Issued: 9 May 2016

EM central banks can do better than go for gold

By Jan Dehn

Kenneth Rogoff thinks EM central banks should sell US dollars and buy gold instead. The renewed focus on EM central bank reserves diversification is welcome and timely, but EM central banks have better options than to go for gold. They can get better yields, better liquidity, more diversification and help global growth in the process if they start buying each other's bonds instead. This edition of the Weekly also provides our take on political developments in Turkey and the United States in addition to the usual snippets.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.4	–	-4.10%
MSCI EM Small Cap	11.0	–	-2.92%
MSCI Frontier	8.9	–	0.68%
MSCI Asia	10.8	–	-3.15%
Shanghai Composite	11.2	–	-1.07%
Hong Kong Hang Seng	6.3	–	-6.50%
MSCI EMEA	9.1	–	-7.02%
MSCI Latam	12.4	–	-5.72%
GBI-EM-GD	6.47%	–	-2.89%
ELMI+	4.07%	–	-1.52%
EM FX spot	–	–	-2.58%
EMBI GD	5.79%	399 bps	-0.37%
EMBI GD IG	4.33%	246 bps	-0.27%
EMBI GD HY	7.82%	615 bps	-0.48%
CEMBI BD	5.58%	397 bps	-0.05%
CEMBI BD IG	4.27%	267 bps	0.16%
CEMBI BD Non-IG	7.81%	619 bps	-0.41%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.4	–	-0.33%
1-3yr UST	0.74%	–	0.13%
3-5yr UST	1.24%	–	0.30%
7-10yr UST	1.79%	–	0.49%
10yr+ UST	2.63%	–	1.14%
10yr+ Germany	0.16%	–	2.52%
10yr+ Japan	-0.08%	–	1.15%
US HY	8.23%	702 bps	-0.75%
European HY	5.31%	547 bps	-0.32%
Barclays Ag	–	236 bps	0.18%
VIX Index*	14.72	–	-0.98%
DXY Index*	93.91	–	1.28%
EURUSD	1.1418	–	-0.99%
USDJPY	107.58	–	1.10%
CRY Index*	179.91	–	-4.70%
Brent	45.8	–	0.00%
Gold spot	1280	–	-0.93%

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

Emerging Markets

Kenneth Rogoff, a prominent economist, proposed last week that central banks in Emerging Markets (EM) should sell US dollars and buy gold instead as a safeguard against fiscal and financial catastrophe.[1]

The renewed focus on EM central bank reserves diversification is welcome and timely. EM central banks control some 80% of the global FX reserves, or USD 8.6trn, and reserves are notoriously undiversified with disproportionately large concentrations in US dollar denominated assets. While heavy exposure to the US dollar has been useful in the last few years the USD has been struggling of late and the outlook is more uncertain.

Reducing the overall level of exposure to Dollars seems eminently sensible. The QE economies, including the US, have spectacularly failed to reform following their crisis in 2008/2009. Instead, they have increased their government debt burdens and re-inflated asset prices to levels that are higher than before the crisis. The big problem they face now is that they have no conventional easing tools left in case of a slump other than very third rate measures such as negative interest rates and Helicopter Money. Rogoff's point about fiscal and financial catastrophe is therefore not entirely misplaced.

To illustrate the level of riskiness in developed markets today consider the following. At the current low yields there is virtually no protection against interest rate shocks in developed market bonds. A mere 150bps move in yield curves would wipe out between six and eight years of carry in US and UK 5-year bonds, while yields on 5-year bonds in Germany and Japan are negative, so no amount of carry would ever make up for the capital losses caused by a rise in yields.

Still, Rogoff's proposal that EM central banks buy gold as an alternative to developed market bonds is somewhat lacking in imagination. Gold is in fact far from the best alternative asset available to EM central banks. They would be far better off if they diversified into EM local currency bonds.

[1] Kenneth Rogoff, *"Emerging Markets Should Go for the Gold"*, Project Syndicate, 3 May 2016 https://www.project-syndicate.org/commentary/gold-as-emerging-market-reserve-asset-by-kenneth-rogoff-2016-05?referrer=/HWASCAYul2

Continued overleaf

Emerging Markets

The obvious reason to consider EM local currency bonds is that they pay yield. EM bond yields today sit very close to levels that prevailed long before the global financial crisis, at a time when the Fed had interest rates above 5%. This should offer a great deal of comfort, because at current yields the capital losses arising from surprise spikes in yields can quickly be recouped via carry. There is no such protection available in gold. Indeed, with retail ETF flows becoming more prominent in the gold market the Sharpe Ratio for gold – a measure of risk adjusted return – is now inferior to that of local currency bonds.

The case for EM bonds over gold goes far beyond the obvious point that EM bonds pay a yield, however. EM local currency bonds are also more liquid than gold. This is critical for EM central banks, because they hold reserves to stabilise their currencies during bouts of risk aversion. The gold market may look large, but it is in fact quite small and so is its liquidity. There is currently just over USD 7trn of gold in the world, based on current prices, but about half has been shaped into wedding rings, necklaces and other jewellery, while central banks, mainly in developed countries, are hoarding another 17%, which they are unlikely to relinquish. A further 12% is being used in industry, so less than 20% of total outstanding gold, or USD 1.4trn, is traded on market.

By contrast, at USD 12trn the total EM local currency bond universe is nearly ten times larger than the gold market. Approximately half of the bonds are government bonds, while the other half is quasi-sovereign and high grade corporate bonds. Nearly every single EM country issues some kind of local securities, such as T-bills and central bank paper, which means that EM bonds can also lay claim to another major advantage over gold, namely diversification.[2]

That is not to say that there is no role for gold. Gold is and should be regarded as a tail hedge asset, but not as a serious alternative to government bonds. Central banks should of course be mindful of tail risks, so a small amount of gold in the portfolio is entirely justified. However, the main portfolio allocation decisions should revolve around standard fixed income securities and currencies.

Central banks should also base their core allocation decisions on global macroeconomic analysis rather than tail risk scenarios. The big macroeconomic issue of our time is debt – and specifically the question of how the QE economies will escape their enormous debt overhangs. Sure, it is possible that the end-game will be fiscal and financial disaster, but the more likely outcome is that the debt problems in developed economies are resolved in the time-honoured fashion of inflation and currency debasement. Central banks should prepare for this by increasing exposure to non-QE currencies, including EM bonds, not just gold.

Greater diversification into EM bonds would likely have important positive externalities for the global economy. To see why, recall that QE central banks kick-started a giant global portfolio shift after the 2008/2009 crisis in order to restore financing to their own markets as quickly as possible. But their highly selective asset purchase programs induced institutional investors to also buy QE assets, which were financed by reducing exposure to non-QE markets, including EM. The result was a misallocation of global capital on an epic scale with disastrous consequences for global growth and the riskiness of in financial markets. Trillions of dollars of perfectly good money have been thrown after bad in one of the most inefficient and counterproductive policy interventions of all time. Asset bubbles have now been more than re-inflated in developed markets without achieving sustained exit velocity, while the world's only viable growth engine, EM, which account for 57% of global GDP was starved of the finances required for sustain global growth.

A concerted program of EM local currency government bond purchases, led by EM central banks and supported, say, by the Fed, would help to boost global growth in three ways. First, it would weaken the Dollar and therefore ease conditions facing America's struggling manufacturing, energy and export sectors. Secondly, money would flow back into EM where financial conditions would ease, so that investment and consumption can pick up. Infrastructure investment would be particularly appropriate to enable EM to resume its role as the world's growth engine while developed markets deleverage and reform. Thirdly, global financial markets would de-risk as dangerous asset bubbles in developed markets are slowly deflated and corporates can spend funds currently used for FX hedging for more productive uses.

EM countries are today the only part of the global economy that would openly welcome stronger currencies. EM currencies have fallen a lot in recent years, so their economies can handle some appreciation. The more important point, however, is that currency movements tend to dictate capital flows. Stronger EM currencies would therefore bring fresh investment capital into EM and hence stimulate not just EM growth. This is exactly what EM countries need after being subjected to strong capital outflows for several years due to the powerful gravitational pull exerted by QE policies on asset allocators. A return to stronger growth in EM would help pull developed countries up as well.

EM countries are still perceived as risky by many central banks. There is no such thing as a risk free investment, however, and EM markets at least have the distinct advantage that risks are known. This alone makes them less risky. Much is being made of EM currency weakness in recent years, but the EUR and JPY

[2] EM fixed income benchmark indices are a poor proxy for the size of the local bond universe. Only 14% of local currency government bonds are covered by the main JP Morgan GBI EM GD index. Only 2% of local currency corporate bonds are covered by the BAML LOCL index.

Continued overleaf

Emerging Markets

have fallen in magnitude as much as many EM currencies over the same period. The big currency story of the last few years has not been an EM FX story; it has been a USD story. Fundamentally, EM countries have also withstood multiple financial shocks with remarkably few actual economic disasters – for example default rates among EM corporates are much lower than, say, among US corporates. Only two sovereigns out of 62 index names – Argentina and Ukraine – have defaulted and these defaults arguably had nothing to do with Taper Tantrum, the USD rally, commodity shocks and Fed hikes. Instead, most EM countries have adjusted and regained significant competitiveness on the back of much weaker currencies. Today, it is the US economy that looks expensive and behaves like an economy where rates are already at 5%. This means that the US could use a weaker US dollar. The real challenge pertains to Europe and Japan; their fundamentals are so weak that they would genuinely get hurt by stronger currencies. This is precisely why a program by EM central banks to sell Dollars and buy EM currencies rather than EUR and JPY would make so much sense.

- Turkey: Much is being made about rising political noise in Turkey. Prime Minister Ahmet Davutoglu resigned after falling out with President Erdogan, but his resignation does not represent a major change in direction of politics in Turkey. Those who follow Turkey closely will recognise that Davutoglu's resignation is simply another step along a path down which Turkey has been trotting for some time, namely the power struggle within the Turkish government between President Erdogan and groups that favour a more institutional approach to governance. Erdogan is winning this battle because he controls the AK party by virtue of his large and repeated election victories. Erdogan is, simply put, the most powerful political force in Turkey and he is using this power to further increase his power.

Erdogan and Davutoglu's specific differences mainly boiled down to political rivalries, i.e. control of the AK party, such as the power to appoint local party heads and who should take credit for Turkey's successes in EU talks. Still, there were also deeper and important differences in their policies with respect to corruption and economic policy. In that sense, Davutoglu's departure is a negative, because he was (rightly) regarded as more technocratic and rule-based in his approach to governance than Erdogan.

Turkey is now likely to become even more dominated by Erdogan's vision for the country. In this vision, Erdogan sees himself presiding over a rapidly growing Asian-style success story. This vision, however, faces two serious challenges. One is that Turkey does not have the large domestic savings base required to finance an Asian-style investment-led growth model. Turkey is running a meaningful current account deficit, which is financed by foreign saving in the form of short-term portfolio inflows. Such savings cannot be relied upon for long-term investments. A bout in risk aversion could quickly cause Turkey's external funding to dry up. Second, Erdogan is personally involved in project selection and policy implementation, including central bank policies. His interventions are unorthodox. Experience from other countries and indeed Turkey itself shows that excessive discretion by a single person over policy does not always guarantee the most efficient outcomes. Hence, it can undermine investment returns and therefore the country's growth potential. Ratings agencies may also take dim view of recent political developments.

- China: China's FX reserves rose for a second consecutive month to USD 3.22trn as of April 2016. The consensus expectation erred on the side of fear, as always, anticipating reserves to drop to USD 3.20trn. The small increase in reserves suggesting that (a) repayments of Dollar loans by corporates is slowing and (b) currency valuation effects waned. China's trade surplus also increased to USD 45.6bn versus USD 40.0bn expected and USD 29.9bn in March. Both exports and imports slowed. The trade balance feeds directly into the GDP calculation, so the market will now have to up their Chinese GDP growth expectation following the larger than expected trade surplus. The government signalled that it is more comfortable with the outlook, that reforms will take time and that supporting the economy exclusively via excessive leverage would be dangerous.

