outright crisis. For example, if the scandal gets so big that opposition parties in Brazil sense a premature change of government is even a remote possibility they will likely turn to full frontal attack mode alongside the media and the courts. This would almost certainly force Dilma to abandon the on-going fiscal adjustment under Finance Minister Joaquim Levy in favour of full-on populism. To prevent this from happening, Dilma needs to calm the waters and buy time for the fiscal adjustment and subsequent economic recovery to take hold, which could easily take a year or two. Bendine's appointment will help, but can Dilma really hope to control events at Petrobras for that long? Bendine's appointment will anger those who want to see real change at Petrobras and will almost certainly lead to increased press scrutiny of Bendine himself. Perhaps the biggest gamble that Dilma is making in appointing Bendine is that the 'cancer' of corruption at Petrobras has not already metastasized to other parts of the Brazilian state apparatus. Inflation in January rose to 7.1% as a result of realignments of prices that were misaligned under former Finance Minister, Guido Mantega.

- Russia-Ukraine: A major diplomatic push involving the leaders of Germany, France and Russia to find a peaceful resolution to the war in Eastern Ukraine is now underway. This follows heavy escalation of fighting on the ground in Eastern Ukraine in recent weeks as both sides sought to gain better bargaining positions at the current talks. A sustainable solution will require agreement principally between the EU and Russia. As such, it is a positive that Germany and France led this latest round of talks. Unlike Europe, the US has little downside risk from a further escalation of the conflict and may even gain from a deeper conflict through weapons sales. Ukraine needs both money and weapons and its hope is to extract as much benefit from the West as possible, if necessary by dividing the Europeans and the Americans, although without losing the support of either. Meanwhile, there are signs that financial stress in Russia is easing. Money market rates and cash in circulation returned to normal ranges in January.

- Ukraine: The central bank abandoned its support for the Hryvnia (UAH) and raised interest rates by 5.5% to 19.5%. USDUAH rose from 16.7 to 25.3. The devaluation will go a long way towards making the economic program in Ukraine more sustainable, but only if the devaluation is accompanied by fiscal measures to reduce domestic demand. The IMF program is now more likely to happen, although the much weaker UAH will now also push the country's debt-to-GDP ratio higher and may require additional support for the banks.

- India: The Reserve Bank of India (RBI) left policy rates unchanged, but eased reserve requirements by 50bps to 21.5% of deposits. The RBI is likely awaiting news on the budget as well as the next CPI and GDP figures before taking its next decision. Indian growth has picked up and inflation has declined, but the key variable for the RBI should be the fiscal stance, in our view. Modi's administration looks set to have suffered its first major political defeat in the local government elections in New Delhi.

[1] See for example *"Survey tools for assessing performance in service delivery"* by Jan Dehn, Ritva Reinikka and Jakob Svensson in Francois Bourguignon and Luiz A. Pereira da Silva (eds.) (2003). *The Impact of Economic Policies on Poverty and Income Distribution: Evaluation Techniques and Tools.* World Bank and Oxford University Press.

Continued overleaf

Global backdrop

Labour market data released last week shows that the US economy continues to absorb labour, but that workers are not able to command higher wages because their productivity is low. This points to a low quality recovery. With investment rates depressed by historical standards, the pace of innovation in the US economy is sluggish. In short, the economy is being pushed by extremely stimulatory monetary policies towards full employment and ultimately inflation, probably towards the tail end of 2016. The prospect of inflation returning long before the economy has deleveraged and productivity has improved to help lift the trend growth rate will place the Fed in a major dilemma – whether to fight inflation at a large cost to an unproductive, over-indebted economy, or to live with higher inflation in order to protect meagre growth. We think the Fed will err on the side of dovishness to protect growth. This does not preclude the Fed from hiking later this year – indeed we expect the Fed to do so. It wants to get away from the zero level for Fed funds to mark progress on a long road to eventual recovery, not squeeze the real economy. The payroll print shifts the odds of the first hike from September to June, but one thing to monitor carefully is the participation rate, which picked up 0.2% in January. The participation rate stopped falling in April 2014 and, if it is now turning higher, it will take considerably longer than anticipated to achieve full employment. Indeed, the rate of unemployment rose from 5.6% to 5.7% last week precisely because of higher labour force participation.

The ECB suspended Greek governments bonds as acceptable collateral for ECB refinancing purposes, but extended a lending program to Greek banks in order to prevent an imminent financial collapse of the Greek economy. The ECB's announcement followed the Greek government's decision not to extend the Troika adjustment program. Greece is insolvent and is being kept alive on ECB 'life-support'.

Oil prices rose again this week and are now marginally up year to date, buoyed by further capex cuts, a small decline in OPEC output and another 7% fall in the US rig count. Lower prices are likely to spur an increase in demand for hydrocarbon-based energy and reduce supply after an initial increase in output as firms attempt to offset lower prices with higher output. We expect oil prices to push higher this year, but not in a straight line. Important seasonal effects, such as the spring refinery maintenance cycle can temporarily weaken demand for crude.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.8%	2.4%	8.2%	0.6%	4.6%
MSCI EM Small Cap	0.3%	1.7%	5.7%	3.7%	5.2%
MSCI FM	1.0%	-3.1%	2.0%	11.8%	7.2%
S&P 500	3.12%	0.02%	18.28%	17.68%	16.44%
GBI EM GD	-0.02%	0.32%	-2.88%	-2.67%	2.88%
ELMI+	0.79%	-2.01%	-7.73%	-3.10%	-0.47%
EM spot FX	0.61%	-2.41%	-12.89%	NA	NA
EMBI GD	0.28%	1.21%	8.53%	5.74%	7.87%
EMBI GD IG	-0.25%	1.54%	10.23%	5.18%	7.24%
EMBI GD HY	1.28%	0.62%	5.73%	6.63%	8.77%
5 year UST	-1.50%	0.95%	3.01%	1.08%	3.38%
7 year UST	-2.02%	1.50%	6.20%	1.99%	5.22%
10 year UST	-2.52%	2.16%	11.08%	3.66%	6.93%
CEMBI BD	0.43%	1.12%	5.43%	5.63%	6.63%
CEMBI BD HG	0.14%	1.60%	7.74%	5.93%	6.84%
CEMBI BD HY	1.08%	0.05%	0.67%	5.28%	6.43%
US HY	0.96%	1.41%	2.70%	7.73%	9.49%
European HY	0.41%	1.57%	6.48%	13.04%	11.93%
Barclays Agg	-0.61%	-0.76%	-1.47%	-0.05%	2.45%

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

Continued overleaf

Ashmore

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

Saudi Arabia
T: +966 11 486 8470

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

Other locations
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2015.

Important information: This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised and regulated by the Financial Conduct Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. Past performance is not a reliable indicator of future results. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment.