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Ashmore

The Tightening Tantrum continues

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Emerging Markets (EM) FX has outperformed both EUR and JPY during this fit of USD exuberance, but the USD surge needs new drivers to keep going or momentum is likely to weaken. Brazil undertakes another policy adjustment. Russia warns the markets that it may intervene. Tensions rise again in Eastern Ukraine as both sides have incentives to keep the fires burning in Donbass. Hungary prepares to finally rid households of FX denominated mortgages. We also discuss the all-important difference between QE Japanese style and anything the ECB might conceivably do. We conclude with a brief comment on the impact of the US mid-term elections on EM.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	999	–	-1.14%
MSCI EM Small Cap	1,030	–	-1.20%
MSCI FM	647	–	-3.36%
GBI EM GD	6.45%	–	-1.36%
EM FX spot		–	-1.34%
ELMI+	3.46%	–	-1.23%
EMBI GD	5.33%	300 bps	-0.53%
EMBI GD IG	4.36%	198 bps	-0.27%
EMBI GD HY	7.36%	518 bps	-0.97%
CEMBI BD	5.26%	316 bps	-0.15%
CEMBI BD HG	4.33%	222 bps	-0.13%
CEMBI BD HY	7.27%	522 bps	-0.18%

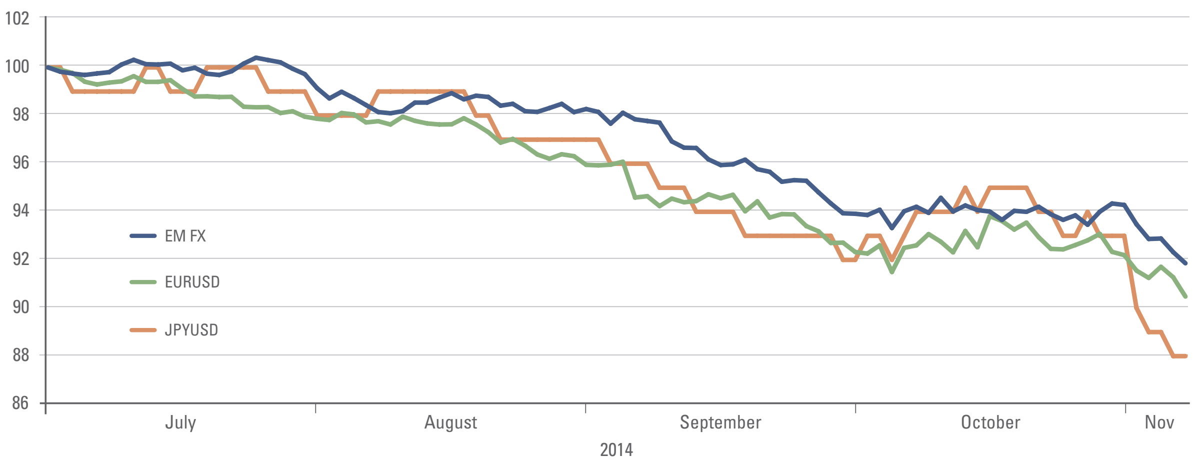
Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2032	0.79%
VIX Index	13.12	-10.93%
5 year UST	1.57%	-6 bps
7 year UST	1.99%	-7 bps
10 year UST	2.29%	-5 bps
US HY	6.20%	-0.10%
European HY	5.07%	0.41%
EURUSD	1.2483	-0.02%
USDJPY	114.12	0.15%
Brent	84.09	0.65%
Copper	309.70	-2.22%
Gold	1170.91	-0.09%

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

Emerging Markets

The surge in the USD since July has not been an EM trade per se

Fig 1: **USD versus other currencies (30 June 2014 = 100)**



Source: Ashmore, Bloomberg.

As the chart shows, EM FX has outperformed both EUR and JPY. Clearly, the USD has been bought against all other currencies in the world. While powerful, we think the USD surge has somewhat flimsy drivers. There have been at least four different drivers of the USD rally since it began on 1 July. First, the USD rose on expectations of stronger US growth after the Q2 growth rate of 4.2% and the Fed's forecast for a first rate hike in Q1 2015. This view then quickly gave way to fears of a Fed policy mistake that briefly caused the VIX to spike and crashed the US stock and corporate high yield markets. Ironically, this fuelled further demand for USDs in the usual knee jerk flight to liabilities reasons. Next, came a strong tailwind as Fed officials moderated their rhetoric about rates, which led to renewed hopes for stronger growth. Most recently, the USD has been aided by ferocious front-running of a major portfolio shift by the Japanese government pension fund (see discussion below) as well as hopes for QE in Europe. It is a zero-sum game between EUR, JPY and the USD and EM

