Mexico says enough is enough

By Jan Dehn

Mexico taught currency speculators a lesson last week. Argentina took a significant stride forward in the holdout case. Venezuela's actions say far more about the government's willingness to pay than its ability to pay. Colombia hikes in a belated response to lower oil prices. Russian data is improving. China's inflation rate was lower than expected, while the trade surplus was higher than anticipated. Brazil was downgraded again – but the time to sell was a long time ago. India's Supreme Court orders disclosure of large bad debtors in a move that may speed up the process of fixing bad public sector banks. The Ukrainian Prime Minister's survival of a no-confidence vote buys President Poroshenko political cover and the government time. In the global backdrop, we discuss the sudden excitement about moving to a cashless society. Be afraid, be very afraid.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.7	–	4.22%
MSCI EM Small Cap	10.4	–	3.74%
MSCI Frontier	8.5	–	1.32%
MSCI Asia	10.2	–	4.26%
Shanghai Composite	10.6	–	3.49%
Hong Kong Hang Seng	5.8	–	8.09%
MSCI EMEA	8.4	–	4.22%
MSCI Latam	10.7	–	3.98%
GBI-EM-GD	6.83%	–	0.52%
ELMI+	4.55%	–	0.10%
EM FX spot	–	–	0.27%
EMBI GD	6.45%	468 bps	1.32%
EMBI GD IG	4.83%	298 bps	0.99%
EMBI GD HY	8.75%	710 bps	1.71%
CEMBI BD	6.50%	492 bps	0.49%
CEMBI BD IG	4.78%	320 bps	0.19%
CEMBI BD Non-IG	9.63%	804 bps	1.03%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P500	14.1	–	4.93%
1-3yr UST	0.77%	–	0.05%
3-5yr UST	1.27%	–	-0.03%
7-10yr UST	1.78%	–	0.04%
10yr+ UST	2.63%	–	-0.05%
10yr+ Germany	0.20%	–	0.40%
10yr+ Japan	-0.01%	–	1.62%
US HY	10.04%	874 bps	1.33%
European HY	6.67%	679 bps	1.43%
Barclays Ag	–	227 bps	0.44%
VIX Index*	20.53	–	-7.61%
DXY Index*	97.49	–	1.55%
EURUSD	1.1021	–	-1.21%
USDJPY	113.25	–	-1.18%
CRY Index*	159.63	–	-0.73%
Brent	34.4	–	2.99%
Gold spot	1211	–	0.17%

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

Emerging Markets

- **Mexico:** What do global currency traders do when global risk aversion rises? Answer: They sell Emerging Markets (EM) currencies, in accordance with long-established, but completely nonsense rules of thumb. When they do so, however, they prefer to sell the largest and most liquid EM currencies. Large liquid EM currencies can be traded in size and they are perceived to be 'safe' from government intervention. This is why MXN along with China's CNH have become particularly popular targets for speculators, despite the fact that risk aversion is rooted in uncertainty about the US outlook. This week, however, the Mexican government showed that it has had enough of this mindless speculation. Believing, rightly in our view, that the sell-off in MXN has become excessive relative to Mexico's solid economic fundamentals – indeed even beginning to pose a threat to the latter – the government reminded markets that Mexico has considerable means at its disposal to inflict damage on speculators. First, the central bank hiked rates by 50bps, taking policy rates to 3.75%. The move is not the start of a hiking cycle. Second, the government cut spending by 0.7% of GDP, with most of the cuts coming through efficiency savings at PEMEX, the massively inefficient state-owned oil company. Third, the central bank dropped its rule-based intervention framework in favour of a discretionary one. Mexico has USD 175bn in FX reserves plus access to USD 65bn via a Flexible Credit Line and USD 40bn via a Fed swap line. Mexico's authorities are right to intervene when markets push the currency to irrational levels, which can actually create disequilibria where none exist to begin with. MXN rallied 5% in the aftermath of the policy changes.
- **Argentina:** The government made significant progress towards normalising relations with global capital markets last week. A US judge responsible for the rulings in the cases with holdout investors lifted the injunctions which have barred international banks from processing coupon payments on otherwise performing Argentinian debt on the conditions that: (a) the government repeals laws barring payment on defaulted bonds and (b) pays those holdout investors with whom it has stuck agreements so far. Clearly, such actions would be prima facie evidence of willingness on the part of the government to resolve the issue. According to the

