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Ashmore

Who's afraid of the stronger dollar?

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A light week for global economic data was dominated by a further increase in the USD against a broad set of currencies and the first week of ECB government bond purchases, which drove EUR government bond yields lower. With the USD not supported by strong US economic data (except for the headline payroll numbers) but propped up by monetary stimulus elsewhere, the disinflationary effects of a strong dollar on the US economy are starting to be being priced in. This can be seen in stalling US equity markets, which last week fell another 1.20% and are lagging other developed markets significantly year-to-date. This was also apparent last week in the retracement of the US treasury yield curve, which reversed the previous week's sell-off to end the week 4 to 13 bps lower, and flatter. The latter move was also supported by renewed weakness in oil prices, with Brent crude contracts down 7.7% on the week to USD 54pb.

In Emerging Markets (EM), data releases confirmed the positive effects of lower oil prices on inflation and trade balances in a number of countries. However the rapid rise in the USD is generating some anxiety in a number of countries – such as Mexico or Turkey for instance – where monetary policy objectives are pivoting from growth to financial stability. The week also brought some interesting insights about the policy intentions of Chinese policy makers, who are grappling with the opposite challenges of having a currency attached to the strong USD.

On Wednesday, Janet Yellen is expected to end the era of forward guidance by cutting the word 'patient' off the FOMC statement, and making the Fed more data-dependent. Despite the tightening risk that this may signal (and the credit implications of a stronger USD) sovereign and corporate EM credit spreads have held up well, outperforming domestic US credit spreads on the month until the middle of last week, when they started to come under pressure.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	940	–	-1.99%
MSCI EM Small Cap	998	–	-1.51%
MSCI FM	593	–	-1.04%
GBI EM GD	6.46%	–	-2.01%
EM FX spot	–	–	-2.03%
ELMI+	5.04%	–	-1.27%
EMBI GD	5.79%	365 bps	-0.64%
EMBI GD IG	4.51%	234 bps	-0.38%
EMBI GD HY	8.49%	647 bps	-1.11%
CEMBI BD	5.52%	356 bps	-0.25%
CEMBI BD HG	4.40%	243 bps	-0.14%
CEMBI BD HY	8.05%	611 bps	-0.46%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2053	-1.20%
VIX Index	16.00	6.24%
5 year UST	1.59%	-7 bps
7 year UST	1.91%	-8 bps
10 year UST	2.10%	-9 bps
US HY	6.73%	-0.47%
European HY	4.45%	0.00%
EURUSD	1.0528	-3.15%
USDJPY	121.39	0.06%
Brent	54.20	-4.33%
Copper	267.85	4.95%
Gold	1158.25	-0.80%

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

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The benign move in EM credit spreads has been in sharp contrast with the downside move in EM currencies, which gained momentum with the release of the strong US payroll number on 6 March. The underperforming currencies were the BRL and the CLP, down 3.9% and 2.7% respectively, while the TRY stabilised after a few difficult weeks and was up 0.7%. The cumulative move since the start of Q4, nearly six months ago, is impressive.

In many countries the move lower in FX rates has been justified by the opportunity, on the part of policy makers, to take advantage of the global disinflation context to let their currencies adjust without excessive risk of pass-through into inflation numbers (e.g. Indonesia, Turkey). Sometimes, lower inflation was simply the result of weak growth, which made real yields too high and demanded a policy response (e.g. Thailand, Korea). Generally speaking, a more 'pro-growth' stance has underpinned many rate cuts by EM central banks since last summer and is the mirror image of all the tightening delivered in the aftermath of the 'taper tantrum' in late 2013.

Among the large EM economies, since the Philippines central bank rate hike last September, only the central bank of Brasil has hiked its policy rate. Moreover, among the 'inflation targetters', only the central banks of Brasil and Peru are committing reserves (or swaps) to slow the rallying dollar – although Brasil has abandoned this policy in the last week. South Africa and Colombia also stand out as having kept rates on hold until now. Now, as their currencies fall to all-time lows, some central bankers may decide that the risks to financial stability outweigh their domestic growth agendas. Last week the CBRT in Turkey, and Banxico in Mexico made small changes to policy that may suggest just that. Will their example be followed and are more rate hikes on the cards?

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- Turkey: Central bank governor Basci and Deputy Prime Minister Babacan met with President Erdogan this week to explain the risk of further rate cuts in an environment of a very weak TRY and poor domestic liquidity. According to some reports, Basci went through a 130 page presentation and, although Erdogan himself admitted that disagreements remain, Basci seems to have achieved a 'truce' with the executive. This was enough to trigger a rebound in the TRY and Turkish assets mid-week. It also suggests that the central bank will be in a position to put its current rate cutting cycle on ice at the MPC meeting on March 17. Meanwhile, Turkey's January Current Account came in above expectations at USD -0.6bn on a seasonally adjusted basis, a sharp improvement on the USD -4.0bn posted in December. The improvement was driven by core trade data, not simply the gold and energy balance, and was associated with a strong capital flow picture.

- Mexico: In response to ongoing FX volatility, the foreign exchange commission announced on 11 March that it will lower the pace of international reserves accumulation between now and June. In practice, Banxico will sell more USD by making USD 52m available each day in an auction with no minimum price. This is in addition to the current auction mechanism of USD 200m per day with a minimum price 1.5% above the previous day's MXN. Since Mexico runs a balance of payments surplus, the new mechanism will not reduce Mexico's reserves but simply reduce the pace of accumulation by a quarter of the current pace of USD 1.4bn per month.

Conversely, a number of countries are still cutting interest rates, with little concern for the impact on the exchange rate: this week's news from India, Thailand and China illustrate three different circumstances justifying policy easing.

- India: India is in no need to focus on financial stability. Growth has been robust and its currency has outperformed. The country's external position has been improving: India's Q4 2014 current account deficit improved to 1.6% of GDP from 2.0% of GDP in the previous quarter, driven by lower oil imports as well as an increase in services exports. Strong capital inflows, notably into domestic equities, have contributed to a balance of payments surplus, which the Reserve Bank of India (RBI) has been using to accumulate reserves. India's February CPI inflation came in last week at 5.4% yoy, up marginally from 5.1% in January but well within the RBI's 6% CPI target for January 2016. After delivering two inter-meeting rate cuts in recent months, the RBI has room to deliver more cuts in view of substantial slack in the economy and a new budget law that is supportive of supply-side reform.

- Thailand: The Bank of Thailand cut its policy rate by 25 bps last week, taking the rate to a four-and-a half-year low of 1.75%. The decision was finely balanced, with at 4-3 vote in favour of the cut, but the statement plainly expresses the policy maker's priority in the current environment: as a large oil importer, the fall in crude prices is a clear bonanza, but with sluggish domestic demand and exports threatened by China's slowdown, the central bank is using a window of opportunity to stimulate, including via a weaker exchange rate if it must.

- Russia: The Russian central bank (CBR) also cut rates by 100 bps to 14%, with a bias to do more. The CBR mentioned the depth of the economic recession that could cut GDP growth to -4% this year, and stating that it expects inflation and growth to peak in Q2 2015. The RUB has stabilised at 62 and local bonds were the best performing asset in local markets last week.

- China: China stands out among the countries leaning towards easing policy. Its options are more limited, because of its managed exchange rate; but the impact of its decisions is more important, because of the size of its balance of payments. China has many strengths, but rapid US dollar appreciation presents two macro challenges: first, because of its managed peg, its currency has been appreciating rapidly against the currencies of all its trading partners save the US and the Gulf, making its exports less competitive. The large trade surplus suggests it is manageable, and China has been preparing for this possibility for a long time by upgrading its supply chain and reforming domestic markets. Secondly, in response to the domestic economic slowdown, Chinese households and companies have been pouring money into foreign assets and created pressure on domestic liquidity. Speculation about a possible devaluation is increasing the pressure further.

Owing to the authorities' strong preference for financial stability, a devaluation is unlikely. It is good news considering the sort of 'race to the bottom' that competitive devaluations may foster. A devaluation is probably not desirable either, in our view, as the problem is not so much with the external accounts as with the domestic balance. As money flowed into China over the last decade, the country accumulated excessive FX reserves and increased its reserve requirement ratio (RRR) in order to control local liquidity. As money starts flowing out, this process will be reversed, with reserves coming down to more palatable levels and the RRR being cut to compensate for the liquidity contraction. The preferred policy option will thus be further monetary policy easing and financial markets reform: this week, credit data for February showed the positive results of recent interest rate and RRR cuts. In addition PBOC Governor Zhou said that deposit insurance will very likely be launched during the first half of this year, and the probability of removing the deposit rate ceiling this year is very high.

- Egypt: Egypt is open for business. This was the message portrayed during the Egyptian Economic Development Conference held on 13-15 March. International investors have heeded Egypt's call and signed investment deals worth USD 138bn. The rich Gulf Arab states – UAE, Kuwait and Saudi Arabia – pledged another USD 12bn in investments, central bank deposits and 'development aid'.

For Egypt the money pledged is validation of its economic and strategic importance. For the Gulf monarchies, an Egypt under President Abdel Fattah Al-Sisi represents the road to stability and provides a bulwark against the

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Muslim Brotherhood. The international investment pledges and agreements validate Egypt's return to doing business after three very challenging years of low growth, higher unemployment and lower FDI. The government unveiled several investment-friendly measures including cutting income tax and new mechanisms to resolve commercial disputes.

Why is all this important? Egypt's stability is important for stability in the Middle East as the ISIS threat is fought throughout the region. Even Egypt's Sinai Peninsula is battling with its own low intensity Islamist armed rebellion. Without Egypt's return to more normalised economics, its political stability and that of President Al-Sisi would be fragile. It is widely believed that Egypt is the last frontier. Egypt's future could have significant implications for the future of the Arab world as Syria, Iraq, Libya and Yemen are embattled with internal wars and instability.

Finally, our review of Emerging Markets developments would not be complete without two posts about recent developments in Argentina and Ukraine, where bond prices have been volatile over the week.

- Argentina: Following a hearing on 3 March, NY District Court Judge Griesa decided that Argentina law exchange foreign currency bonds (Pars and Discounts) issued in the 2005 and 2010 exchanges, cannot be serviced by intermediaries coming under the scope of his pari passu ruling, and thus that Citibank Argentina cannot process the payments on those bonds. This decision indicates that Judge Griesa does not consider these bonds to be 'domestic foreign currency indebtedness' (DFCI), but part of the Republic's 'External Debt' and thus within the scope of his injunction. There is still some uncertainty about the perimeter of Griesa's injunctions, including other local law bonds instruments that were hitherto out of scope.

- Ukraine: The IMF board approved the USD 17.5bn four-year program negotiated with the government in January. Disbursements could begin very shortly, shoring up the country's battered reserves. The Ukrainian Hryvnia (UAH) has rebounded from UAH 34 to UAH 21.3 in the last two weeks following the imposition of capital controls and increase in interest rates to 30%. In a webcast last Friday, Finance Minister Jaresko confirmed that as part of the agreement with the IMF the government will seek: i) USD 15.3bn in cash flow relief over the next four years from the restructuring of existing debt (this means a debt exchange into longer-dated bonds); ii) a deal with creditors allowing it to achieve a target public sector debt ratio of 71% by 2020, with limited gross financing needs in the interim period. Jaresko mentioned in her remarks that maturity extension, coupon deferral and haircuts on interest and principal were among the options that would be considered, and that all the country's Eurobonds including the USD 3bn owed to Russia would be included in the negotiations with the country's creditors.

