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WEEKLY INVESTOR RESEARCH

Ashmore

Yearning for inflation

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Why is the market so desperate for the ECB to ease? We explain why EUR strength is merely a precursor for much larger changes in global currencies that are likely to leave many countries, especially Europe and Japan, yearning for inflation. We provide an update on Russia-Ukraine situation, talk about politics in Indonesia, South Africa, Brazil, and Thailand. We also note Venezuela's gut-wrenching domestic economic adjustment and discuss Mexico and China's low inflation prints.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,013		1.23%
MSCI EM Small Cap	1,046		-0.31%
MSCI FM	666		-0.47%
GBI EM GD	6.69%		1.11%
ELMI+	3.42%		0.44%
EMBI GD	5.28%	264 bps	1.11%
EMBI GD IG	4.48%	178 bps	1.08%
EMBI GD HY	7.26%	490 bps	1.15%
CEMBI BD	5.30%	303 bps	0.40%
CEMBI BD HG	4.37%	211 bps	0.38%
CEMBI BD HY	7.12%	486 bps	0.45%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	1878	-0.24%
VIX Index	12.92	-2.78%
5 year UST	1.65%	-3 bps
10 year UST	2.64%	3 bps
US HY	5.28%	0.24%
European HY	4.37%	0.35%
EURUSD	1.3769	-0.78%
USDJPY	101.94	-0.12%
Brent	108.38	0.97%
Copper	322.25	3.37%
Gold	1300.99	-0.66%

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

Emerging Markets

- **Yearning for inflation:** Europe, Japan, the US, and Emerging Markets (EM) differ in important ways. EM countries have much less debt. This makes them less sensitive to higher rates than developed economies. Europe and Japan differ from the US as the US dollar is the global reserve currency. And EM countries differ from Japan and Europe in that they own the bulk of the world's currency reserves (which are mainly invested in US dollar assets). We believe these fundamental differences will have profound implications for how Europe, Japan, the US, and EM will experience the normalisation of global monetary policy in the coming years. The US will use the Dollar's global reserve currency status to inflict as much of the pain of adjustment as possible onto foreigners and future generations by inflating at home and devaluing its currency abroad. Europe and Japan will experience the normalisation of global monetary policy through a combination of higher real rates (because they cannot create inflation) and stronger currencies versus the Dollar (because they cannot inflate). And EM countries will mainly feel the pinch via stronger currencies, while higher real rates pose less of a challenge due to their lower debt burdens.

The high debt levels in the US, Europe, and Japan mean that in just a few years' time policymakers and voters in these countries will clamour for inflation to soften the blow from rising nominal bond yields. Rising nominal yields in the US will also push nominal yields higher in Europe and Japan, but while the US is likely to be able to generate inflation, Europe and Japan will struggle to do so due to their structural problems. Hence, rising nominal yields in Europe and Japan will translate directly into rising real yields, whereas in the US inflation will simply be allowed to drift higher to keep real rates very low. Low real yields will help to push down the Dollar, but without the means to create inflation, real yields will stay high in Europe and Japan and thus strengthen their currencies versus the Dollar.

These dynamics are already beginning to make themselves felt in currency markets, even if real rates still remain very low in Europe. The EUR defies all predictions of its demise and its strength is now the single most important focus in global monetary policy. There are mounting calls for the ECB to ease monetary policy, not because of very weak growth, but because of fears that continuing EUR strength could cause growth to weaken. While a strong EUR certainly taxes Europe's less efficient exporters, a strong EUR is nothing compared to what higher real rates would do to Europe (including, in passing, causing the EUR to get even stronger). The market senses this, which is why it is already demanding more easing from the ECB. Still, does anyone really seriously believe that more easing from the ECB will fix the underlying structural problems of debt and banking sector balance sheets that are the root cause of low inflation in the Eurozone? So far, it would appear this belief is alive and kicking. Or perhaps it is just that the market remains in denial about the mirror image of a stronger EUR, namely a weaker US dollar.

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Emerging Markets

- **Russia and Ukraine:** Intense diplomatic relations continued between the West and Russia this week. On balance, tensions at international level eased further, but were matched by rising tensions on the ground in Ukraine. The de-escalation of tensions at international level has been evident in a number of recent developments, including:

1. The US/EU announced weaker than expected sanctions.
2. President Putin promised to pull back some troops.
3. German Chancellor Merkel quietly secured the release of OSCE observers.
4. The US/EU signalled that the next round of sanctions would only occur after the 25 May.
5. Chancellor Merkel said that EU support for sanctions would require unanimity among EU member states.
6. EU President Von Rompuy said the Geneva Accord could be renegotiated.
7. President Putin said he would support the postponement of referenda in parts of Eastern Ukraine and support elections in Ukraine set for 25 May.

Even so, referenda in parts of Eastern Ukraine went ahead this weekend the results of which are likely to show support for greater independence from Kiev. Regardless of their legitimacy or otherwise these referenda will likely be used by Russia to push its interests in Ukraine. We think tensions between Russia and the West are likely to persist through the election cycle in Ukraine, starting with the presidential elections, then the constitutional process, and finally likely new parliamentary elections towards the end of this year. The IMF disbursed USD 3.2bn to Ukraine this week.

- **Indonesia:** The 9 April parliamentary election outcome was largely in line with expectations and gave the main opposition party PDIP and its allies (NasDem and PKB) a total of 34.7% of the vote. This is enough to push Jakarta governor Joko Widodo (aka Jokowi) forward as presidential candidate ahead of the 9 July presidential election. Jokowi has pledged market friendly policies, including infrastructure spending and gradual elimination of fuel subsidies. The ruling Democratic Party got 10% of the vote, while the Gerindra party won 12%. The runner up Golkar party won 15% of the vote, which was better than expected. This result is likely to pitch Jokowi against Gerindra's Prabowo Subianto on 9 July, although this requires a formal coalition between Gerindra and another party in order to achieve a minimum 25% of the vote, which is a precondition for any coalition to field a presidential candidate (likely to happen soon). The presidency is awarded based on a simple majority. Indonesia's net FX reserves rose to USD 105bn, up from USD 93bn during the 'Fragile Five' panic in June last year. Indonesia's reserves have averaged USD 89bn since 2008.

- **South Africa:** ANC won a decisive victory in South Africa's elections, capturing 62% of the vote. This was widely expected and signals continuity in the country. There is now some upside potential in that the government's renewed political capital will be employed to deal with some of the country's deeper structural challenges by improving the investment climate and pursuing other supply-side policies.

- **Thailand:** Prime Minister Yingluck has been dismissed from office by the constitutional court along with nine cabinet members over abuse of office. The country is now run by a care-taker administration pending fresh elections. The odds are that these would usher in a government similar to the ousted Yingluck administration on account of deep binary divisions between income classes and rural/urban populations in Thailand.

- **Brazil:** A fresh poll issued by Datafolha (a credible pollster) shows support for President Dilma Rousseff's government dropping to 35%, down 1% in a month. The level of support for Dilma is still as great as the sum of support for all other candidates and we expect her to win the presidential election in October, although as her approval rating continues to slip, the odds are increasing that a second round run-off will be required to crown a winner. Meanwhile, inflation in Brazil was lower than expected in April. The IPCA index showed inflation at 0.67% mom, which was below consensus expectations of 0.79% mom. Regulated prices are pushing Brazil's inflation higher due to changes in electricity tariffs, while non-regulated prices, notably food prices, are falling. Core inflation is also declining in April's numbers but, at 6.28% yoy, inflation remains close to the top of the central bank's band (6.5% yoy) and up versus March (6.15% yoy).

- **Mexico:** Inflation was lower than expected as prices declined by 0.19% in April, which took inflation to 3.5% from 3.8% in March. Core inflation is running at 3.1%. Banxico's policy rate is 3.5%, unchanged in Friday's monetary policy meeting.

- **China:** Inflation declined to 1.8% yoy in April from 2.4% yoy in March. The large decline was due to a sharp fall in pork prices, while non-food prices rose slightly to 1.6% yoy from 1.5% yoy. The low level of inflation in China is useful at a time when large structural changes are causing growth to moderate. China, unlike many developed countries, has plenty of room to stimulate the economy both with fiscal and monetary policy, but we think the amount of stimulus required is very modest with larger interventions, if administered, targeted at particular sectors rather than the economy as a whole. Indeed, China's trade data surprised to the upside in April. Exports rose 0.9% yoy versus an expectation of -3.0% yoy, while imports rose 0.8% yoy versus an expectation of a decline of 2.0% yoy.

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Emerging Markets

- **Venezuela:** The effects of recent economic policy adjustments are now becoming evident in the macroeconomic data. In Q1, domestic demand declined by 6.2% yoy, imports collapsed alongside investment rates and purchases of vehicles. These are the consequences of devaluation in a country heavily dependent on imports due to policies that strongly discourage any production other than oil. Oil production and oil prices have however largely remained stable. The combination of a sharp collapse in domestic demand and stable oil production and prices are good for Venezuela's capacity to pay. It also underlines the tragedy of Venezuelan politics; namely a government that has convinced its people that it is on the side of the poor, while in fact the cost of its economic policies are almost exclusive borne by the local population, particularly by those with no access to inflation hedges. Venezuela is one of a very small number of EM countries that face genuine inflation problems.

- **Belarus:** Russia extended a USD 2bn loan to Belarus in order to replenish the country's FX reserves, which have dropped by USD 2bn since August 2013. Reserves currently stand at USD 2.6bn. Unlike Ukraine, Belarus has agreed to join the Russian-led Eurasian Economic Union. This is likely to mean a strong Russian 'put' under Belarus' poorly managed economy.