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Emerging Markets

government, the votes exist in the legislature to make the necessary legal changes. The Macri Administration has so far approached the holdout issue in a very constructive way and the US court is now applying pressure on the holdouts instead of the government. This bodes well for an eventual full restoration of Argentina to global capital markets. We expect the government to rely heavily on fiscal stimulus once it has gained market access in order to support growth while the monetary policy excesses of the Kirchner era are reversed. The objective of the government is to get growth going before mid-term elections in 2017. In related news, Argentina last week reached agreement with another small group of holders of defaulted EUR denominated bonds.

- Venezuela: The government undertook two major initiatives last week that underscore its willingness to pay, but do not sufficiently address economic weaknesses that could yet call into question the government's ability to pay. The first was to replace Vice President of Economic Affairs Luis Salas with the more business friendly Minister of Industry Miguel Perez Abad. Salas' dismissal is significant, because it followed hot on the heels of Salas' pronouncement that the government should default on its debt. This message was clearly not acceptable to the Maduro administration. The second initiative was a cocktail of economic measures, including a devaluation of the currency, replacing the three-tier currency system with a binary one and increasing fuel prices. These measures are grossly insufficient in terms of restoring Venezuela's public finances to a sustainable footing, but they do suggest that the government's willingness to adjust is improving. It is a step in the right direction. In other news, opposition leader Henrique Capriles, hitherto in favour of a more moderate approach, announced that he is in favour of a referendum to recall President Nicholas Maduro.

- Colombia: The central bank raised rates by 25bps to 6.25% and lowered the threshold for intervention to support the COP. Colombian inflation has recently picked up following significant currency weakness. S&P, the ratings agency, downgraded the outlook on the country's BBB sovereign rating from stable to negative. These developments are related. Colombia has been slow to adjust to lower oil prices, perhaps reflecting the Santos administration's intense focus on striking a permanent peace deal with the FARC, a drug financed rebel group. However, the effect of the delayed response to lower oil prices has been to place domestic demand on a now unsustainable footing, which the central bank is belatedly beginning to address. Industrial production rose 3.9% yoy in December. This was weaker than the 4.4% yoy pace expected. The economy is likely to slow further, in our view.

- Russia: A broad raft of economic indicators suggests that the Russian economy may now be finding a bottom after adjusting to the second leg down in oil prices in late 2015. Industrial production, real wages, retail sales and unemployment were all better than expected in December, while the weekly inflation prints pointed to a significant slowdown in yoy inflation (from 9.8% in January to 8.2% in February). Russian inflation is almost exclusively due to base effects arising from a weaker RUB and since the central bank has been hawkish throughout the period of declining oil prices, Russia's macroeconomic fundamentals have remained on a solid footing. In other Russian news, the government has begun legal proceedings against Ukraine for failing to repay a USD 3bn bond that fell due last year. The bond has no cross-default provisions to existing performing Ukraine debt.

- China: CPI inflation was marginally softer than expected in January (1.8% yoy versus 1.9% yoy expected). Inflation pressures are likely to continue to be muted as China reforms its economy in order to ensure it can continue to grow when the Western world's currencies (and economies) subside under excessive monetary stimulus, bubbles, lack of reform, populism and waning growth. New loans picked up sharply in January (RMB 2.51trn vs RMB 1.9trn expected) and the CBRC's Q4 review of Chinese banks was reassuring. PBOC Governor Zhou Xiaochuan re-stated why China does not need devaluation, a statement supported by the trade surplus, which increased in January to USD 63.3bn from USD 60.9bn in December. China changed the head of the country's main regulatory agency following considerable volatility in financial markets in the past 12 months, but we do not think the broad direction of travel will change in China. China will, however, learn from its experiences as it increases its engagement with global financial markets. One of the lessons from recent times will be that China needs to deepen the institutional involvement in its markets.

