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Ashmore

Renminbi a global reserve currency by 2015

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The Chinese renminbi is now a prime candidate for inclusion in the IMF's SDR, meaning global reserve currency status in 2015. This is only the start of the rise of the Renminbi, which we believe will compete directly with both the Euro and the Dollar and outperform both due to China's dramatically stronger fundamentals. We also discuss how Saudi Arabia will adjust to lower oil prices and review how falling prices have seen falling inflation rates across a number of EM countries. The Russia-Ukraine story is moving and Russia hiked rates again. Plus we note issues of relevance to serious investors in Mexico, Brazil, Malaysia, Turkey, India and Nigeria. As for the global backdrop, Santa is coming, so the markets are getting more illiquid and volatile; we recommend a healthy dose of discounting of the price action in the next few weeks.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	932	–	-4.54%
MSCI EM Small Cap	980	–	-2.67%
MSCI FM	590	–	-5.43%
GBI EM GD	6.60%	–	-1.88%
EM FX spot	–	–	-1.21%
ELMI+	4.43%	–	-0.60%
EMBI GD	5.86%	374 bps	-2.63%
EMBI GD IG	4.60%	244 bps	-1.65%
EMBI GD HY	8.59%	661 bps	-4.37%
CEMBI BD	5.60%	367 bps	-1.01%
CEMBI BD HG	4.49%	255 bps	-0.52%
CEMBI BD HY	8.05%	615 bps	-2.06%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2002	-2.77%
VIX Index	21.08	48.35%
5 year UST	1.57%	-10 bps
7 year UST	1.90%	-12 bps
10 year UST	2.13%	-13 bps
US HY	7.42%	-1.86%
European HY	5.19%	-0.65%
EURUSD	1.2426	0.89%
USDJPY	118.66	-1.76%
Brent	62.21	-5.27%
Copper	300.41	-0.97%
Gold	1211.76	1.52%

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

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- **China:** China's renminbi (CNY, but also referred to as RMB) is on track to become a global reserve currency as early as 2015. The pace of financial liberalisation has been so rapid that late next year, when the IMF conducts its twice-a-decade review of currencies for qualification for inclusion in the Special Drawing Right (SDR) it may well choose to include the CNY for the first time. About time. China trades more than any other country on earth and has made dramatic progress towards making its currency freely usable, including rolling out RQFII programs and the Shanghai-Hong Kong stock connect. China's bid is likely to get widespread support from most IMF members. China's currency is destined not only to be the strongest currency in the world but also one of the largest and most widely used. As such, it will compete directly with both the USD and EUR. China has dramatically stronger public finances, faster growth and healthier external balances than either the US or Europe. But perhaps the most important driving factor for China and its currency is that the country is constantly reforming in order to stay ahead of global developments. By contrast, the heavily indebted developed countries have squandered seven years of hyper-easy monetary policy by failing to reform or deleverage. Those chickens will come home to roost. We see two risks to the base case of CNY promotion to global reserve currency status. First, the Chinese themselves may feel that they still need to develop their domestic financial institutions further before proceeding with more capital account liberalisation. If so, inclusion could be made conditional upon terms acceptable to the Chinese themselves. Secondly, the US could use its veto. A US veto would be a sign of profound weakness in our view, equivalent to King Canute's futile attempt to keep out the rising tide. Regardless of the US reaction, we think the Chinese currency will be among the strongest in the world over the next decade, aided by international inflows to its domestic markets. The technicals are mind-boggling. Foreigners have virtually zero exposure to the massive local bond market (USD 4.4trn -equivalent to 25% of US GDP) and the onshore stock market (USD 5.25trn equivalent to 30% of US GDP). In addition, the Chinese central bank is likely to diversify its own reserves away from the Dollar, while continuing to promote its currency for use in trade, finance and as a reserve currency by other official sector institutions.

Falling inflation: Real domestic bond yields are rising in EM due to a combination of year-end risk aversion, central bank reluctance to cut rates and – importantly – slowing inflation. Inflation is falling mainly due to declining oil prices. The combination of steady nominal yields but falling inflation is increasing the value embedded in local bond markets. But there are broader implications too. Remember why investors are selling local currency: the market is assuming that rising rates in the US will trigger massive outflows from EM that in

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turn will generate inflation via the pass-through from currency weakness. Worse, as EM central banks are then forced to hike rates, their economies collapse, undermining demand for EM FX even further. Well, this is simply not happening. Over the past two years, EM spot exchange rates have declined 20% versus the Dollar (due to a combination of the last year's 'Taper Tantrum' and this year's 'Tightening Tantrum'). Yet, inflation is not only benign, it is actually falling. Currencies will gyrate, as currencies do. But real rates are what matter to bond markets and, ultimately, returns. If EM inflation remains under control then EM currencies will also get stronger. In the past week alone inflation declined month on month in India, South Africa, Hungary, Romania, Dominican Republic, China and Mexico. As for central banks, Bank of Korea left rates unchanged at 2%, while The Philippines central bank left the policy rate and special deposit account rates unchanged at 4% and 2.5%, respectively. Bank Indonesia left the policy rate unchanged at 7.75% (lending rate also unchanged at 5.75%). Peru also left rates unchanged at 3.5%, citing increased global market volatility. China's PBOC injected liquidity via China Development Bank which will then extend the short-term financing to other banks via the large interbank market. These are liquidity injections. They are common in China and do not comprise policy easing.

- Saudi Arabia: The decline in oil prices will compel Saudi Arabia to rethink its fiscal spending program. If expenditures continue at the actual pace of 2014, export capacity is maintained at 7m bpd and oil is priced at USD70 per barrel then Saudi Arabia will deplete its foreign reserves by 2022. This means that Saudi Arabia is starting out from a position of very sizeable fiscal buffers due to average budget surpluses of 11% of GDP over the past 11 years. Indeed, the only deficit was in 2009 when Brent oil averaged USD 62 per barrel, when Saudi Arabia ran a manageable deficit of 5.4% of GDP.

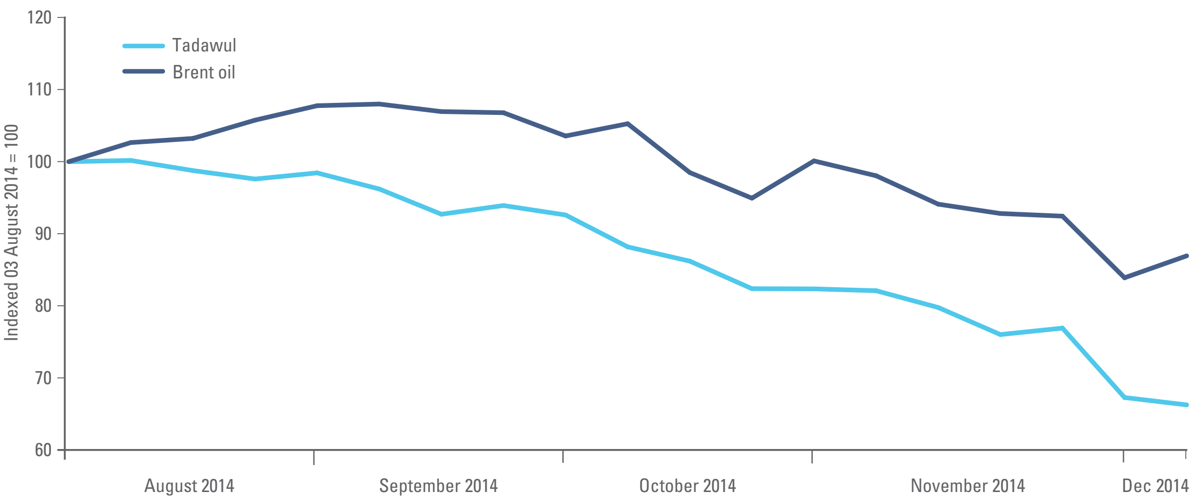
The first 'winner' to emerge from falling oil prices is rationality. The decline in oil revenues has a clear silver lining as it offers the government an opportunity to push forward the Tenth National Development Plan, a central tenet of which is to introduce Key Performance Indicators (KPIs) for line ministries. The idea is to institutionalise spending prioritisation and efficiency improvements through a rational medium term expenditure framework. This process is now likely to receive a boost. Moreover, it's opportune to link diversification efforts in all segments of the economy with particular targets and goals for each ministry.

