Issued: 1 June 2015

WEEKLY INVESTOR RESEARCH

Ashmore

The approaching dearth of Reserve Currencies

By Jan Dehn

In the not-so-distant future the world's central bankers will have to find alternative global reserve currencies to replace the developed world incumbents. China has seen the light, but other Emerging Markets countries are still to fully grasp the risks and opportunities associated with the demise of the global reserve currencies in the years ahead. In other news, the EBRD takes a 10% stake in the Istanbul Stock Exchange, A-shares make their way into the FTSE Emerging Markets stock index and Brazil's senate passes reforms. US GDP is revised down sharply amidst mixed higher frequency data and continuing concerns about Greece.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	14.4	–	-3.18%
MSCI EM Small Cap	23.1	–	-0.80%
MSCI Frontier	11.1	–	-1.06%
MSCI Asia	12.8	–	-2.26%
MSCI EMEA	13.2	–	-5.87%
MSCI Latam	22.9	–	-4.41%
GBI-EM-GD	6.58%	–	-1.98%
ELMI+	4.38%	–	-1.47%
EM FX spot	–	–	-1.83%
EMBI GD	5.51%	338 bps	-0.31%
EMBI GD IG	4.29%	210 bps	-0.24%
EMBI GD HY	7.68%	570 bps	-0.41%
CEMBI BD	5.24%	334 bps	-0.10%
CEMBI BD HG	4.18%	228 bps	0.00%
CEMBI BD HY	7.24%	535 bps	-0.27%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.6	–	-1.06%
2 year UST	0.62%	–	0.14%
5 year UST	1.49%	–	0.53%
7 year UST	1.87%	–	0.81%
10 year UST	2.13%	–	2.20%
US HY	6.41%	515	0.10%
European HY	4.15%	419	0.09%
Barclays Ag	–	444	-0.21%
VIX Index*	13.84	–	1.73%
DXY Index*	97.36	–	1.34%
CRY Index*	223.18	–	-5.06%
EURUSD	1.0906	–	-0.72%
USDJPY	124.07	–	-2.07%
Brent	64.7	–	-1.30%
Gold spot	1186	–	-1.75%

*See last page for index definitions.

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

Emerging Markets

More than 95% of global foreign exchange reserves are today held in the currencies of the US, the Eurozone, UK and Japan. Central banks in these countries have each been tasked with fixing problems that go far beyond what central banks ordinarily do, including raising trend growth rates, reversing unsustainable debt burdens in the public and private sectors and making up for lack of structural reforms in increasingly sclerotic economies. To their credit, they have acted boldly by pushing interest rates to zero and engaging in the unprecedented printing money sprees we call Quantitative Easing (QE). But it is obvious that they will only be able to meet some of the objectives they have been set. At best, they will succeed in converting their debt problems into inflation problems. But when they do so, the world is likely to wake up to a new and difficult problem – how to find new, healthy currencies to replace the current global reserve currencies.

In private conversation, most Emerging Markets (EM) central bankers will admit that they are extremely worried about the threat posed to their foreign reserve holdings by the easing policies of the reserve currency countries and their governments' failures to deal with deeper economic problems. The fears are justified. EM central banks hold nearly 80% of the world's FX reserves and the vast majority is invested in reserve currencies. Technocrats in EM central banks are well aware that once inflation and currency debasement really take hold in the global reserve currencies, the purchasing power of EM central bank reserves will be decimated. This, of course, is exactly what the US, Eurozone, UK and Japan want. By debasing their currencies they are in effect passing the cost of adjustment to foreigners instead of inflicting politically costly austerity on voters at home.

Sadly, EM's central bankers have been unsuccessful in convincing their political leaders of the dangers ahead and the need to diversify before it is too late. What is perhaps even more remarkable is that EM policy makers appear to have completely failed to grasp the opportunity that lies before them; namely that their own currencies can become part of a brand new breed of global reserve currencies that will be sorely needed in just a few years' time.