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Emerging Markets

currencies have very much been caught up in the momentum, but featuring prominently in the narrative. This is one reason why EM local bond yields have actually declined since early July and why EM external debt has outperformed US government bonds of the same duration by 370bps this year. This year's "Tightening Tantrum" is, in other words, very different from last year's "Taper Tantrum". But these two, along with the other recent tantrums – the Eurozone debt crisis in 2011-12 and 'Abenomics' in late 2012 – have one thing in common: They all involve purchases of USDs and sales of other currencies. USD longs get ever more pregnant. This is a negative technical that will eventually unwind, but probably not until everyone is up to the limit on USD exposure.

- Brazil: In the second policy change since President Dilma Rousseff's re-election (the first was a rate hike by the central bank) the government allowed Petrobras, the state owned energy company, to increase fuel prices. This is good news, but we estimate that gasoline prices and diesel prices in Brazil are still some 2% and 5% respectively below world prices. This means that Petrobras is still accruing a loss for every drop of fuel it sells. These losses eat into the profitability of the firm in addition to eroding economic efficiency in the country. There was good news on the inflation front when Brazil's main consumer price index rose 0.42% in October compared to 0.48% expected (and 0.57% last). Still, we expect inflation to tick up on a one-off basis in the next month of two as a result of the energy price adjustments. Meanwhile, the economic outlook continues to deteriorate as Dilma has still not provided clarity about a new economic team and fiscal adjustment. September saw industrial production fall 0.2% relative to August.

- Russia: Russia this morning changed its FX policy towards something that looks close to a free float. According to press reports, the Russian central bank will eliminate the mechanism for regular currency interventions, including the floating RUB corridor. This is a big step towards a flexible exchange rate and underlines the Russian government's stated commitment not to impose capital controls. Russia retains the right to intervene if financial stability is threatened. Russian bonds and the currency have recently obeyed different dynamics. Russian bond yields have naturally drifted higher as the RUB has weakened, but in an orderly fashion. Foreigners still hold significant positions in the OFZ market and yields of 10% are expensive to forego. The Russian central bank has not shied away from hiking rates, and may do more if inflation expectations begin to shift significantly. Russia has been able to cancel OFZ auctions because its oil revenues have increased in RUB terms as the currency has weakened. The bulk of the RUB move is directly related to the fall in oil prices, although speculation surrounding the USD, tensions in Ukraine and some indications that Russians are converting their deposits to USD have also weighed on the currency. A floating currency provides major insulation against oil price shocks, in our view. Russia's central bank also has USD 439bn in reserves and the central bank has given fair warning that it could intervene at any time, in any size. In other news, Russia has entered into agreement with China to supply 30bn cubic metres of gas to China over a 30 year period. This follows a supply agreement for 38bn cubic metres signed in May 2014. China will now become Russia's largest gas customer. It also means that Russia has insured itself against a decline in European demand following the dispute over Ukraine. Europe, on the other hand, has yet to figure out how to replace Russian gas supplies.

- Ukraine: Tensions are rising again in Eastern Ukraine after Russia gave de facto legitimacy to regional elections in areas occupied by pro-Russian rebels in Eastern Ukraine. Ukraine has incentives to keep the conflict alive, because it keeps the Europeans and the Americans on side. Besides, the strong support for Prime Minister Yatsenyuk probably accounts for a more aggressive stance in Kiev. Russia also has incentives to keep the fires burning in Donetsk and Luhansk. Russia does not trust the West at all and wants to make sure that Ukraine never joins NATO. The best way to achieve this is to keep Ukraine locked in a permanent armed conflict. NATO would not let Ukraine join while it is engaged in active military conflict, because NATO rules require the organisation to come to the aid of any member state engaged in military conflict. No one in NATO wants direct confrontation with Russia.

- Hungary: The government is finally getting to grips with the stock of foreign currency denominated loans on household balance sheets. The central bank has USD 36bn of FX reserves and has announced that it will make USD 9bn available to enable Hungarian mortgage holders to convert their mortgages to HUF. This will dramatically reduce the sensitivity of consumption to moves in the currency. Meanwhile, Hungary's trade surplus in September rose to EUR 925m versus EUR 775m expected.