- Brazil: S&P, the ratings agency, cut Brazil's long-term sovereign debt rating by one notch from BB+ to BB, with negative outlook. The ratings agencies are reacting long after the economic and political situation in Brazil had started to deteriorate. Those investors that base their trading decisions on ratings actions are likely to sell precisely at the time when they should start to build positions. This and subsequent downgrades of Brazil, which seem likely, are cases in point. Retail sales declined 2.7% in the month of December (-11% yoy, -7.1% yoy core). The rapid decline in domestic demand is likely to bring inflation meaningfully lower this year and contribute to a current account surplus, which in turn will push up FX reserves. This makes for a benign environment for fixed income, in our view. Whether Brazil becomes an equity opportunity too depends largely on the impeachment process against President Dilma Rousseff.

- India: The Supreme Court has requested the Reserve Bank of India to disclose all defaulters with more than INR 5bn of outstanding dues. This is likely to go a long way towards exposing the full extent of bad loans, particularly among public sector banks. We see this as a positive development though one that in the short term can create some uncertainty and nervousness. A sound banking system is critical to growth and enables India to open its capital markets to the wider world. The trade deficit in January was USD 7.6bn, which was much lower than expected (USD 9.9bn).

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Emerging Markets

- **Ukraine:** Prime Minister Yatsenyuk survived a no-confidence vote in the Rada (Ukraine's parliament). This follows accusations that Yatsenyuk has engaged in corrupt practices and acts on behalf of oligarchs. The failure of the no-confidence vote against Yatsenyuk improves the near-term political outlook marginally, since no no-confidence votes can now be held until September 2016. President Poroshenko and the Rada are aware that without a working coalition and a Cabinet in place – both of which require the support of Yatsenyuk – there will be no further funding from the IMF. At the moment, there is no viable alternative to Yatsenyuk that will satisfy both the west and local elite. Poroshenko called the no-confidence vote; having lost it he can now say that it was the Rada, not him that decided to keep Yatsenyuk. This gives Poroshenko a political hedge against further fallout arising from Yatsenyuk's actions, which may be valuable as the risk of an early election in Ukraine in the next twelve months continues to rise. Bond holders are mainly focused on whether Ukraine can secure the release of the next IMF tranche.

- **Indonesia:** The central bank cut the policy rate by 25bps to 7.0%. The trade balance swung into a small USD 51m surplus in January from a USD 161m deficit in December. The government has also trimmed the list of the sectors eligible for foreign investor participation.

Snippets:

- **Kazakhstan:** S&P, the ratings agency, downgraded Kazakhstan from BBB to BBB-.
- **Malaysia:** The economy expanded by a solid 4.5% yoy in Q4 2015 versus 4.1% yoy expected.
- **Mongolia:** The economy expanded 2.3% in 2015, down from 7.8% in 2014.
- **Nigeria:** Inflation was unchanged in January at 9.6% yoy, which is above the 6-9% target range of the central bank.
- **Peru:** Growth surprised to the upside in December as economic activity was up 6.4% yoy versus 5.3% yoy expected.
- **Romania:** Inflation fell at a yoy pace of 2.13% in January following a cut in the rate of VAT from 20% to 24%.
- **Saudi Arabia:** S&P, the ratings agency, downgraded Saudi Arabia's sovereign credit rating to A- from A+ and moved the outlook to stable.
- **South Africa:** CPI core inflation rose to 5.6% yoy in January from 5.2% yoy in December. The main driver was base effects due to energy prices.
- **South Korea:** Bank of Korea left rates unchanged at 1.5%.
- **Sri Lanka:** The central bank raised rates by 50bps following a 150bps move in December. Sri Lanka's perennial problem is fiscal indiscipline to which the central bank is now responding.