Emerging Markets

The benefits of becoming a global reserve currency should not be under-estimated. For one, a country that achieves global reserve currency status will no longer need as many central bank reserves. For EM central banks this means that a large chunk of reserves can be re-designated as 'windfall' to be invested in return-generating activities rather than sitting dangerously and unproductively exposed in loss-generating reserve currency country bonds. Countries with global reserve currencies can also consume more, because they no longer need to repress domestic demand in order to accumulate reserves. And above all, once a currency has become a global reserve currency it will be 'sponsored' by a stable investor base consisting of central bankers that now consider the currency risk free.

So far, only China appears to have understood both the risks and opportunities facing EM central banks today. China is moving quickly to make the Renminbi a global reserve currency. This is perfect timing on the part of the Chinese and should put China in a position to gain spectacularly, when the rest of the world discovers that the global reserve currencies are not worth the paper they are written on. Several other large EM reserve holders, such as Mexico, India, Brazil, South Korea and Russia, just to mention a few, also have excellent potential, in our view to join China as part of the next generation of global reserve currency nations. Unfortunately, they do not yet appear to have realised the opportunities in front of them. China's experience shows that it is possible to quickly become a global reserve currency, but also that it takes a lot of work on many fronts. For the sake of EM, one can hope that the rise of the Renminbi will provide a wake-up call for other EM central bankers from the inertia induced by a temporarily strong USD.

- Turkey: The European Bank for Reconstruction and Development (EBRD) announced last week that it is buying a 10% stake in Borsa Istanbul, the main stock exchange in Turkey. This is positive news ahead of the expected IPO of the stock exchange next year. The involvement of the EBRD is likely to increase the scope for it to extend more equity financing in Turkey. EBRD's involvement will also likely enable Borsa Istanbul to reach further into neighbouring financial markets. In other news, the trade deficit narrowed to USD 5bn in April from USD 7.3bn in the same month of 2014, mainly due to lower oil prices.

- China: FTSE, an index provider, announced that China's share of the FTSE Emerging Markets index will increase from 26% today to 50% by the time China's A-share market is fully available to foreign investors, starting with a 5% weight to the A-share market, which will then be increased to 32% over time. Meanwhile prices in the onshore stock market were volatile last week as news emerged that the central bank (PBOC) had drained RMB 100bn in liquidity using repos with large banks. A hefty IPO pipeline is also likely to have contributed to some selling. Overall, financial conditions continue to tighten in China as inflation drops faster than policy rates.

- Brazil: The fiscal accounts for April were stronger than expected as the primary surplus reached BRL 13.4bn versus BRL 12.5bn expected. This suggests that austerity measures imposed by the new economic team are beginning to work. Restoration of responsible fiscal policies is critical to Brazil's outlook, in our view. In related news, the Senate approved bills to reform import taxes, sick-leave and pension benefits. The bills will now be signed into law by President Dilma Rousseff. The passage of these bills is part of Finance Minister Joaquim Levy's fiscal adjustment program. In other news, the central bank made marginal changes to credit conditions by easing mortgage credit reserves requirements, while at the same time tightening the reserve requirements on shorter term deposits, thus maintaining overall monetary neutrality. Growth in Q1 2015 contracted by 0.2% qoq which, though poor, was more than twice as strong as expected (0.5% qoq).

Snippets:

- Ethiopia: Observers from the African Union declared the parliamentary election free and fair. The ruling coalition lead by the Ethiopian People's Revolutionary Democratic Front was re-elected with a landslide according to the electoral commission. Peaceful elections are now the norm rather than the exception in Africa.
- Hungary: The central bank lowered interest rates by 15bps to 1.65%
- India: The real economy expanded 7.5% yoy in real terms in Q1 2015, taking the full-year real GDP growth rate to 7.3% yoy. The growth rate was faster than expected and represented a notable increase in the rate of growth compared to both expectations (7.3% yoy) and growth in the previous quarter (6.6.% yoy). Both consumption and investment picked up, while government spending (affected by fiscal adjustment) and agriculture (hit by drought) performed worse than expected.
- Mexico: Private sector credit growth is now clearly rebounding after a slump that began in 2011. Credit to the private sector rose 7.6% yoy in April, representing the third consecutive increase and nearly doubling the rate of credit growth compared to the same time last year. Retail sales also continued their recent solid run.
- The Philippines: Growth in Q1 2015 was only 5.2% yoy versus 6.6% yoy expected. The main culprit was exports, while imports held up well due to solid domestic demand.