- China: Consumer prices inflation remained very low at 1.6% yoy in October. Producer prices declined 2.2% yoy, down from -1.8% in September. USDCNY fixed sharply lower this morning at 6.1377 following the announcement that the Hong Kong Shanghai stock connect will be launched on 17 November. Meanwhile, the Chinese trade balance increased sharply to USD 45.4bn from USD 31.0bn in September. China's 5yr bonds have performed strongly on the back of moderately slowing growth, low inflation, and the well-supported currency. Even so, 5yr real yields in China are still 2.3% compared to -0.14% for the US 5yr inflation indexed bond.

- South Africa: Moody's downgraded South Africa's sovereign credit rating to Baa2 (two notches into the investment grade category) from Baa1 on the back of sluggish growth. Despite the downgrade, South African PMI picked up in October to 52.7 (well into economic expansion territory).

- The Philippines: Inflation is declining nicely. In October, inflation eased to 4.3% yoy from 4.4% in the previous month. The central bank's target is 2-4% inflation for 2015. We expect this target to be met.

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Emerging Markets

- **Chile:** The trade surplus is up 40% yoy, taking the cumulative surplus to USD 7.5bn over the past 12 months. Like many other economies in EM, Chile's economy is highly flexible due to large informal labour markets. This means that the economy adjusts rapidly to changing conditions. Thus, even though exports are declining, imports are weakening even faster as the economy rebalances.
- **Indonesia:** The economy expanded 5.0% yoy in Q3. Growth has slowed somewhat in the past year due in part to the sluggishness of the departing SBY administration and partly to the uncertainty surrounding the closely fought recent election. Markets are likely to become more buoyant in next couple of years as President Jokowi makes progress on subsidy reductions and infrastructure spending.
- **Saudi Arabia:** The Saudi government lowered the oil price it charges customers in the US resulting in a further decline in the price of West Texas Intermediate, which now trades around USD 78 per barrel.
- **Malaysia:** The trade surplus rose sharply to MYR 9.3bn in September, taking the YTD surplus to MYR 62bn. At the same time in 2013 the trade surplus was MYR 43bn. Imports of intermediate goods are robust, which continues to bode well for exports.
- **Korea:** Inflation continues to moderate. Core inflation fell to 1.8% yoy in October from 1.9% yoy in September. This is the lowest reading for inflation in a year. Future inflation may be impacted by ongoing currency weakening on account of the current USD surge. South Korea has 'effectively' reached a free trade agreement with China. The agreement is expected to add more than 2.25% to Korea's GDP in the decade after the agreement takes effect (2016). Trade volumes between EM countries are rising. We expect this trend to continue on account of far better growth prospects in EM compared to developed economies. The free trade agreement with China will also aid Korean trade as Japan pursues ever more aggressive policies to manipulate its exchange rate lower.
- **Mexico:** The pickup in economic activity of the past few months will continue based on leading indicators. In October the PMI rose to 53.3 and the IMEF leading indicator rose to 54.8, well above the expansion threshold of 50.
- **Middle East:** Last week, we took a cursory glance at the World Bank's recently-published *"Doing Business"* report for 2015, which gauges the ease of opening and running small to medium-sized businesses. This week we briefly discuss the report in relation to the Middle East and North Africa (MENA). In general, MENA ranked very poorly in the survey at 106 out of 188 countries, but the low ranking masks enormous variation within the region. The Gulf sees a wide spread with the UAE ranking highest (22) and Kuwait lowest (86), while Saudi Arabia sits in the middle (49). North African economies score a low 117, but Tunisia is ranked 60 in sharp contrast with Libya's rock bottom rank of 188. The reasons for the large discrepancies are many. Gulf economies have been trying to diversify and make their economies more attractive to private local and foreign businesses, but contract enforcement remains a challenge for most Gulf economies. Some North African economies are close to the EU and Morocco, Tunisia and Egypt in particular have long tried to become more business friendly. Libya's business reforms lagged amongst political grappling. The rest of the Middle East appears much less open to business. There is civil war in Syria, and violence in Iraq and Yemen. For North African economies access to credit and challenges related to starting a business linger. For the rest of the Middle East, cross-border trading and lack of safeguards for minority investors present obstacles to new businesses. Going forward, we believe the outlook for the business climate is most likely to improve in Egypt, Tunisia and Morocco as they pursue reforms. The Gulf economies will diversify further, which should enhance conditions for the private sector. The outlook for many of the other countries in the Middle East is far less promising, however, due to civil war, violence and domestic instability that will continue to inhibit business.