- Argentina: The government has eased capital controls, allowing imports to rise to USD 5m per month from USD 2m before. This is important for growth, because companies will be able to get hold of the inputs they need in the production process. Argentina last week paid in full holders of discount and par bonds that last year became subject to a court-imposed injunction of non-payment. The central bank cut rates by 50bps to 37.5% as core inflation begins to slow. Standard & Poor's, a ratings agency, raised Argentina's sovereign debt rating from SD to B- with a stable outlook. Ratings agencies are likely to be far behind the market, which has already priced bonds consistent with ratings substantially higher than those currently assigned by the three main ratings agencies.

- Colombia: The approval rating for President Juan Manuel Santos has dropped sharply as the adjustment to lower oil prices takes hold. Santos' approval rating is now just 21%, down from 42% at the end of last year. The decline in Santo's approval ratings has no major consequences for economic reforms, which were undertaken early in Santos's first term, but could pose a significant risk to chances of success in an expected referendum on a peace deal with the FARC rebel movement. IMF commented on the Colombian economy, forecasting a soft landing. We share this view.

Continued overleaf

Emerging Markets

Snippets:

- **Brazil:** The speaker of the Lower House, Eduardo Cunha, has been suspended by the Supreme Court. We do not expect this to impact the impeachment process of President Dilma Rousseff. Fitch, the ratings agency, downgraded Brazil's sovereign debt rating to BB from BB+, with negative outlook. As in most other cases, the ratings agencies are far behind the curve.
- **Chile:** Inflation was 0.3% in April, half of the rate of inflation in the same month of 2015.
- **Dominican Republic:** Remittances rose at a rate of 7.4% yoy in Q1 2016, mostly from the US. FDI flows were 29.5% higher in Q1 2016 than Q1 2015.
- **India:** India's Lower House has passed a new bankruptcy and insolvency reform, which could significantly increase efficiency of resource allocation in the Indian economy. The bill now goes to the Senate for debate and vote.
- **Indonesia:** The economy expanded at a pace of 4.1% yoy in Q1. This was less than expected (5.1% yoy). Investment was lower than expected, but given the lumpiness of investment one should not read too much into this, in our view.
- **Malaysia:** The February trade surplus rose to MYR 11.2bn, which was far greater than expected (MYR 7.4bn). Exports beat expectations. A trade surplus feeds positively into the calculation of GDP growth.
- **Mexico:** The MPC left rates unchanged at 3.75%. Inflation is modest and domestic spending is picking up. The main risks as perceived by the MPC are external, notably developments in the US. Gross fixed investment was stronger than expected (5.2% yoy versus 4.4% yoy expected).
- **Philippines:** Core inflation was unchanged at 1.5% yoy in April, marginally lower than expected (1.6% yoy).
- **Russia:** Monthly inflation in April decelerated to 0.4% per month from 0.5% per month in March. Inflation rates are now down to 7.3% yoy, less than the 7.4% yoy rate expected.
- **South Korea:** The trade balance expanded to USD 8.8bn in April, the 51st month of surpluses. Export volumes picked up.
- **Taiwan:** Inflation and manufacturing both declined. Inflation dropped to 1.9% from 2.0% yoy, while manufacturing PMI declined to 49.7 from 51.1.
- **Venezuela:** The Supreme Court blocked an opposition-led proposal to put more judges onto the Supreme Court. The Court had no objection when the National Assembly approved a similar proposal by President Maduro last year. This underlines how politicised the Supreme Court has become. It is, in effect, being used to neuter the National Assembly.

