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Ashmore

Is the Cold War coming back?

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Is the Cold War coming back? Judging by recent exchanges between NATO officials and Russia's Medvedev, the answer is yes. We beg to differ. We outline why this question is extra-ordinarily important for Emerging Markets (EM) countries and explain why fears of a return of the Cold War of old are unfounded. We also explain the world's Dollar Problem, a vicious cycle where the stronger Dollar destroys growth, which in turn begets an even stronger Dollar. There is of course nothing new in this, except that the strong Dollar is now also hurting the US. And that is why a Dollar Accord is no longer a remote possibility.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.4	–	-3.83%
MSCI EM Small Cap	10.0	–	-4.30%
MSCI Frontier	8.2	–	-1.11%
MSCI Asia	9.8	–	-3.70%
Shanghai Composite	9.9	–	0.95%
Hong Kong Hang Seng	5.5	–	-6.84%
MSCI EMEA	8.1	–	-3.37%
MSCI Latam	10.1	–	-3.62%
GBI-EM-GD	6.85%	–	-0.47%
ELMI+	4.35%	–	-0.53%
EM FX spot	–	–	-0.50%
EMBI GD	6.64%	487 bps	-0.60%
EMBI GD IG	4.94%	310 bps	-0.20%
EMBI GD HY	9.04%	741 bps	-1.08%
CEMBI BD	6.57%	500 bps	-0.38%
CEMBI BD IG	4.80%	324 bps	-0.05%
CEMBI BD Non-IG	9.81%	824 bps	-0.94%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P500	13.7	–	-0.72%
1-3yr UST	0.72%	–	0.04%
3-5yr UST	1.21%	–	0.11%
7-10yr UST	1.75%	–	0.62%
10yr+ UST	2.61%	–	1.79%
10yr+ Germany	0.25%	–	1.08%
10yr+ Japan	0.09%	–	-1.05%
US HY	10.33%	902 bps	-1.93%
European HY	7.05%	713 bps	-1.98%
Barclays Ag	–	226 bps	-0.39%
VIX Index*	25.40	–	2.02%
DXY Index*	96.50	–	-0.07%
EURUSD	1.1177	–	-0.14%
USDJPY	114.16	–	-1.46%
CRY Index*	160.36	–	-1.57%
Brent	33.7	–	2.43%
Gold spot	1213	–	1.96%

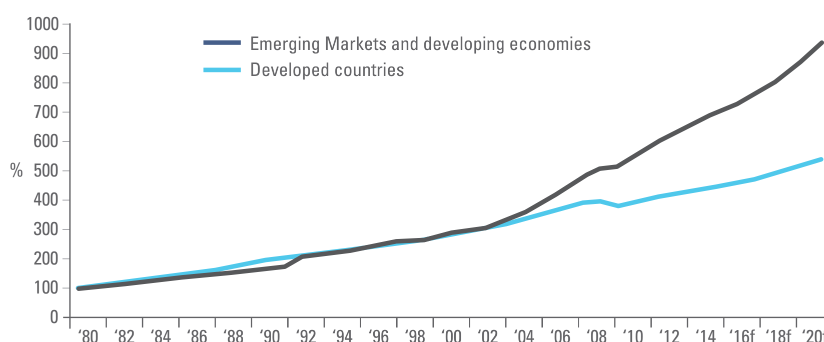
Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Is the Cold War coming back?

As world leaders gather in Munich for their annual security summit, the air is already full of alarmist messages about the return of the Cold War. NATO Chief Jens Stoltenberg and Russian Prime Minister Dmitry Medvedev have traded accusations ahead of the conference, each blaming the other for rising tensions, particularly in and around the Syrian theatre. At first sight, it does indeed look ominously like the bad old Cold War days are back. But are they? And what should EM investors make of the rising tensions between Russia and NATO?

Let there be no doubt about the importance of this question – it is of extreme importance to EM investors. Recall that the original Cold War, which lasted from the end of World War II to the collapse of the Soviet Union in 1989, was an unmitigated disaster for EM. This is perhaps best illustrated in the figure 1 below, which shows per capita income in developed and EM countries from 1980 to 2020 (indexed to 100 in 1980). The data is from the IMF's World Economic Outlook, October 2015 and based on IMF forecasts.

Fig 1: **Cold War, thaw and take-off: Per capita income in EM and developed economies 1980-2020**



Source: IMF, Ashmore.

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Three clear phases can be discerned – the Cold War period up to the early 1990s, the transition period between the early 1990s and the early 2000s and the period since the early 2000s. The former saw per capita income in EM countries expand slower than in developed countries. By the early 2000s, this underperformance is replaced by a dramatic and accelerating outperformance.