Global backdrop

This week the ECB failed to live up to expectations of sovereign QE, but ECB President Mario Draghi did commit to expanding the ECB's balance sheet, while at the same time confirming that the institution is looking at new policy instruments. This will keep alive the prospect of sovereign QE in future meetings. Additional policy easing has become imperative in both Europe and Japan after the US ended QE, because the Fed's next step is widely expected to be a rate hike. Given Europe and Japan's structural problems, particularly the inability to grow and to generate inflation, the prospect of higher US nominal rates translating into higher real yields across Europe and Japan is frightening the living daylights out of policy makers. Hence, the sudden urgency in pursuing additional policy easing.

Still, amidst all the frenzied selling of EUR and JPY there is a danger that the market loses sight of an extremely important difference between the QE that the ECB might pursue and the latest policy changes in Japan. Years of experience of conventional QE in Japan, the UK and the US have shown there is no guarantee that printing money generates inflation. Money does not go shopping on its own. So if the ECB commences sovereign QE there is little doubt that markets will, at least for a time, jump on the trade and push EURUSD lower, but if there is no impact on either growth or inflation then there is little fundamental reason to believe that EURUSD will break out of its broader ranges on a permanent basis. Indeed, EURUSD has obeyed the 1.20-1.50 range since 2007 despite abundant QE in the US, a European debt crisis of some note and other emotional experiences.

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Global backdrop

Indeed, it is quite possible that real rates will actually rise in Europe even under QE if the region does not succeed in generating inflation at a time when US rates are rising (correlations between yields on European and US government bonds are much higher than, say, correlations between US and EM yields). If this happens, Europe's growth will slow, inflation will fall, the region will import less, the current account surplus will increase, and ultimately the EUR will strengthen. Hence, there are good reasons to regard the market's current fascination with a lower EUR more as a speculative momentum trade than a move derived from sound fundamental analysis, especially if it turns out that the current pessimism surrounding European growth is overdone (we think it is – for example, Euro area retail sales are still trending up, Euro area PMIs are improving, and German industrial orders picked up in September).

If Europe was to embark upon sovereign QE, the situation in Japan today would still be hugely different. Japan, of course, has been pursuing QE for years without decisively escaping low growth and deflation. But the real difference would be that the latest policy move by Japan involves not just bond buying by the BOJ, but also a related set of dramatic portfolio shifts by GPIF, the massive Japanese government pension fund. The GPIF's portfolio shift will likely trigger copycat moves by a number of other pension institutions in Japan. In other words, the key difference between Europe and Japan is that there will be an actual flow accompanying the latest QE move by the BOJ; the moves in the Nikkei and the JPY are not driven purely by expected changes in inflation or growth as result of QE alone.

Specifically, the USD 1.3trn GPIF has announced that it will reduce its holdings of JGBs from 60% to 35% by increasing allocations to domestic and foreign equities in roughly the same proportions plus buying some foreign bonds, including EM bonds. A reduction in the GPIF's holdings of JGBs of this scale can only be done without crashing the bond market if a new buyer steps in – cue the BOJ. The BOJ will buy the bonds by printing money. The timeline for the portfolio shift is not yet known, but global financial markets are currently extremely busy front-running the GPIF's expected portfolio shift. Beyond the actual flow, the excitement and momentum generated by the price action is almost certainly going to result in an overshoot (excessively weak JPY, excessively strong USD and temporary collateral damage to other currencies, including EM currencies).

There are a couple of other important points to make about Japan's desperate policy gamble. The GPIF portfolio shift is large, but obviously finite in nature. Once the reallocation has been done the flows – and therefore the moves in the Nikkei and JPY – stop. Hence, the Abe Administration is making an extremely risky bet that temporary weakening of the JPY and inflating the Japanese stock market can somehow jolt Japan out of its long-standing economic malaise. Yet, it is hard to see how that can happen. Japan's ageing population relies mainly on income-type products that do not benefit significantly from higher stock prices. The real purchasing power of these income products will, in fact, be adversely affected by the weaker JPY, because imports will get more expensive. Will exports recover sharply on the back of the weaker currency to help growth recover? We think probably not. Many Japanese exporters have already relocated outside Japan. Their incentives to move back home are small, because consumer taxes are being raised in a futile attempt to deal with the massive government debt problem and as a result there is little domestic demand. In a nutshell, the GPIF's portfolio shift will only drive up stock prices, but without healing the underlying economy. Of course, the condition where asset prices rise far above the levels justified by fundamentals is known as a bubble. To avoid this bubble from bursting with devastating effects on the economy the BOJ will have to continue to print indefinitely. And it will also have to continue to buy government bonds, because the debt burden is now so large such that Japan's government will never be able to repay the BOJ. One does not solve structural problems without structural remedies, but it is certainly possible to create a short-lived party.