Global backdrop

Last week, the USD index, DXY, was up 2.4% for a total move of 10.6% ytd. In particular EURUSD fell 2.9% to just below 1.05, closing on Friday at its lowest level of the week. The magnitude of the move in EUR (or equivalent) is the third biggest in forty years and the fastest one over that period, with a 31% annualised rate of USD appreciation since last June.

The move in EURUSD was all the more impressive as it came against a very disappointing US retail sales release for February: retail sales contracted -0.8% and the January number was revised to -0.1% from +0.2%. This was the third consecutive deep contraction in headline retail sales, which show no signs of responding to the fall in gas prices. US economic data continues to underperform versus expectations, in contrast to European economic data releases.

The consensus is that if the dollar is no longer propped up by economic data, it is being driven higher by expectations of a higher Fed Funds rate. On this note, the FOMC is meeting this week and important changes are expected: the FOMC is widely expected to drop the last vestige of forward guidance by removing the word 'patient' from the statement, ushering in a new era of data dependent policy decisions. In addition, an update in the staff economic projections (SEP) will probably see the 2015 GDP and inflation (PCE) forecast revised lower from the December release. These changes make the timing of the first Feds Funds hike more uncertain, but money market rates have been trading in a narrow range and are not pricing in a more hawkish scenario.

In fact, it seems that USD has been propped not so much by the Fed as by the ECB: last week the ECB bought EUR 9.8bn of European government bonds, a run rate equivalent to EUR 70bn a month. Owing to relative scarcity of paper eligible for purchase, ECB buying has triggered a significant rally, notably in bund yields which fell by 15 to 25 bps in the long end of the curve. This was in contrast to the experience of previous quantitative easing programmes, where bond yields have rallied before the start of the programme but sold off at its inception. ECB buying has massive implications for the EUR: as Eurozone investors benchmarked to EUR bond indices and Eurozone banks are structurally pushed to own these increasingly scarce securities, the bulk of the investors who will sell their Eurozone government bonds to the ECB are likely to be international investors moving into more attractive opportunities. The evidence from global reserves managers is that these investors will unwind their EUR exposure as they sell these securities, pushing EURUSD lower in the process.

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Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-5.1%	-1.6%	2.5%	-1.3%	1.7%
MSCI EM Small Cap	-3.1%	0.5%	-0.4%	1.8%	3.0%
MSCI FM	-1.3%	-2.5%	1.5%	11.0%	5.6%
S&P 500	-2.33%	0.19%	13.50%	16.18%	14.66%
GBI EM GD	-6.00%	-6.95%	-11.22%	-5.05%	0.33%
ELMI+	-2.68%	-4.46%	-10.59%	-4.06%	-1.56%
EM spot FX	-4.83%	-8.24%	-18.67%	NA	NA
EMBI GD	-1.54%	0.22%	5.59%	4.34%	6.80%
EMBI GD IG	-1.81%	0.26%	7.36%	3.87%	6.21%
EMBI GD HY	-1.08%	0.12%	2.58%	5.14%	7.70%
5 year UST	-0.34%	0.67%	2.38%	1.33%	3.41%
7 year UST	-0.60%	0.81%	4.73%	2.11%	5.14%
10 year UST	-0.96%	0.87%	8.19%	3.66%	6.80%
CEMBI BD	-0.34%	1.49%	4.63%	5.00%	6.23%
CEMBI BD HG	-0.50%	1.48%	6.33%	5.33%	6.43%
CEMBI BD HY	-0.02%	1.51%	1.11%	4.52%	5.99%
US HY	-1.03%	1.96%	1.34%	7.35%	9.02%
European HY	0.30%	3.58%	6.24%	12.42%	11.70%
Barclays Agg	-2.44%	-3.38%	-5.46%	-0.57%	1.83%

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

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