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Global backdrop

US growth in Q1 was revised down from 0.2% qoq annualised to -0.7% qoq annualised. Inventories were not quite as large a drag on growth as expected, but on the other hand the net export drag was disproportionately larger than anticipated. Net exports contributed -1.9 percentage points to growth compared to -1.25 percentage points in the first release. The challenge posed by this data to the consensus view that the USD can rise relentlessly against other currencies is obvious; if the strong USD is already hurting exports this much what would be the economic damage if, say, the USD was to rise another 10%, 20% or 30%? And how realistic is the prospect of meaningful Fed interest rate hikes under such a scenario? The higher frequency data was mixed with weaker Chicago PMI, but stronger durable goods being the main data releases of note ahead of the upcoming non-farm payroll number. In Europe, the focus remains on Greece, while the economic data continues to suggest that the cyclical upturn is still on track.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-3.99%	5.72%	0.29%	6.30%	4.40%
MSCI EM Small Cap	0.42%	13.48%	7.28%	11.13%	6.67%
MSCI Frontier	-3.44%	-3.36%	-14.17%	12.68%	6.75%
MSCI Asia	-2.61%	9.51%	10.61%	12.37%	8.93%
MSCI EMEA	-6.36%	3.65%	-13.15%	1.76%	1.26%
MSCI Latam	-7.01%	-7.18%	-20.83%	-6.99%	-4.97%
GBI EM GD	-2.58%	-3.71%	-13.49%	-1.62%	1.37%
ELMI+	-1.39%	-0.75%	-9.32%	-0.89%	0.04%
EM FX Spot	-2.57%	-6.21%	-18.72%	N/A	N/A
EMBI GD	-0.39%	3.28%	2.46%	6.07%	7.50%
EMBI GD IG	-0.55%	2.44%	3.88%	4.95%	6.71%
EMBI GD HY	-0.15%	4.32%	-0.50%	7.86%	8.66%
CEMBI BD	0.52%	4.65%	3.95%	6.20%	6.85%
CEMBI BD HG	0.01%	3.23%	4.41%	5.70%	6.67%
CEMBI BD HY	1.46%	7.31%	2.63%	7.47%	7.41%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.29%	3.23%	11.80%	19.71%	16.51%
2 year UST	0.12%	0.84%	1.06%	0.61%	0.84%
5 year UST	0.14%	1.79%	2.53%	1.07%	2.85%
7 year UST	-0.04%	1.74%	3.85%	1.39%	4.35%
10 year UST	-1.51%	-1.73%	5.53%	1.00%	6.21%
US HY	0.37%	4.18%	1.48%	8.12%	9.50%
European HY	0.18%	4.16%	4.87%	12.95%	12.02%
Barclays Ag	-1.79%	-2.65%	-6.00%	-0.51%	2.47%
VIX Index*	0.00%	-27.92%	21.40%	-48.09%	-61.06%
DXY Index*	0.47%	7.85%	21.14%	17.46%	12.37%
CRY Index*	0.00%	-2.95%	-26.94%	-16.82%	-11.58%
EURUSD	-0.73%	-9.87%	-19.79%	-12.29%	-11.16%
USDJPY	0.06%	-3.41%	-17.48%	-37.12%	-26.54%
Brent	-1.36%	12.80%	-40.89%	-34.30%	-11.06%
Gold spot	-0.38%	-0.16%	-4.68%	-26.97%	-3.19%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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