- **Argentina:** The Buenos Aires Grains Exchange has upped its forecast for this year's soybean crop to 54.5 million tons, a new record. The US harvest is also expected to be strong this year, but demand from China and drought elsewhere have so far helped to push prices for soybeans close to their all-time highs. This raises odds that Argentina will manage to avoid a balance of payments crises between now and the end of President Cristina Kirchner's term in 2015. Meanwhile, in the case of holdouts versus the government, the US Supreme Court has now completed the phase of receiving briefings from parties to the conflict ahead of its decision whether to take the case. Recall that the Second District Court of New York has already ruled that financial intermediaries must divert payments from performing bonds to holdout investors. If the Supreme Court does not take the case then the New York court's ruling stands. Coupon payments on Discount bonds and the Global 17s fall due on 30 June and 2 June, respectively. We would expect the government to offer holders of these bonds a swap into identical securities under local law. The Supreme Court could rule sometime in Q2 or in early Q4, but it could also ask the US Solicitor General to give its opinion on whether the Supreme Court should take the case – a decision that could take six months or more.

- **Turkey:** Industrial production is slowing. In March, output expanded at a pace of 4.2% yoy, down from 4.6% yoy in February. Turkey's central bank was recently forced to hike, which is likely to cause a slowdown in domestic demand, because Turkey's domestic economic expansion has been heavily dependent on credit. Still, a slowdown would be welcome news. Our view is that the domestic slowdown will help to improve Turkey's external balances this year.

Monetary policy:

- **Peru, Romania, Mexico, Indonesia, Czech Republic, Poland, South Korea** all left rates unchanged in their regular monetary policy meetings.

- The central bank of the **Philippines** kept policy rates unchanged, but raised reserve requirements by 100bps to 20% effective 30 May. Inflation is in the central bank's 3-5% target range, but growth is strong, which tilts odds in favour of a modest hike depending on the coming data releases. S&P raised Philippines sovereign rating from BBB- to BBB (both investment grade).

Global backdrop

The ECB did not ease policy last week despite recent strength in the EUR, but the market continues to hope for easing in June. ECB President Mario Draghi said he and his team were "comfortable to act", though he later discounted odds for QE. The fact that the EUR continues to show strength versus the US dollar continues to cause much consternation in currency markets due to a strong pre-disposition to bullishness about America and the Dollar and bearishness about anything European, especially the EUR. The facts, however, are clearly that the main drivers of currencies in the past few years have hardly been fundamental in nature, that is growth, inflation, and policy rates, which have been extremely low and stable in both sides of the Atlantic. Indeed, this is why EURUSD has been remarkably range-bound over the past 6-7 years. Instead, currencies have been pushed about by investors chasing yarns, stories, fads, and fashions. Here is a reminder of the main ones: Yarn number one – the Eurozone will break up. Yarn number two – monetary and fiscal stimulus ('Abenomics') solves all Japan's deep-rooted structural problems. Yarn number three – tapering ends the EM era. Each of these proved effective in driving massive changes in global currency portfolios even though we believe each yarn is proving completely fatuous. It would appear that investors focus more on what other investors are doing than on the fundamental validity of arguments put forward to support changes in portfolios. The danger of chasing yarns is of course that investors will miss the bigger fundamental picture and be caught on the wrong side

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Global backdrop

when fundamental drivers re-manifest themselves. We certainly believe that growth, inflation, and interest rates will begin to move again, probably within the next couple of years. The world will then become almost unrecognisable from today. Policy makers and voters in developed countries will find themselves yearning for inflation to take the sting out of higher rates because of still enormous debt burdens. EM central bankers will wish they had diversified faster out of Dollars as the relationship between money supply and inflation in the US suddenly returns with a vengeance. European and Japanese officials will be searching desperately for scapegoats to blame for the return of debt crises. This nasty déjà vu will of course be due to their own failures to recapitalise banks and fix other structural problems while money was cheap. EM countries will also face their fair share of challenges, but the EM universe is enormously diverse and investors have a wealth of options for how to defend the purchasing power of their assets by actively selecting their exposures.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.8%	1.1%	-2.4%	-1.9%	9.7%
MSCI EM Small Cap	0.5%	4.2%	-3.0%	-1.7%	13.2%
MSCI FM	1.0%	14.7%	26.7%	9.4%	12.2%
S&P 500	-0.19%	2.37%	17.91%	14.20%	17.57%
GBI EM GD	1.49%	4.34%	-8.85%	0.94%	7.83%
ELMI+	0.73%	1.49%	-2.27%	-1.16%	3.09%
EMBI GD	1.42%	6.51%	-0.19%	7.28%	10.40%
EMBI GD IG	1.54%	6.61%	-2.04%	6.01%	8.45%
EMBI GD HY	1.18%	6.35%	3.32%	9.54%	13.21%
5 year UST	0.32%	1.71%	-1.49%	2.62%	3.38%
7 year UST	0.34%	3.34%	-2.89%	3.95%	4.57%
10 year UST	0.36%	5.83%	-2.98%	6.05%	5.19%
CEMBI BD	0.63%	4.25%	1.16%	5.69%	10.54%
CEMBI BD HG	0.67%	4.60%	1.21%	6.13%	9.28%
CEMBI BD HY	0.55%	3.51%	1.06%	5.14%	14.83%
US HY	0.33%	4.29%	6.47%	9.51%	15.70%
European HY	0.47%	4.92%	11.34%	13.16%	19.10%
Barclays Ag	0.18%	3.75%	2.53%	2.42%	5.05%

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