As the chart shows, the Cold War period was damaging for EM because the otherwise natural forces of economic convergence, which cause EM countries to outgrow developed economies, were actually put into reverse. The result was horrific political and economic conditions. Indeed, conditions were so bad that it took EM countries the better part of the 1990s to adjust before they had finally overcome the hangovers from the Cold War. Only by the 2000s were EM countries able to begin to realise their growth potential.

The Cold War was damaging for EM countries for two reasons. One was that the protagonists in the conflict – the Soviet Union and NATO – fought numerous 'hot' wars with EM countries as proxies. Examples include the Greek civil war, the Korean War, the Vietnam War, the Angolan civil war, various iterations of Middle East conflicts, the Indo-Pakistani war, the Soviet war in Afghanistan, the US invasions of Grenada and Panama, the Cuban Missile Crisis, various crushed uprisings against the Soviet Union in Easter Europe, etc. Needless to say, these wars had substantial economic costs.

The other less recognised, but far more important reason why the Cold War was so devastating for EM was that the Superpowers installed unaccountable dictators in countries right across the EM world. Nearly all of EM was impacted; almost every country in Latin America was a CIA sponsored dictatorship, almost every country in Eastern Europe a KGB sponsored dictatorship and most African countries one or the other. The situation in Asia and the Middle East was no better. The accountability of these despots was to their Superpower overlords rather than to their own people. Propped up by foreign money and guns, they ruled with impunity. The complete lack of local political accountability led to rampant corruption, populism, economic mismanagement and human rights abuses on a scale that seems almost incomprehensible today. Needless to say, coups were frequent, often bloody. No one in their right mind invested in such countries, except for short spells during commodity price booms. Much of the now outdated perception that EM investing is a 'commodity play' dates back to this period.

The good news is that the Cold War is not coming back as far as the vast majority of EM countries are concerned. The most obvious reason is that none of the original Superpowers have the financial or political clout to re-install and control puppet governments across the 165 odd EM countries. EM countries themselves are much richer and stronger militarily. And China, the new Superpower kid on the block, has never harboured ambitions to exercise global control and its strategic political ambitions do not reach far beyond its most strategically important neighbours. In particular, the long reach of China's economic power has not been accompanied by an equally ambitious military and political agenda.

There is another reason why it is wrong to conclude from the rising tensions in Syria that the Cold War is coming back. The truth is that the Cold War never actually ended in the Middle East, which retains its essential strategic importance on account of the region's enormous wealth of energy resources. The 2008/2009 crisis in developed economies may have forced the West to rationalise its support of authoritarian governments in Middle Eastern periphery resulting in the Arab Spring in North Africa, but the fight between Russia and the West for influence over the core Middle Eastern countries never abated. This is also why, should President Assad's forces manage to take Aleppo and thereby effectively end the war in Syria, the implications are not as serious as they may seem at first sight. After all, it 'only' means that Syria reverts to its former sphere of Russian influence. Europe, of course, is concerned, but its concern is not primarily that Russia re-manifests its control over Syria; rather it is that the resulting stream of refugees to Europe poses huge problems for the European Union, which has so far proven completely unable to organise credible border controls and a rational policy for distributing refugees within in its borders.

It is also important to consider the domestic political context of the alleged new Cold War protagonists. President Obama, Chancellor Merkel and Prime Minister Cameron are all in their second/final terms in office. It is customary to conduct foreign policy in second terms, because leaders usually do not have enough political capital left in order to undertake domestic policy changes. In Russia, the situation also calls for more foreign policy activism, albeit for different reasons. Russia is undergoing a painful adjustment to lower prices, so President Putin has a strong incentive to whip up a few distractions in the Middle East to detract attention from issues at home. In other words, the rise in Russo-Western tensions may not be evidence of Cold War per se as much as simply a confluence of transitory domestic weakness in both the West and in Russia.

If anything, there are signs that another remnant of the Cold War in EM is in the process of collapsing. Three populist governments in Latin America that have, at various times, made heavy use of anti-American Cold War style rhetoric to win and hold on to power have recently fallen or are well on the way to falling. They are Argentina, Venezuela and Brazil. Cuba is also thawing relations with the United States. Ecuador, Nicaragua and Bolivia have become far more pragmatic. It is extremely positive that the false political choice between right-wing and left-wing authoritarian and populist governments in a region as burdened by inequality as Latin America gives way to more technocratic governments that have a genuine chance of delivering sustainable economic progress.

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The Dollar Problem

The Dollar is rapidly becoming the biggest economic problem in the world. The strong Dollar is pushing the US economy to a stand-still and jeopardising global growth by tightening financial conditions for everyone else. The Dollar is driven by fear. Each time it rallies, it slows growth, which creates more fear, which in turn causes the Dollar to rally even more and so on. At the root of the Dollar problem is the deteriorating political and economic outlook, particularly in developed economies, where (a) most of the world's capital is invested; (b) a downturn is unfolding and (c) policy makers have barely any policy tools left.

