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Ashmore

Benign inflation allows China to cut rates

By Jan Dehn

China's central bank cuts the policy rate by 25bps amidst further steps towards freeing up markets. India's lower house approves GST and Governor Rajan secures the right to regulate bond markets as India moves slowly but steadily towards capital account liberalisation. Brazil's parliament approves important fiscal measures despite opposition from within the President's own party. Russian economic activity and inflation beat expectations. In developed markets, bond prices have become very volatile as major consensus trades based on a bullish US outlook fail to face up to reality.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,038	–	-0.93%
MSCI EM Small Cap	1,105	–	-1.23%
MSCI FM	596	–	-1.21%
GBI EM GD	6.52%	–	0.69%
EM FX spot	–	–	0.75%
ELMI+	4.92%	–	0.36%
EMBI GD	5.42%	325 bps	0.16%
EMBI GD IG	4.23%	200 bps	-0.01%
EMBI GD HY	7.57%	554 bps	0.39%
CEMBI BD	5.25%	331 bps	0.23%
CEMBI BD HG	4.20%	225 bps	0.02%
CEMBI BD HY	7.25%	534 bps	0.60%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2116	0.17%
VIX Index	12.86	0.08%
5 year UST	1.51%	1 bps
7 year UST	1.90%	1 bps
10 year UST	2.17%	2 bps
US HY	6.52%	-0.17%
European HY	4.64%	-0.39%
EURUSD	1.1164	0.04%
USDJPY	119.92	-0.19%
Brent	64.87	-1.58%
Copper	292.35	-0.05%
Gold	1185.87	-0.28%

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

Emerging Markets

- **China:** China is in the fortunate position that it can liberate interest rates while also cutting them due to very benign inflation dynamics. In April, CPI inflation was just 1.5% yoy, which was lower than expected and follows several previous soft inflation prints. Combined, they have now given the PBOC room to effect a 25bp rate cut. The benchmark 1-year lending rate now sits at 5.1% and 1-year deposit rate is at 2.2%, while the ceiling on deposit rates was increased to 1.5 times the benchmark rate from 1.3 times prior (i.e. creating a larger range within which banks can set the rate). The government is making intelligent use of the disinflation caused by economic reforms and a strong currency to allow real interest rates to drift higher, even as it slowly cuts policy rates. This strategy is part of a wider set of reforms aimed at bringing domestic interest rates into equilibrium as the capital account is gradually liberalised. The combination of a strong currency, disinflation, extremely strong technicals and high real yields makes China's bond market attractive, in our view.

China is launching a facility that allows the CNY's value to be fixed against gold. A gold fixing facility exists in London, but China wants its own – reflecting its ambitions as a global financial player. The establishment of a China-based gold fix for the CNY also marginally undermines the USD as the global benchmark currency. Finally, the establishment of a gold fix will probably also aid China's ambition to achieve Special Drawing Rights inclusion this year.

It was also reported that the Hong Kong-Shenzhen trading link will start this year in another move by China to liberalise its capital account. SAFE, the State Administration of Foreign Exchange, announced steps to ease controls on banks' USD positions. Since in aggregate these positions are net long, the measure is likely to support CNY.

In economic news, the services PMI from HSBC was higher than expected in April, rising to 52.9 from 52.3 in March. This marks a four month high. China's trade surplus also rebounded strongly after a blip in March due to the Chinese New Year. The trade surplus rose to USD 34.1bn from USD 3.1bn in March, though both imports and exports were softer than expected.

- **India:** In a very positive development, the lower house approved the goods and services tax (GST) bill by 352 votes to 37. The bill now goes to the upper chamber, where the government does not have a majority. Hence, approval here will require a deal with the opposition and States. The GST is a pan India tax regime which will replace all indirect taxes levied by the Centre & States. This will dramatically improve economic efficiency in India as well as the fiscal situation of the central government.

Continued overleaf

Emerging Markets

In another positive development, Prime Minister Modi has backed the central bank (RBI) in its turf war with the finance ministry over the right to regulate bond markets and manage public debt. The RBI, under the leadership of Governor Raghuram Rajan, has been instrumental in the re-establishment of investor confidence in India. There have also been significant improvements in the fiscal management under Finance Minister, Arun Jaitley, but the fiscal stance has historically posed the larger threat to macroeconomic stability in India. This is why it is so important that regulation stays with the RBI, in our view.

We think that the Indian rupee has the potential – like the Renminbi – to become a global reserve currency sooner than expected. The world will need new reserve currencies as the QE economies gradually succeed in converting their excessive debt into inflation problems (with negative ramifications for their currencies). Having won the turf war over regulation, we think the RBI will now slowly move towards making the INR freely convertible. Despite significant opposition from conservatives and vested interest groups, Governor Rajan is slowly but steadily pushing India towards capital account liberalisation. Bond quotes are being made more flexible, Indian companies are being allowed to issue INR denominated debt abroad, Indian banks are being recapitalised and local currency government debt is being made Euroclearable. The INR is destined to become one of the great new reserve currencies of the world, albeit over a much longer time frame than, say, the Renminbi. The RBI is the best placed institution to oversee this process, including the establishment of an efficient and modern regulatory regime to ensure that liberalisation serves the national interest rather than special interests. Greater openness is consistent with Prime Minister Modi's "Made in India" slogan, which encapsulates a commitment on the part of his administration to remove unnecessary regulation and to simplify procedures.

- Brazil: The lower house approved important fiscal measures that will improve Brazil's public finances by reducing access to unemployment insurance.

The bill forms a central element in a broader package of legislative and other measures intended to reduce public spending by some USD 6bn as the government targets a return to a 2% of GDP primary surplus by the end of next year. The bill still has to be approved in the upper house and may yet be amended. Still, the 'guts' of the bill remain in place. Passage was complicated by opposition from within President Dilma Rousseff's own PT party, but a solution was found under the leadership of Michel Temer (of the PMDB). Temer was recently appointed to head up negotiations in parliament in a clear sign of the Dilma administration's willingness to reach across the centre ground in Brazilian politics in order to get support for reforms. Hence, the passage of this bill is very good news.

Brazil is 'pulling back from the brink' by correcting a number of entirely self-inflicted fiscal problems created by former finance minister Guido Mantega, who also exacerbated business conditions by pursuing heterodox macroeconomic policies. Under the new finance minister, Joaquim Levy, this damage is now being reversed. Levy has the backing of opposition politicians, whose constituents want to see Brazil return to growth. While President Dilma Rousseff also supports Levy, elements within the PT strongly oppose reforms.

On the monetary policy side, the minutes from the central bank's most recent meeting (where it raised rates by 50bps to 13.50%) was clearly hawkish suggesting that the central bank is determined to bring inflation back to target range. Monthly inflation surprised by coming slightly below expectations in April at 0.71% mom versus 0.75% mom expected, but the yoy rate of inflation continues to be excessive (8.17% yoy).

Meanwhile, the economy continues to suffer under the necessary fiscal and monetary adjustments. Industrial production fell 0.8% in the month of March. This decline was a little bit faster than expected (-0.7% mom).

- Russia: Russia's economy continues to perform better than market expectations. Both inflation and the economy are outperforming. Headline inflation in April was 16.4%, down from 16.9% yoy in March and lower than consensus expectations of 16.7%, while April's Manufacturing and Services PMI numbers both came stronger than expected. Services PMI was 50.7 versus 45.6 expected and 46.1 in March, while the Manufacturing PMI rose to 48.9 in April from 48.1 in March.

Snippets:

- Malaysia: The trade surplus increased sharply to USD 2.1bn in March compared to USD 1.3bn in February. This is equivalent to a 6.7% mom increase in seasonally adjusted terms. The improvement in the trade balance was mainly due to rising exports (imports declined marginally).
- Colombia: Inflation was higher than expected at 4.64% yoy in April, mainly due to food prices.
- Romania: The central bank cut benchmark interest rates to 1.75% from 2%.
- Kenya: The Central Bank of Kenya's monetary policy committee kept the policy rate unchanged at 8.50%, but the rhetoric was hawkish.

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Emerging Markets

- **Vietnam:** Vietnam devalued the Dong by 1%. This is the second devaluation this year.
- **Poland:** The central bank left rates unchanged at 1.50%.
- **Czech Republic:** The central bank left rates unchanged at 0.05%.
- **Mexico:** Core inflation was 2.4% yoy in April with headline at 3.06% yoy.
- **Turkey:** Industrial production rose 4.7% yoy versus 0.9% yoy expected.
- **Hungary:** The yoy rate of CPI inflation rises from -0.6% yoy to -0.3% yoy.

Global backdrop

Long bonds in developed economies have recently exhibited significant volatility. The reason is simple: valuations in these markets have moved completely out of line with fundamentals. Until recently, the market operated on the view that the US economy would continue to expand rapidly without inflation regardless of the sharp rise in the USD and approaching Fed hikes. This perception sustained bear flattening of the US treasury curve and a solid rally in the USD versus JPY, EUR and Emerging Markets (EM) currencies. Other trades were also predicated on the 'goldilocks view' of the US, including long positions in duration in the European bond market (also supported by QE from the ECB). In EM, the strong USD led to widespread cautious sentiment towards the asset class over the past couple of years, including an irrational Taper Tantrum in 2013.

These popular trades now look somewhat at odds with reality. US growth is now tracking -0.5% in Q1 and the outlook for Q2 is hardly inspiring. Payrolls did not impress. European growth has been stronger than expected and oil prices are up 40% this year, so record low yields sit increasingly uneasily alongside rising inflation expectations. EM, of course, has also proved very resilient.

Hence, the trades predicated on the bullish US view are now being reversed. Specifically, a stronger EUR requires higher European rates, so bond yields are rising. Rising inflation expectations requires bear steepening of the yield curve, so the long end sells off. And many EM markets have strongly outperformed developed markets this year, including corporate high yield, sovereign Dollar bonds and stocks.

The bullish view of the US economy remains largely intact. Most will discount recent US weakness and European strength and treat the recent volatility as a healthy correction in the market. Global macroeconomic conditions have barely changed. Market sentiment towards EM is likely to remain cautious.

This amounts to complacency. The bullish US view is facing serious fundamental constraints. The current market correction buys time, but does not remove these constraints. Can the US economy really grow if the USD rallies for another two years? Will investors really buy European bonds if yields fall deeper into negative territory? Investors should pay attention to the recent volatility, because it is a warning about the limits of current central bank policies in developed economies.

ECB President Draghi knows this. He went on the record saying that quantitative easing (QE) is "sufficiently flexible" to change if needed...remember that the ECB initiated QE mainly to prevent a 'blow-up' in European periphery bond markets in the event of US rates hikes. If the Fed does not hike anytime soon it means that the ECB does not need more QE either, particularly since excessive QE causes precisely the kind of volatility problems we have seen in German bond markets over the last couple of weeks. For this reason, there is a non-trivial risk now that the ECB will scale back QE if the US data continues to disappoint.

We end with a basic observation from the recently concluded UK election. This event was largely irrelevant for EM except for one thing: The broader trend in continental European politics is that right-wing populist sentiment is on the rise in 'core' countries, while left-wing populism is rising in 'periphery' countries. This pattern was exactly replicated in the UK general election, where, in UK's 'core', i.e. England, voters shifted sharply towards right-wing populist messages such as anti-immigration and anti-EU, while voters in UK's 'periphery', i.e. Scotland, gave land-slide support to the populist left (Scottish National Party). Geopolitically, the crisis-affected developed world is slowly sliding towards greater social dislocation.

Continued overleaf

Market data	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.19%	8.80%	5.36%	4.28%	5.07%
MSCI EM Small Cap	-1.71%	11.07%	7.47%	7.15%	5.81%
MSCI FM	-0.91%	-0.83%	-7.82%	11.60%	5.84%
S&P 500	1.54%	3.49%	15.12%	18.27%	16.16%
GBI EM GD	-0.33%	-1.48%	-11.32%	-2.90%	2.22%
ELMI+	-0.07%	0.58%	-8.02%	-2.03%	0.28%
EM spot FX	-0.01%	-3.74%	-17.03%	NA	NA
EMBI GD	0.00%	3.68%	4.47%	5.21%	7.81%
EMBI GD IG	-0.29%	2.70%	5.61%	4.25%	7.03%
EMBI GD HY	0.42%	4.91%		6.73%	8.96%
5 year UST	-0.21%	1.54%	3.26%	1.15%	3.18%
7 year UST	-0.43%	1.54%	5.08%	1.58%	4.70%
10 year UST	-0.83%	1.08%	7.17%	2.79%	6.20%
CEMBI BD	0.16%	4.28%	5.05%	5.58%	6.69%
CEMBI BD HG	-0.16%	3.06%	5.60%	5.36%	6.61%
CEMBI BD HY	0.75%	6.57%	3.59%	6.20%	7.00%
US HY	-0.06%	3.73%	1.74%	7.36%	9.20%
European HY	-0.43%	3.56%	4.38%	11.90%	11.79%
Barclays Agg	-0.53%	-1.40%	-4.77%	-0.38%	2.68%

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

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