Global backdrop

Europe announced this week that it will get rid of the EUR 500 bill. Larry Summers, an influential former US Treasury Secretary, also called for getting rid of the USD 100 bill. Allegedly, the sudden zealousness in favour of getting rid of large denomination bills is that it will help to fight money laundering and other types of illegal money flows.[1] However, the real reason is far more sinister, in our view. It is no coincidence that the discussion about large denomination bills is happening at exactly the same time as a wider discussion about moving to a cashless society, which in turn is occurring at the same time as the current debate about negative interest rates. To understand how these debates are linked, recall that negative interest rates are almost the only remaining easing option available to most developed economies. The main challenge in making negative interest rates work, however, is that, as a tax on deposits, negative interest rates threaten to destroy the deposit base, which is the main source of funding for most banks. For example, if depositors withdraw money from banks to put under the mattress instead, then negative interest rates will fail to achieve their objective of locking in funding for asset purchases by banks. Indeed, negative interest rates could even foster forced asset sales. By eliminating cash, this problem can be eliminated. Without cash, it is no longer possible to take money out of the banking system, though in order to make the trap complete it may eventually become necessary also to impose capital controls in developed economies. This may seem almost inconceivable today, yet it is logical that policy makers will move in this direction as their dependence on monetary stimuli to keep asset prices afloat intensifies even as other means of monetary stimuli are exhausted.

One of the consequences of failing to deal with deeper rooted economic problems in developed economies is that voters are becoming ever more disgruntled with establishment policies and politicians. This has resulted in a situation where populists and populist ideas are rising across the Western world. In the US, the extremely

[1] See Peter Sands (2016), *"Making it hard for the bad guys: the case for eliminating high denomination bills"*, M-RCBG Associate Working Papers, No.52, Harvard Kennedy School.

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Global backdrop

populist but less than evangelical Donald Trump decisively won the Republican Party nomination for presidential candidate in the conservative state of South Carolina. This places him in a strong position to win the overall nomination, which now increasingly hinges on winning in less conservative states. In the UK, the Cameron administration announced that 23 June will be the date for the UK's referendum on leaving or staying within the European Union. This referendum risks economic disaster for the sake of neutralising internal political divisions over Europe within Cameron's Conservative Party. Yet, those divisions are now likely to reappear in force, in our view. In Spain, Prime Minister Rajoy told EU leaders that he expects new elections in Spain, likely in the next six months. This justifies close monitoring on account of the rise of populist parties in Spain.

Russia and Saudi Arabia agreed to freeze the output of oil at current levels, but the announcement failed to have any lasting impact on energy prices, which have been bound in a USD 25-35 per barrel range since December (Brent first future). In Japan, Q4 GDP declined 0.4% qoq sa versus -0.2% qoq sa expected.