The situation is made worse by the Dollar's impact via commodity prices. A rising Dollar pushes down commodity prices, which eliminates much of the windfall that has fuelled the US stock markets in recent years. When oil traded at USD 100 per barrel, Saudi Arabia's windfall would be USD 91 per barrel, which went straight into US stocks. Now it is USD 21, assuming USD 9 per barrel extraction cost.

The real threat to the global economy remains the developed economies, not EM. QE programs are running out of effectiveness. US stocks turned negative last year and have continued to perform badly this year. More than 40% of European bonds now pay negative yields. Ten year Japan yields are negative. There is very little if any upside left in developed markets.

Central banks are turning to negative policy rates in a bid to keep the party going, but this only hurts bank funding – by taxing deposits - so banks may have to deleverage. Too much funding is now going into hedging Dollar liabilities instead of financing productive investment in the real economy: this is not good.

It is becoming increasingly urgent to break the vicious and irrational cycle of tightening Dollar liquidity, not just in the interest of the US economy, but also in the interest of the entire global economy.

Central banks will have to play a key role in this process, but the incentive facing each individual central bank is to hoard Dollars, which, in aggregate, only worsens the problem. That is why careful coordination at the highest political level is required to overcome the moral hazard problem. A Dollar Accord is likely to be required to arrest the self-defeating surge in – and coordinate an orderly decline of – the US dollar.

The odds of a Dollar Accord are rising, because the US is now also hurting from the Dollar. This means that something can actually be done, given the fact that the US still has de facto veto power in matters of global finance.

Sadly, navel-gazing policy-makers in developed economies are distracted by other issues. Merkel is dealing with refugees. Cameron is thinking Brexit. Obama is preparing for retirement. Abe is trying to resuscitate a failing economic program with even more short-term stimulus. A bit more pain may be required to focus minds.

Until then, central banks will continue to try to hold things together even as they struggle with growing impotence and loss of credibility. These problems were on painful display at Fed Chairwoman Janet Yellen's testimony to Congress last week. She came under vicious attack from elected members concerned about the recent downturn in the economy and poor stock market performance. Yellen struck a dovish tone, but she failed to reassure markets.

It is clear that the Fed is dramatically behind the curve. The actual data, inflation expectations, markets, all say that the Fed made a mistake by hiking in December. They simply did not read the economy right. Now they have to run just to stand still. Some may say that Yellen missed an opportunity to close the credibility gap. Perhaps she did not want to venture too far from script without consulting with the rest of the FOMC. Either way, she did not impart confidence and leadership.

At the end of the day it actually does not matter what Yellen says. It is naive to continue to expect a single central bank to fix the problem. The returns to further monetary stimulus in the US are diminishing, perhaps even negative already. Japan's move to negative rates did not achieve any easing at all with USDJPY now trading as low as 111, down from 126 in June. Neither did the ECB's easing efforts.

The reason is basic and obvious. The economic problems in the developed economies are genuinely structural – excessive debt, low productivity, terrible demographics, inability to reform, rampant populism, addition to easy money, bubbles in bond and stock markets and, in the case of the US, a seriously overvalued currency. These problems simply cannot be solved with monetary policy alone.

There are no safe havens in financial markets. The tragedy is that so many think that the safe havens are in developed economies. Today, EM looks the stronger part of the world. EM has been on the receiving end of the irrational Dollar rally for several years and has survived to tell the tale. Currency adjustments and tighter financial conditions have helped to restore EM competitiveness. Current account balances are improving sharply. Many countries have done reforms. 2016 is likely to be the first year since 2011 when EM growth re-accelerates away from developed market growth.

In addition to overcoming a cyclical tightening, EM has also survived serious shocks. Huge declines in commodity prices, the Taper Tantrums, a crazy Dollar rally and even a Fed hike. Yet, EM has only seen two sovereign defaults, Argentina and Ukraine, which are hardly typical of the rest of the 62 EM countries in the main benchmark indices. Corporate default rates in EM are now lower than default rates in the US.

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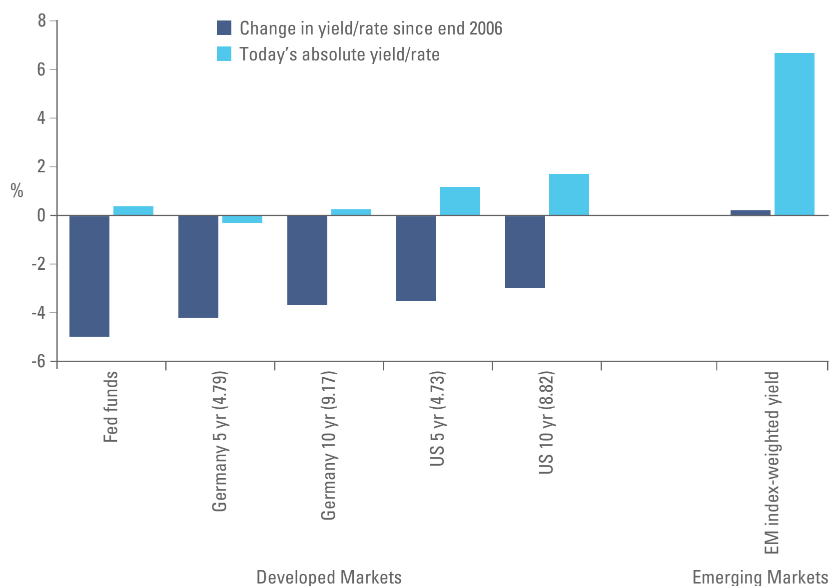
Perhaps most importantly, EM governments retain key policy tools such as room to cut rates and increase fiscal spending, if required. This now sets them apart from developed markets. EM also retains its core strengths of large stocks of reserves, much lower debt levels, inflation under control, better demographics and, above all, no QE. Sure, the price action has been ugly, but are you surprised? Surely everyone knows by now that much of the price action has been technical rather than fundamental and that price volatility is patently not the same as risk. If fundamentals hold up – which they have done – value has been created. EM bonds today pay a higher yield than when the Fed had rates at 5.375%. With an improving fundamental picture, you are not only safer in EM you also get paid more (see figure 2 below).

Fig 2: **EM versus developed market yields: Today versus end-2006**



Source: Ashmore, JP Morgan, Bloomberg.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-4.17%	-10.39%	-24.77%	-9.97%	-5.58%
MSCI EM Small Cap	-4.19%	-11.73%	-18.45%	-6.27%	-4.30%
MSCI Frontier	1.52%	-5.43%	-16.00%	-0.04%	-0.74%
MSCI Asia	-4.37%	-11.68%	-21.46%	-4.70%	-1.27%
Shanghai Composite	0.95%	-21.92%	-10.50%	7.11%	2.22%
Hong Kong Hang Seng	-8.91%	-22.29%	-34.33%	-10.26%	-5.76%
MSCI EMEA	-3.45%	-7.49%	-28.74%	-15.10%	-9.40%
MSCI Latam	-3.16%	-7.59%	-33.14%	-21.94%	-14.67%
GBI EM GD	0.69%	1.04%	-13.04%	-9.94%	-3.02%
ELMI+	0.04%	-1.11%	-6.27%	-6.17%	-3.35%
EM FX Spot	0.30%	-0.98%	-15.60%	-13.54%	-9.55%
EMBI GD	-0.62%	-0.80%	-0.43%	1.22%	5.41%
EMBI GD IG	-0.11%	0.71%	-1.47%	1.04%	4.90%
EMBI GD HY	-1.21%	-2.67%	1.20%	1.51%	6.24%
CEMBI BD	-0.01%	-0.36%	-0.07%	1.67%	4.34%
CEMBI BD IG	0.24%	0.30%	0.36%	2.46%	5.08%
CEMBI BD Non-IG	-0.45%	-1.52%	-0.79%	0.11%	3.05%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P500	-3.74%	-8.51%	-8.80%	9.34%	9.30%
1-3yr UST	0.18%	0.93%	1.13%	0.64%	0.78%
3-5yr UST	0.45%	2.15%	2.92%	1.88%	2.51%
7-10yr UST	1.36%	4.57%	4.82%	3.47%	6.24%
10yr+ UST	3.26%	8.67%	4.24%	7.08%	11.43%
10yr+ Germany	1.83%	8.36%	1.14%	10.10%	11.79%
10yr+ Japan	-0.72%	2.57%	7.28%	6.65%	6.00%
US HY	-2.91%	-4.67%	-10.89%	-0.33%	3.70%
European HY	-2.54%	-3.25%	-3.56%	5.08%	7.88%
Barclays Ag	-0.40%	0.05%	-1.61%	2.68%	4.63%
VIX Index*	25.74%	39.48%	72.91%	103.85%	55.16%
DXY Index*	-3.12%	-2.16%	2.44%	19.76%	22.82%
CRY Index*	-3.83%	-8.96%	-30.03%	-46.27%	-52.31%
EURUSD	3.19%	2.90%	-1.57%	-16.34%	-17.13%
USDJPY	-5.76%	-5.04%	-3.65%	22.10%	36.28%
Brent	-3.05%	-9.66%	-45.25%	-71.38%	-66.86%
Gold spot	8.43%	14.27%	-1.62%	-24.69%	-11.74%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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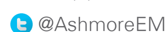
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