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Ashmore

Tapering is priced and China returns

The most important developments last week were the market getting comfortable with the notion that tapering and rate hikes are not the same thing, and China rising from the ashes, once again defying predictions of an elusive hard landing. Emerging Markets inflation also failed to disappoint despite June's currency volatility, and we also think this will be the case going forward. **So what do you get when you add treasury market stability to improving sentiment about Emerging Markets? Answer: Opportunity.**

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	957.01		0.17%
MSCI FM	562.06		0.18%
GBI-GD	6.44%		0.83%
ELMI+	4.15%		0.40%
EMBI GD	5.74%	312 bps	0.10%
EMBI GD IG	4.84%	220 bps	-0.06%
EMBI GD HY	8.93%	653 bps	0.45%
CEMBI BD	5.63%	348 bps	0.12%
CEMBI BD HG	4.76%	261 bps	0.09%
CEMBI BD HY	7.54%	542 bps	0.14%

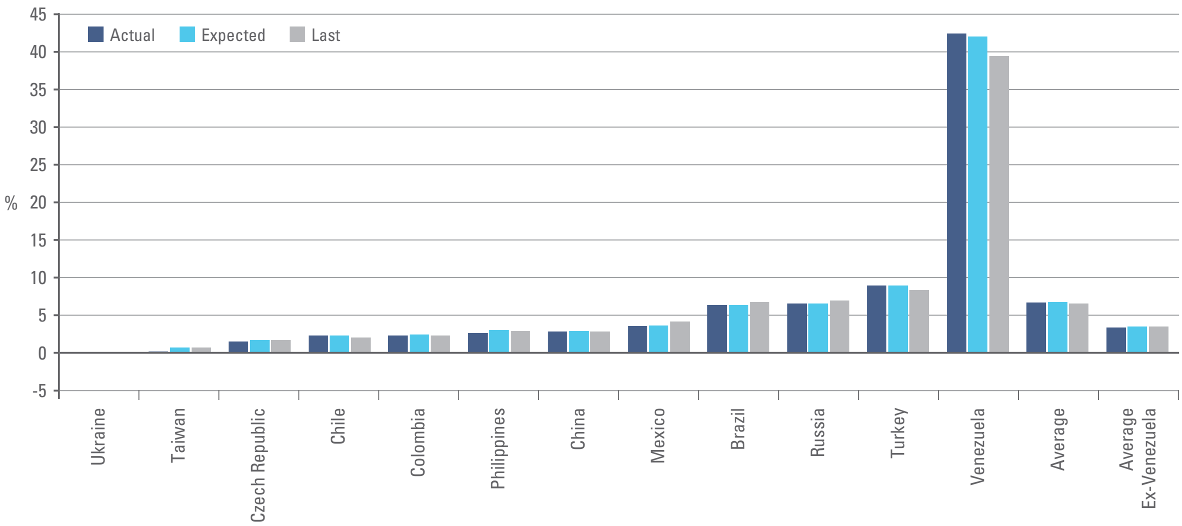
Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1691.42	-0.84%
VIX Index	13.41	13.26%
5 year UST	1.36%	-2 bps
10 year UST	2.58%	-6 bps
10 year Bund	1.68%	-1 bps
EURUSD	1.3323	0.49%
USDJPY	96.52	-1.84%
Brent	109.359	0.00%
Copper	333.64	3.31%
Gold	1331.69	2.15%

Emerging Markets

A backdrop of perky oil prices and currency volatility in June made this week's release of inflation prints across Emerging Markets interesting. Would Emerging Markets fundamentals fall apart as predicted by many on the back of the sell-off in June?

The answer was a resounding NO. In broad terms, June's market volatility had hardly any impact. In fact average inflation declined marginally across 11 of the 12 countries that reported inflation last week, from 3.42% yoy in June to 3.29% yoy in July. The inflation prints on average produced a small beat versus expectations – see Fig 1.

Fig 1: **CPI inflation (%, yoy) in 12 Emerging Markets economies**



Source: Bloomberg.

This week's inflation snapshot reflects the broader picture in Emerging Markets. Firstly there's a small group of countries – represented here by Venezuela – which have serious inflation problems. Venezuela's inflation rate increased from 39.6% yoy in June to 42.6% you in July. Second, a slightly larger number of larger Emerging Markets countries with a history of higher GDP growth operate with stable but somewhat higher inflation rates (Turkey, Russia, and Brazil). These countries saw inflation decline marginally from June to July. Finally, the largest group comprising the bulk of Emerging Markets economies saw inflation fall the fastest. These countries variously target inflation, maintain strong macroeconomic discipline, and have traditionally managed inflation at low levels.

Continued overleaf

Emerging Markets

Where is Emerging Markets inflation heading? In our view:

- Inflation discipline will be maintained across most Emerging Markets.
  Inflation is a big political no-no in Emerging Markets, where most ordinary people have no effective inflation hedge. The resulting low tolerance for inflation creates strong political buy-in for policies that keep inflation under control. Inflation risks are idiosyncratic, not systemic. The systemic inflation risks are in those countries that have the biggest debt and print the most money developed economies.
- Emerging Markets will experience disinflation over the medium term.
  This is mainly due to the way global imbalances will unwind. The world largely divides into developed economies with huge liabilities (public debt) and Emerging Markets with huge assets (FX reserves). These imbalances are unsustainable and will be resolved through falling real rates, rising inflation, currency weakness in developed economies and currency appreciation and slower growth in Emerging Markets. Slower growth and currency appreciation are both strongly disinflationary, so policy rates will decline. This should be good for local bonds.
- Credit calls will become more important – and inflation will be a key indicator to watch.
  Future inflation dynamics in Emerging Markets will increasingly be impacted by how countries respond to currency appreciation pressures, especially when inflation begins to rise in developed economies. Most Emerging Markets will accept stronger currencies, reform, and adapt, though some will react late but get there in the end. Inflation risks will be highest in countries with major political problems, because bad politics creates myopia. The good news is that the high risk countries constitute a very small part of the 65+ country Emerging Markets universe.
- Emerging Markets central banks manage inflation asymmetrically – at a small loss of efficiency.
  Emerging Markets central banks cut early and hike late. Wrongly failing to cut rates risks recession, which is costlier politically than hiking a bit late to crush inflation once growth picks up. This asymmetry is less efficient than perfect foresight, but safer. The loss of efficiency is small in countries prone to volatility due to their relatively less diversified economic structures.

Global backdrop

There were two important shifts in the global backdrop this week.

First, sentiment about Emerging Markets improved on the back of better macroeconomic data out of China. Once again, it appears, the prediction of a hard landing in China proved unfounded. Chinese exports in July rose 5.1% yoy against estimates of a 2% rise and imports rose 10.9% yoy versus a market expectation of just 1%. Beneath the bonnet of the import data, copper imports rose to 14-month high, iron ore imports hit a record high, crude imports soared to a record high, and soy imports too hit a record high. Additionally, new loans in July increased by CNY700bn versus CNY640bn expected, while the ratio of broad to narrow money expanded in a sign that the banking system is lending. The on-balance sheet share of credit increased to 86.5% (from 28% in Dec 2012), which is a sign that China's drive to move financing onto transparent platforms (i.e. on balance sheet) is working without causing a major problem with credit supply overall. That said, in our view China's growth is not suddenly going to accelerate. China is transitioning to domestic demand-led growth, and this will take several years. During this time growth will remain below recent averages. There are also profound implications for macroeconomic policy. The good news is that China will be better prepared than most for the world of tomorrow.

The second important development last week was that the market became more comfortable with the idea that Quantitative Easing tapering – which is due to start next month – is not going to translate into interest rate hikes. Both the Fed minutes and Chairman Bernanke himself have reiterated this point frequently, but without much success. However FOMC officials Evans, Pianalto, Lockhart, and Fischer all pointed to a September start for tapering. In contrast with previous such statements, the US treasury market did not over-react. Rationality and a modicum of sophistication appear to be returning to this market.

Finally, it is worth pointing out that a hangover has now arrived at the door step of Prime Minister Shinzo Abe in Japan. This follows his Senate election victory on the back of one of the world's most aggressive politically motivated artificial stock market booms in recent memory. Unable to sustain the pre-election pace of fiscal and monetary stimulus going forward Abe now faces the tougher challenge of dealing with Japan's deep-seated structural problems. Meanwhile, Europe sentiment is moving the other way, improving with an upturn in the manufacturing cycle. As in Japan, however, significant structural problems lurk beneath the surface.

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