The riskiness of Japan's chosen policies are undoubtedly one of the reasons why there is such an intense debate in Europe whether the ECB should ape Abe. However, the policies are really quite different, because Europe is not presently considering forcing its pension funds to buy stocks. As to the question whether the ECB should engage in conventional sovereign QE we think Europe may have little choice. Higher US rates are certain to increase pressures on European periphery bond markets.

But this is not an immediate risk. The FOMC members themselves are suggesting Q1 2015 as the likely time for the first hike via the 'dots', but the markets' inflation expectations are well below the Fed's inflation target and do not expect a hike until late 2015. Payrolls disappointed somewhat, but this was offset in part by a better participation rate, so the net outcome was largely neutral. We think the Fed shifts its 'dots' to Q3 2015 at the next policy meeting on 19 December to meet the market roughly halfway. In short, no rate hikes for another year or so.

This means that there is no huge urgency for the ECB to carry out sovereign QE. In the meantime, the ECB should focus on fixing Europe's specific problems. The US QE experience has been positive precisely because it has targeted the biggest problems in the economy, namely banks and household balance sheets. The Fed enabled the US government to roll out massive fiscal measures that in turn helped to fix the US banks and facilitate significant deleveraging of US household balance sheets. The US now has a fighting chance of improving consumer spending and generating the inflation the economy needs in order to erode away its still excessive overall debt burden. Europe needs to focus its policy measures the same way. It needs to fix its credit markets, get debt levels down in the private sector and heal the asset backed securities markets. Sovereign QE, by contrast, has the look of a defensive move intended to guard against future speculative attacks on vulnerable periphery economies.

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Global backdrop

Finally, a word on the US mid-term elections: Republicans gained control of Congress. The impact in terms of economic reforms will be insignificant, because President Obama is now firmly a lame duck. In terms of politics, we expect more noise. Republicans will try to put President Obama in a bad light to help their presidential ambitions in 2016. One way to do this is to force Obama into a position of 'wrecker' by proposing various pieces of legislation that he will then have to veto. In terms of the US fiscal stance, periods with Democrat presidents and a Republican Congress have witnessed declining fiscal deficits. On average, fiscal deficits have declined by 0.38% of GDP each year under that particular constellation of powers. In fact, the Obama Administration has done better than that. During Obama's term in office the fiscal deficit has declined by an average of 1.14% of GDP per year, which is by far the fastest pace of fiscal improvement in recent history. The contrast with the fiscal stance under President George W. Bush is particularly extreme; the Bush presidency oversaw an average increase in the fiscal deficit of 1.01% of GDP per year. We do not expect any major changes in the current direction of fiscal policy in the US during the remaining two Obama years. Finally, we believe that lame duck governments are more likely to resort to foreign policy. Hence, expect a more active stance against Russia, intensification of the fight against Islamic State, increasing pressure on Iran over its nuclear programme, and escalating tensions with China over the balance of power in the South China Sea.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.7%	0.9%	0.5%	2.8%	3.9%
MSCI EM Small Cap	-1.3%	3.8%	3.5%	5.5%	5.7%
MSCI FM	-3.3%	12.1%	16.1%	13.7%	7.5%
S&P 500	0.78%	11.85%	18.69%	19.79%	16.10%
GBI EM GD	-2.05%	-0.53%	-2.61%	0.61%	3.90%
ELMI+	-1.60%	-3.75%	-4.11%	-0.68%	0.30%
EM spot FX	-1.99%	-7.89%	-9.34%	NA	NA
EMBI GD	-0.59%	9.23%	9.02%	6.54%	8.27%
EMBI GD IG	-0.39%	9.73%	8.96%	5.09%	7.03%
EMBI GD HY	-0.95%	8.36%	9.31%	8.99%	10.18%
5 year UST	0.17%	3.23%	1.48%	1.09%	3.44%
7 year UST	0.28%	6.15%	3.44%	1.87%	5.01%
10 year UST	0.39%	10.31%	6.98%	3.04%	6.28%
CEMBI BD	-0.15%	7.05%	7.23%	6.70%	7.41%
CEMBI BD HG	-0.11%	7.76%	7.69%	6.17%	6.99%
CEMBI BD HY	-0.23%	5.52%	6.26%	8.19%	8.73%
US HY	-0.10%	4.67%	5.82%	9.72%	10.88%
European HY	0.43%	5.30%	6.84%	14.84%	12.87%
Barclays Agg	-0.73%	0.91%	0.24%	0.56%	2.40%

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

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