As far as immediate fiscal adjustment is concerned, the policy of expanding budgetary outlays by an annual rate of 14% per annum in 2008-2013 is obviously now likely to be changed. In doing so, the aim will be to strike a delicate balance between expenditure and revenue without sacrificing the development goals of the country. Overspending which averaged 25% in 2004-2013 is expected to be reined in.

Meaningful fiscal discipline is likely to feature prominently in the 2015 budget, expressed both on the expenditure and revenue sides. Current expenditures – mainly salaries and wages for 2014 – are unlikely to change much. Rather, capital spending, which makes up a large part of overall fiscal outlays, will be slashed or prolonged over a longer time-frame with the exception of national priority projects such as development plans in the holy cities of Mecca and Medina and housing and transportation projects that address important quality of life needs. All have earmarked resources from past budget surpluses and pose no major fiscal risk. Economic aid to regional states such as Egypt, Jordan and Yemen is not anticipated to burden the 2015 budget.

On the revenue side, the intention will be to increase non-oil revenues. A complicating factor here is that the broader economy is being hit indirectly through wealth effects as the stock market has recorded an unusually high correlation of 0.64 with the price of oil (see chart below). Taxes on vacant land are being considered, but in Saudi Arabia raising domestic energy prices are more politically unpalatable than in other EM countries, despite their size (12% of GDP) and distortive effects.

Fig 1: **Tadawul and Brent oil**



Source: Bloomberg.

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Saudi Arabia is also likely to finance more of its public spending with debt. Debt to GDP stands at just 2.7% of GDP, but this means that excessively rapid issuance would quickly impact liquidity. A gradual approach seems likely.

Much obviously depends on the further evolution of oil prices. Our oil view is that the move in prices has been exaggerated somewhat to the downside. We believe that as global economies – especially in the US and China – recover and the rest of the Emerging Markets pick up from 2015 onwards there will enough demand to sustain a gradual increase in oil prices. The steep and sudden decline in oil prices should therefore not lead to gloomy predictions of Saudi Arabia's fiscal outlook.

Revenues of SR700 bn in 2015 against expenditures of SR800 bn could comfortably be covered by a combination of deficit financing from accumulated savings of past surpluses and occasional fresh issuance of debt. This policy mix would be sustainable over the medium term. Over time, Saudi Arabia's non-oil deficit should decline as infrastructure spending gradually levels out. In the short run, fiscal performance will meander in line with the actual spending versus the announced annual outlay targets, but unless oil prices spike in 2015 overspending on a sustained basis should now be thing of the past. This is a good thing.

- Russia-Ukraine conflict: At the start of the conflict in Eastern Ukraine in February 2014, all parties saw political upside in escalating the conflict while the economic consequences were conveniently ignored. Today, this equation has been turned on its head. All sides are now smarting from the economic consequences of war, while the political upside from further escalation has become unclear or downright non-existent. All sides now have greater incentives to find a solution.

With resolution, Ukraine faces a possible 'frozen' conflict on its territory and an unsustainable economic situation. Russia's pain is evident in the weakening of the RUB and rising inflation. Europe is being presented with another hefty bill to keep Ukraine afloat – and one that could prove to be recurring unless the conflict finds resolution – or letting Ukraine fail at the risk of another European default (which will be blamed on German Chancellor Merkel) and chaos on the very borders of the EU. The US has little skin in the game, but with a bit of vision it could broker a deal as Bill Clinton successfully did in the Balkan conflict in the 1990s. This offers pure upside potential for President Obama.

All of this adds up to improving odds of an end to the conflict. News that Russian troops have arrived in Donetsk at the request of the Ukrainians – on the surface a curious headline given that the two sides are at war – means that Russia is trying to assert control over the separatists as a precursor to a broader settlement. Russia has also called an urgent 'contact group' meeting. Renewed Russia-Ukraine gas trading and peace talks in Minsk also point to progress.

What needs to happen to make a deal hold? The ingredients have always been: (a) a mutual decision on the part of all parties to ignore the question of Crimea; (b) a political settlement in Eastern Ukraine; and (c) renewing trust between Germany (EU) and Russia over their mutual financial and energy-related interests.

In practice, this means that a lasting ceasefire in Donbass followed by legitimate elections will have to be put in place. A resumption of coal supplies from Donbass to the rest of Ukraine can then go ahead. Fresh financing from the IMF is also needed to keep Ukraine on an even keel. The amount of foreign currency financial support Ukraine needs depends critically on ending the conflict in Donbass. For example, Ukraine's FX bill – and therefore the volume of IMF funding required – would fall by as much as USD 13bn (at current oil prices) if coal sales from Donbass to Western Ukraine were to resume. A peace deal in Donbass would also dramatically reduce the drain on Russia's finances as Donbass would gain financial self-sufficiency. The added benefit to the Russians would be that fresh support from the West would enable Ukraine to repay its many obligations to Russia. In turn, that would enable Europe to lower its financial commitments to Ukraine as Russia resumes lending, particularly if prospects for removal of sanctions improved. In related news, the Ukrainian parliament approved the government's reform programme required for IMF financing.

- Russia: The Russian central bank's decision to hike rates by 100bps to 10.5% is the right decision in our view. Inflation has risen and it is important that the central bank keeps inflation expectations in check. As for the impact on the RUB, the right instrument is not rates. The RUB should move with oil prices as befits the currency of an oil producer. Unless bank deposits show signs of major flight risk it is right to let the market determine the value of the currency. It may become necessary for the Russian central bank at some point to intervene in the currency, but then timing becomes critical. Oil prices have yet to settle and current markets conditions are illiquid due to year-end effects. Hence, it is not a great time to intervene.

Stepping back, it is clear that the Russian central bank is focused on inflation. Good. Russia has 14% debt to GDP ratio and USD 420bn of reserves. Very good. Policy makers are right not to panic. The main challenge right now is a so-called 'buyers' strike', meaning that investors are not buying despite evident value. Buyers' strikes arise because of high momentum in prices as well as illiquidity concerns (i.e. the inability to exit a trade once it has been entered into). Both are technical in nature and temporary, likely to improve meaningfully in January after the holiday seasons (Western and Russian). It is noteworthy that Russian sovereign bonds now trade materially wider than Zambia, Sri Lanka, Senegal, Paraguay, Pakistan, Lebanon, Kenya, Jamaica, and Angola.

In other material Russian news Rosneft, the state owned oil company, raised the RUB equivalent of more than USD 11bn in an off-market transaction. This funding is required to settle the latest instalment in the payment for

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the TNK-BP purchase. Rosneft will now convert the RUB into USD via the domestic banking system, which in turn will tap into Russia's USD 420bn in FX reserves. The removal of this liability is positive. Clearly, mechanisms exist for Russian corporates to finance in Dollars despite sanctions. For 2015, the Russian central bank anticipates about USD 100bn in Dollar liabilities coming due but 25% of these are in fact RUB liabilities, while as much as 25% are inter-company liabilities that do not comprise a net Dollar need. Thus, we think the total drain on Russia's reserves in 2015 could be closer to USD 50bn, which is very manageable. One final point to make on the Rosneft deal: it is not going to be widely available to all corporates in Russia. As such, this operation looks similar to what Russia did in 2008/2009, when a few select institutions - state banks at the time – secured dollars and credit, while the cost of adjusting was pushed to the others. The strong survived, the weak got hurt. This deal suggests that strong state names may well be a great deal safer than the market is pricing.

- Malaysia: Malaysia has been under some pressure recently due to lower oil prices. The negative price action is based on little else than the fact that Malaysia is Asia's only large country with the status of net energy exporter. The argument is easy to make: Petronas' dividends could decline and the current account surplus would shrink. This analysis, however, fails to take into account that the government is likely to react to change in oil prices. Lower oil prices will result in lower fuel subsides and the government is on track to introduce VAT in April next year. Policy rates are 3.25% in Malaysia, so the central bank has plenty of room to cut rates Malaysia's current account surplus is a whopping 5.5% of GDP. As a minor testament to Malaysia's very healthy fundamentals, industrial production rose 5% yoy in October versus 4.2% yoy expected.

- Brazil: The monetary policy committee of the Brazilian central bank (COPOM) released the minutes that accompanied its recent decision to hike 50bps. They contained the code phrases "especially vigilant" and "parsimony", which translate into further rate hikes, but at a moderate measured pace. This seems like a sensible strategy. Fiscal policy will lead the policy restoration of credibility in Brazil as only when fiscal policy has improved should the central bank begin to ease. Further hikes at this point however would be relatively ineffective given that centrality of the fiscal problem. The Selic policy rate has so far been raised from 7.25% in early 2013 to 11.75%. The peak of the previous rate hike cycle was 12.50%.

- Mexico: Gross fixed investment slowed in September, though the pace of investment remained strong on a yoy basis. The slowdown relative to August was -0.43%, but the yoy rate rose from 3.9% yoy in August to 5.7% in September. Within the overall investment picture, construction rose at the strongest pace since 2012. In a development that got the media very excited for 24 hours, the Mexican Exchange Rate Commission re-initiated a time-worn mechanism for managing currency volatility. Under the market-friendly rules-based system the Mexicans offer fixed USD 200m blocks of Dollars to the FX market, whenever the MXN weakens by more than 1.5% from the previous day's fix. The mechanism is not intended to fight currency depreciation; it is entirely a measure to prevent excessive volatility. Currency markets have displayed considerable volatility in December due mainly to year-end effects. In addition, Mexico has been singled out for special treatment by the 'fast money crowd' on account of its large liquid markets, the falling oil price and domestic political noise due to drug-related violence in parts of Mexico.

- Turkey: GDP growth in Q3 was strong with positive contributions from consumption, investment, exports and declining imports. The performance of each of these components of GDP rose strongly on a sequential basis. Only one component – change in inventories – detracted from the overall picture. Inventories declined by a whopping 2.4% of GDP and thus caused the overall GDP print to fall short of expectations (1.7% qoq versus 2.8% qoq expected). However, the drawdown in inventories may well turn out to be a good thing. Given the pickup in government and household spending, as well as exports, it is likely that Turkish firms will have to boost production in the coming quarters. This bodes well for growth in Q4, in our view.

- India: The government has taken an important step forward to strengthen the weakest part of the Indian banking system by approving state banks to raise an additional USD 26bn equity to boost bank capital. Strengthening of state banks will be critical not just to improving lending in India, but also to prepare the banks for further liberalisation of the capital account. The government will maintain overall control of the state banks. In other news, CPI and WPI inflation both continued to decline. CPI inflation fell to 4.4% yoy in November from 5.5% yoy in October. November WPI inflation was 0% mom vs 1.08% mom expected, down from 1.77% mom in the month of October. Industrial production was softer than expected, but mainly due to working day adjustments on account of Diwali and a single corporate shutdown.

- Indonesia: The currency weakened sharply last week mainly for technical reasons. Taking effect on 1 January 2015, new regulations issued by Bank Indonesia require non-bank corporates to hedge 20% of their uncovered FX liabilities with less than 6 months to maturity and to provide liquid foreign assets to cover at least 50% of their FX liabilities falling due within 3 months. The scramble by some corporates to meet these requirements in highly illiquid conditions ahead of year-end accounts for the volatility in FX. The new regulations further strengthen Indonesia's domestic corporates from large moves in exchange rates. The net FX exposure of EM corporates should be assessed on a case by case basis. In general, we think most EM corporates hedge major FX liabilities, while others can offset FX liabilities against FX assets.

- Nigeria: President Jonathan has been selected as the candidate for the ruling PDP in the presidential election scheduled for 14 February 2015. The main opposition parties have yet to appoint their candidates.

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Global backdrop

Warning! Santa is coming! The usual decline in December trading volumes is causing some volatility, aided by headline grabbing political and policy-related events between now and year-end. Investors should heavily discount short term price volatility at this time, in our view. One event of note is the 17 December FOMC meeting, wherein the Fed is likely to replace the "considerable period" phrase with some other indication that it is patient. Growth in Q4 is now only tracking 2.0% after retail sales, business inventories and a reversal in defence spending. This means that US growth in Q4 is now less than half of the speed of growth in Q3. On the other hand, consumer confidence is setting new highs, aided by falling energy prices. Hence, the change in wording should not be seen to be a sign of imminent hawkishness. Rather, the Fed only anticipates to implement the first rate hike in June 2015, so "considerable period" has to be dropped because it was originally defined to mean six months. On 17 December, Greece's parliament begins to vote on a new president. It has until 29 December to do this. With a majority of 155 votes, but in need of 180 votes, this vote could easily fail. If it does, parliament is dissolved and elections called within 10 days and held within a further 21 days. Polls show that the pro-default Syriza party may now be the largest in Greece. Greece's debt to GDP ratio is more than 170% and will need another haircut, in our view. Meanwhile, elsewhere in Europe the take-up of the second LTRO from the ECB was EUR 130bn, thus taking the total take-up so far to EUR 213bn. This is nearly EUR 200bn less than the maximum available. The target by 2016 is EUR 3trn. The take-up is low because there is little demand for credit due to the many structural and debt related problems facing the Eurozone, in addition to lingering questions about the health of Europe's banks. Europe, like Japan and the US, continue to squander hyper-easy monetary policies by failing to reform and deleverage. Finally, as predicted by numerous polls Japanese voters renewed Prime Minister Shinzo Abe's mandate to pursue further efforts to inflation and devalue Japan out of its enormous debt problems

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-7.1%	-4.0%	-2.7%	3.4%	2.1%
MSCI EM Small Cap	-4.5%	0.1%	1.5%	7.2%	3.7%
MSCI FM	-7.5%	4.8%	6.4%	12.3%	8.0%
S&P 500	-3.06%	10.48%	15.10%	19.97%	14.97%
GBI EM GD	-5.49%	-5.28%	-5.88%	0.02%	2.70%
ELMI+	-2.35%	-6.72%	-7.06%	-0.79%	-0.43%
EM spot FX	-3.75%	-11.90%	-12.58%	NA	NA
EMBI GD	-3.86%	5.73%	6.27%	5.74%	7.24%
EMBI GD IG	-2.56%	8.03%	8.10%	4.83%	6.33%
EMBI GD HY	-6.17%	1.75%	3.23%	7.17%	8.52%
5 year UST	-0.05%	3.93%	2.99%	1.19%	3.44%
7 year UST	0.36%	7.65%	6.39%	2.16%	5.21%
10 year UST	1.04%	13.07%	12.13%	3.73%	6.75%
CEMBI BD	-2.27%	4.59%	4.77%	6.31%	6.77%
CEMBI BD HG	-1.16%	6.92%	6.91%	6.24%	6.77%
CEMBI BD HY	-4.54%	-0.16%	0.41%	6.84%	7.12%
US HY	-3.31%	0.47%	0.90%	8.35%	9.34%
European HY	-0.35%	5.45%	6.31%	15.30%	12.37%
Barclays Agg	0.09%	1.37%	1.01%	1.16%	2.44%

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

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