Turning to the data, US CPI jumped from 0.7% yoy to 1.4% yoy in January, reflecting the powerful base effects created by the sharp decline in oil prices a year ago. Even core inflation (ex-energy) jumped to 2.2% yoy from 2.1% yoy. Rising inflation pressures at a time of weakness in manufacturing, a strong US dollar and havoc in the energy sector pose awkward questions for the Fed. The Fed is unlikely to hike rates in March. St Louis Fed President James Bullard, a voting hawk, said last week that it would be unwise for the FOMC to continue the hiking process. The minutes of the FOMC's January meeting also pointed to the same conclusion based on rising downside risks to growth. So the most likely way the FOMC will get around a potential stagflation situation is to downplay the risk from inflation in order to protect growth. This case is already being made forcefully. For example, this week the Federal Reserve Board of San Francisco, Fed Chairwoman Janet Yellen's former home, issued an *Economic Letter* arguing in favour of letting inflation overshoot.[2] Similar arguments have also been put forward by other Fed officials such as Kocherlakota. We think such arguments are likely to become far more common place for two reasons. First, the US economy today faces a genuine trade-off between price-stability and growth, because productivity is so low and there is so much debt. Secondly, inflation and currency debasement are the only realistic means to exit the country's debt problem given that no one wants to implement reforms. As for the substance of the academic argument – that it is ok to let inflation rise above target for a period because it has been below target for some time and therefore will be on target on average – it is clearly rubbish. It amounts to saying that if you have your feet in the freezer and your head in the oven – you are, on average, comfortable.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.13%	-6.62%	-22.71%	-8.86%	-5.33%
MSCI EM Small Cap	-0.60%	-8.42%	-16.52%	-5.46%	-3.99%
MSCI Frontier	2.85%	-4.18%	-16.89%	0.51%	-0.02%
MSCI Asia	-0.30%	-7.92%	-19.20%	-3.60%	-1.09%
Shanghai Composite	4.47%	-19.19%	-10.52%	9.10%	2.20%
Hong Kong Hang Seng	-1.54%	-16.01%	-30.68%	-7.61%	-5.29%
MSCI EMEA	0.62%	-3.59%	-26.83%	-13.93%	-8.72%
MSCI Latam	0.70%	-3.92%	-31.67%	-20.88%	-14.43%
GBI EM GD	1.22%	1.57%	-13.10%	-9.83%	-3.13%
ELMI+	0.14%	-1.01%	-6.88%	-6.12%	-3.43%
EM FX Spot	0.57%	-0.71%	-15.70%	-13.44%	-9.63%
EMBI GD	0.69%	0.51%	0.73%	1.71%	5.63%
EMBI GD IG	0.88%	1.70%	-0.84%	1.47%	5.01%
EMBI GD HY	0.48%	-1.01%	3.13%	2.03%	6.58%
CEMBI BD	0.48%	0.12%	0.00%	1.79%	4.38%
CEMBI BD IG	0.43%	0.49%	0.26%	2.52%	5.07%
CEMBI BD Non-IG	0.57%	-0.51%	-0.48%	0.29%	3.17%

[2] See Vasco Curdia, *"Is there a case for inflation overshooting?"*, FRBSF Economic Letter, February 16 2016.

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P500	-0.94%	-5.85%	-6.59%	10.08%	9.69%
1-3yr UST	0.23%	0.98%	1.18%	0.66%	0.77%
3-5yr UST	0.42%	2.13%	3.16%	1.88%	2.43%
7-10yr UST	1.40%	4.61%	5.76%	3.54%	6.16%
10yr+ UST	3.20%	8.62%	6.92%	7.25%	11.40%
10yr+ Germany	2.24%	8.80%	3.67%	10.31%	11.73%
10yr+ Japan	0.89%	4.23%	9.07%	7.04%	6.38%
US HY	-1.62%	-3.40%	-10.07%	-0.01%	3.86%
European HY	-1.14%	-1.87%	-2.77%	5.38%	8.07%
Barclays Ag	0.04%	0.49%	-0.85%	2.81%	4.64%
VIX Index*	1.63%	12.74%	43.57%	44.88%	-1.30%
DXY Index*	-2.12%	-1.15%	3.44%	19.65%	25.36%
CRY Index*	-4.27%	-9.37%	-28.98%	-45.61%	-53.64%
EURUSD	1.75%	1.46%	-2.77%	-16.47%	-19.26%
USDJPY	-6.51%	-5.80%	-4.68%	21.23%	36.82%
Brent	-1.01%	-7.75%	-42.89%	-69.86%	-67.49%
Gold spot	8.33%	14.16%	0.79%	-23.39%	-13.42%

*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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