Global backdrop

The US economy continues to grow slower than last year, and at a sluggish pace. The payroll number did not change that impression, but will likely have put the final nail in the coffin of a June rate hike. Meanwhile, political risks are clearly rising. Donald Trump became the de facto undisputed Republican candidate for the job of President of the United States. As such, Trump's statements must now be given far greater weight, in our view. His recent comments on Fed Chairwoman Janet Yellen (that he will replace her) and the US debt problem (that he will negotiate the debt) are particularly important. After all, directly and indirectly the debt overhang is the main reason for the sluggishness of the US recovery from 2008/2009 and the only realistic way out is inflation and devaluation. If Trump is to deliver greater prosperity for hardworking American families he will have to find a way to deal with the debt problem. His solution appears to be quite pragmatic: asked what would happen in the event of an economic crash Trump indicated he would negotiate repayment. He also said that if rates go up a few percentage points "we don't have a country", meaning that the economy will slump under the weight of debt service. Here is the problem: The market is ignoring these statements, thinking they are just the populist rantings of a politician on a roll. In this complacency lies great danger. Risks are simply not priced into developed market securities. By contrast, in EM they are always priced, though one can debate whether they are priced correctly.

Continued overleaf

Ashmore

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-4.10%	1.93%	-20.41%	-5.80%	-4.46%
MSCI EM Small Cap	-2.92%	-0.50%	-16.62%	-3.85%	-2.99%
MSCI Frontier	0.68%	2.70%	-12.22%	1.44%	1.24%
MSCI Asia	-3.15%	-2.34%	-19.99%	-1.82%	-0.80%
Shanghai Composite	-0.83%	-17.64%	-30.01%	12.20%	2.83%
Hong Kong Hang Seng	-5.23%	-12.29%	-37.60%	-4.80%	-4.75%
MSCI EMEA	-7.02%	9.07%	-20.82%	-9.48%	-7.76%
MSCI Latam	-5.72%	19.12%	-18.32%	-14.35%	-10.71%
GBI EM GD	-2.89%	10.58%	-4.48%	-7.90%	-2.78%
ELMI+	-1.52%	4.78%	-4.12%	-4.52%	-3.19%
EM FX Spot	-2.58%	4.21%	-10.99%	-11.88%	-9.48%
EMBI GD	-0.37%	6.51%	4.33%	2.81%	6.08%
EMBI GD IG	-0.27%	6.73%	3.15%	2.14%	5.32%
EMBI GD HY	-0.48%	6.09%	5.86%	3.67%	7.20%
CEMBI BD	-0.05%	5.63%	2.81%	2.96%	4.93%
CEMBI BD IG	0.16%	4.52%	2.98%	3.19%	5.34%
CEMBI BD Non-IG	-0.41%	7.55%	2.23%	2.32%	4.17%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.33%	1.40%	1.07%	10.64%	11.30%
1-3yr UST	0.13%	1.19%	1.23%	0.67%	0.70%
3-5yr UST	0.30%	2.62%	3.23%	1.86%	2.09%
7-10yr UST	0.49%	4.94%	6.36%	2.83%	5.35%
10yr+ UST	1.14%	8.59%	11.22%	5.56%	9.76%
10yr+ Germany	2.52%	10.33%	7.87%	9.13%	11.64%
10yr+ Japan	1.15%	13.84%	17.69%	8.45%	7.85%
US HY	-0.75%	6.39%	-2.60%	1.87%	5.41%
European HY	-0.32%	3.64%	1.38%	5.93%	8.92%
Barclays Ag	0.18%	4.63%	3.92%	3.34%	4.97%
VIX Index*	-6.24%	-19.17%	14.46%	12.11%	-14.22%
DXY Index*	0.88%	-4.79%	-0.94%	13.42%	25.65%
CRY Index*	-2.55%	2.14%	-21.49%	-38.27%	-47.72%
EURUSD	-0.24%	5.18%	2.36%	-12.46%	-20.52%
USDJPY	1.08%	-10.39%	-10.41%	6.95%	33.87%
Brent	-4.78%	22.93%	-29.91%	-56.13%	-60.46%
Gold spot	-1.03%	20.56%	8.08%	-12.25%	-15.47%

*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.

Continued overleaf

Ashmore

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 347 0649

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Istanbul
T: +90 212 349 40 00

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Washington
T: +1 703 243 8800

Other locations
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper