China again surprises on speed of reforms

By Jan Dehn

China confounds the bears again as the bond market is opened fully – do not bet against China. Odds of GST reform rises significantly in India. Mehmet Simsek may prove to be a lame duck in the Turkish government. Argentina tightens reserve requirements as monetary policy normalisation continues amidst speculative currency appreciation. Russia shows that sanctions are ineffective. Brazil's twin surpluses. Nigeria concedes defeat on its fixed exchange rate policy. In addition to the snippets section, we discuss the complex balancing act facing the US, Europe and Japan when it comes to currencies.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.7	–	2.43%
MSCI EM Small Cap	11.2	–	1.17%
MSCI Frontier	9.1	–	1.25%
MSCI Asia	11.1	–	2.77%
Shanghai Composite	11.8	–	-0.73%
Hong Kong Hang Seng	6.7	–	4.02%
MSCI EMEA	9.7	–	2.87%
MSCI Latam	12.2	–	-0.12%
GBI-EM-GD	6.61%	–	0.22%
ELMI+	4.21%	–	0.27%
EM FX spot	–	–	0.01%
EMBI GD	5.81%	394 bps	0.29%
EMBI GD IG	4.39%	245 bps	0.28%
EMBI GD HY	7.79%	602 bps	0.29%
CEMBI BD	5.60%	388 bps	0.21%
CEMBI BD IG	4.31%	260 bps	0.16%
CEMBI BD Non-IG	7.78%	605 bps	0.28%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.8	–	2.32%
1-3yr UST	0.93%	–	0.02%
3-5yr UST	1.41%	–	-0.07%
7-10yr UST	1.88%	–	-0.04%
10yr+ UST	2.67%	–	-0.38%
10yr+ Germany	0.19%	–	0.16%
10yr+ Japan	-0.11%	–	0.02%
US HY	7.87%	654 bps	0.78%
European HY	4.76%	505 bps	0.77%
Barclays Ag	–	236 bps	0.34%
VIX Index*	13.12	–	-2.08%
DXY Index*	95.71	–	0.14%
EURUSD	1.1128	–	-0.12%
USDJPY	111.21	–	1.11%
CRY Index*	186.14	–	1.93%
Brent	49.6	–	2.12%
Gold spot	1211	–	-1.30%

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

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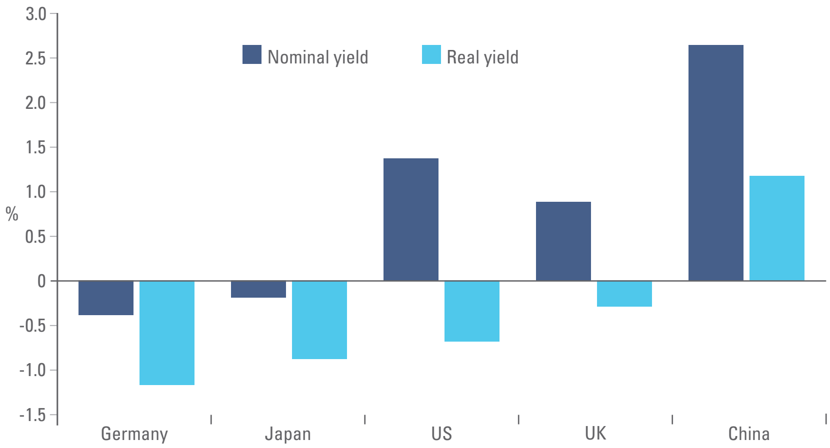
Fig 1: **5 year bonds yields: SDR countries**



Source: Ashmore, Bloomberg.

- **China:** Do not bet against China. China has once again confounded investors by moving faster and more aggressively on reforms than most expected. With immediate effect, the People's Bank of China (PBoC) has opened China's interbank bond market (CBIM) to all global institutional investors. In a sign of the seriousness of China's intentions to incorporate its economy into global capital markets, including becoming a major global reserve currency, PBoC opened with market subject to rules that were more flexible than anticipated. Specifically, there are no restrictions whatsoever on inflows and outflows. Remittances can be in CNY or in

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foreign currency. Foreigners also face no restrictions participating in both cash bonds and derivative markets, such as interest rate swaps, forward bond markets, securities lending and forward rate agreements. Quotas are entirely eliminated. In our view, this development paves the way for China's government bond market to enter key fixed income benchmark indices this year as we anticipated in the 2016 Fixed Income Outlook.[1] Last year's big policy objective was to commence SDR inclusion, a process that will also be completed this year. China's interbank bond market is more than USD 7trn in size, but foreign involvement has been limited by quotas and lack of index inclusion. These constraints are now either gone or likely to fall away soon. China is the first Emerging Markets (EM) currency to be admitted as a global reserve currency. China is also the only large global reserve currency nation not to print money through QE programs. Unlike bonds in the other main SDR countries, Chinese bonds pay yields that are positive in both nominal and real terms (China's core inflation rate is 1.5%). Concerns about China's debt stock are overblown. China has large debt because it has a large savings rate, which in turn means that deposits in the banking system are high. Banks lend out the money with moderate leverage compared to Western banks. China's debt levels are roughly similar to that of Western economies, but China has ten times higher savings.

- India: The odds that the government manages to pass the Goods and Service Tax (GST) bill in the Senate in the July-September session are rising sharply. The GST bill would, if passed, change India by significantly reducing barriers to trade within India, enabling firms to lower transport and trade costs and increase the scope for scale economies. In fact, it is arguably the single most important structural reform that could be done in India today, in our view. Key to the bill's passage is that the ruling BJP party and coalition partners can secure 162 of the 244 seats in the Senate. Currently the government can only muster 145 seats, but Senate elections scheduled for 11 June will decide 57 Senate seats which could change all that. Local polls suggest that BJP and its allies could secure as many as 161 seats, which would be close enough to warrant expectations that the GST bill could pass, if necessary with the aid of some bargaining. If passed, the bill could be implemented by April 2017.

- Turkey: Recently appointed Prime Minister Binali Yildirim kept Mehmet Simsek as Deputy Premier with responsibility for the economy. Simsek is a key anchor for economic policy credibility in the government. However, Yildirim will take over the role of overall coordination of economic policy, according to a decree published in the Official Gazette. This means that Simsek is not only alone in an increasingly politicised cabinet, but he has also had his wings clipped in terms of influence. Meanwhile, tourism arrivals declined 28.1% yoy in April.

- Argentina: The central bank is struggling to contain currency appreciation; if anyone had said that twelve months ago, they would have been labelled unstable. Yet, today the appreciation of the ARS is a reality. This led the government to exclude non-resident investors from LEBAC auctions last week (LEBAC is the main short term monetary policy instrument) for fear that monetary instruments become the objective of speculative frenzied buying by foreign investors. ARS is up nearly 12% against the USD since early March. Meanwhile, the central bank is continuing to gradually tighten credit conditions as policy rates gradually come down – last week the central bank announced two further increases in reserve requirements of 2.5% to be implemented in June and July, respectively. The trade balance moved into a modest surplus of USD 332m in April after bottoming out in December 2015 at USD -1,091m. Finally, the government has submitted a pension reform to parliament that would recognise the previous governments' failures to meet their obligations with funding from funds repatriated under a tax amnesty plan.

- Russia: The Russian government demonstrated in no uncertain terms that it is able to raise funding in global markets despite sanctions on several Russian quasi-sovereign entities and 'destructive ambiguity' on the part of officials in both the US and Europe with respect to participation of Western banks and clearing houses in the bond issue. The bond is also not index eligible – the index providers deem that settlement with an internationally recognised settlement agency is required for eligibility for inclusion in external bond indices. Still, Russia placed USD 1.75bn with attractive yields relative to the curve. The bond may or may not eventually become eligible for Euroclear settlement, though for now it looks unlikely. Industrial production rose at a yoy pace of 0.5% in April versus -0.5% yoy expected. Retail sales remained soft, but wages rose due to higher private sector wages. This bodes well for retail sales going forward.

- Brazil: Brazil is now running a twin surplus, at least for now. The current account went into surplus for the first time since 2009 and the government ran a primary surplus in April. The improvement in Brazil's external balances has been – and remains – a corner stone that supports the outlook for fixed income for Brazil. Still, the achievement of a current account surplus was sooner than expected. April's current account surplus was USD 412m versus a consensus expectation of a deficit of USD 900m. As for the primary surplus, it was larger than expected (BRL 9.8bn in April versus BRL 2.5bn expected) though in large part caused by seasonal effects that may reverse in coming months. In other economic news, the labour market continued to deteriorate and lending contracted. On the political front, Acting President Temer won approval for an austere budget. The budget constitutes two improvements relative to previous versions. First, it recognises the remaining fiscal skeletons. Secondly, it proposes cuts of more than 2% of GDP. If implemented as passed, Brazil's public finances will gradually move back onto a sustainable footing. Meanwhile, a spokesperson for the impeachment

[1] http://www.ashmoregroup.com/sites/default/files/article-docs/AnnualOutlook_FI_2016_5.pdf

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commission in the Senate announced that the impeachment trial of President Dilma Rousseff will take place in two steps. First, the Senate will vote to decide if there is a legitimate basis for impeachment (no later than 2 August). This vote will then be followed by a final decisive verdict on Dilma, which will happen on 21 August at the soonest. The Olympics opens in Rio on 5 August. Finally, the corruption scandal has already claimed two ministers in the new Temer administration. The Budget and Anti-corruption Ministers were both sacked without further ceremony as soon as allegations arose that they had interfered with the corruption investigation. This decisive stance by Temer will help limit the political fallout, in our view.

- Nigeria: The central bank last week made an important concession to economic sanity when it announced that the currency will be allowed greater flexibility. However, the currency has not yet moved. President Buhari has maintained that a pegged currency is desirable despite sharply falling oil revenues. This policy has caused a major loss of reserves, forced imports and capital outflows to be curtailed, the latter resulting in Nigeria's expulsion from the JP Morgan GBI EM GD benchmark index. If the government is now finally beginning to recognise the importance of sustainable macroeconomic policies it would be a major improvement relative to recent policies.

- Mexico: The IMF approved an up-sized Flexible Credit Line (FCL) of USD 88bn for Mexico. The previous FCL facility was USD 67bn. Mexico has USD 177bn in reserves and does not need the IMF money. The FCL does not hurt Mexico, while it helps the IMF to commit some funds. Meanwhile, Mexico's unemployment rate dipped to a lower than expected 3.80% in April from 4.31% a year ago. The current account deficit narrowed to USD 7.0bn in Q1 2016 from USD 7.3bn in Q4 2015, which means that the current account deficit is 17% narrower than at the same time last year. Inflation in the first half of May 2016 was -0.48% versus -0.34% expected.

Snippets:

- Chile: The current account surplus increased further in Q1 2016, rising to 0.9% of GDP from 0.7% of GDP in Q1 2015.
- China: The yoy pace of industrial profit moderated in April to 4.2% from 11.1% in March. This means that cumulative industrial profits ytd reached CNY 1844bn from CNY 1734bn in the same month of 2015.
- Colombia: Moody's affirmed Colombia's foreign currency sovereign rating and the investment grade Baa2 ratings with stable outlook. The central bank increased interest rates by 25bps to 7.25%.
- Costa Rica: The trade deficit declined by 9% to 2.9% of GDP in the first four months of 2016. The deficit in the equivalent period of 2015 was 3.4% of GDP.
- Dominican Republic: Tourist arrivals in Jan-April rose 5.5% yoy.
- El Salvador: The trade deficit in the first four months of 2016 was 9.3% narrower than over the period in 2015.
- Hong Kong: The trade balance in April was much better than expected (USD -31bn versus USD -42bn expected).
- Mozambique: S&P downgrades Mozambique's foreign currency sovereign rating to CCC citing challenges to the country's ability to pay.
- Panama: Economic growth accelerated on a yoy basis in March. The real economy was up 5.4% yoy versus 4.5% yoy in February, based on the latest index of monthly economic activity. Panama Canal revenues declined 0.4% in Q1 2016 relative to Q1 2015 – the main reason for the decline was lower tonnage passing through the Canal. Tourism earnings were up 5% yoy in Q1 2016.
- Ukraine: The central bank was able to cut the policy interest rate by 1% to 18% following an 8% appreciation of the Hryvnia and a current account surplus in April. FX reserves have increased by 156% since early 2015.
- Singapore: Industrial production rose sharply in April. The mom change was 4.8% sa, which took the yoy rate of increase to 2.9% (versus -0.2% yoy expected).
- South Korea: Industrial production weakened at a pace of -2/8% yoy in April, partly due to working day adjustments.
- Taiwan: Q1 GDP declined by 68bps compared to -80bps expected.
- Thailand: At USD 721m, the trade surplus was significantly better than expectations (USD 450m).
- Vietnam: The trade deficit narrowed to USD 400m in April from USD 1,239m in April last year due to lower imports and higher exports.

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Global backdrop

Japan's political leadership is once again issuing warnings about the global economic outlook. This follows further deflation in Japan in April (-0.3% yoy versus -0.1% yoy in March) and weakness in manufacturing, household spending and employment, though industrial production was better than expected. Overall, recent Japanese data can best be described as mixed. Still, it was weak enough to prompt Finance Minister Taro Aso to delay a planned hike in sales taxes and replace it with yet more fiscal stimulus, according to Nikkei, a newspaper.

Japan's recipe of yet more stimulus has been tried before – it only pushes the government even further into debt. Policies of fiscal and monetary stimulus and ignoring structural reforms are policies that are being followed right across the developed world. So far, they have not worked, yet no one is seriously considering alternative approaches.

Japan's political leaders are not just worried about domestic economic weakness. They are also worried about currencies. A global downturn would put upwards pressure on JPY with adverse implications for both inflation and growth in Japan. If so, the BOJ would be left with few options other than to engage in Helicopter Money, thereby exposing the country to accusations that it is engaging in currency manipulation.

It is important to keep a close eye on Japan's predicament, because Japan is so much further down the road of unconventional policies than other Western crisis economies. Right now Japan is clearly finding it impossible to reform and impossible to remove stimulus for fear of the short-term economic consequences. The worry is that Japan's situation is not dramatically different from the situation in the other developed economies. In Europe, bond yields are so low that even the risk of materially higher bond yields would probably elicit further bond purchases by the ECB.

In the US, the probability of a Fed hike has gone up following Fed Chairwoman Janet Yellen's comments to the media last week. The odds of a June hike are now 30% and 54% for July. Our view is that the Fed's ability to tighten monetary policies meaningfully in real terms is constrained by elevated asset prices, high debt levels, terrible productivity, a poor earnings picture and an overvalued USD. If inflation rises the Fed can hike without tightening in real terms. The US has an important advantage over Europe and Japan – it has better odds of being able to generate inflation. The US can also weaken its currency, since the US dollar is up 40%-50% versus most currencies in the world, including the EUR and JPY. A weaker USD would materially help the US economy by easing pressures on shale, manufacturing and exports. Unfortunately, inflation expectations are declining right now, which is why the combined odds for June-July is still for the Fed to stand pat.

If the US eventually manages to inflate and weaken its currency both Europe and Japan will find themselves in a spot of bother. Neither is in a position to handle stronger currencies. How, then would Europe, Japan and the US work out their little currency predicament? In the short term, there is likely going to be a strong desire on the part of all parties to maintain their currencies within relatively narrow ranges. This seems possible, because neither the US, Europe nor Japan seem likely to experience major economic shocks in the very near term.

However, eventually something will shatter the detente. At some point inflation and/or recession becomes inevitable, even if their timing is currently uncertain. If recession hits, a policy response will naturally be required. And the only remaining policy options are negative interest rates and Helicopter Money. Both would have big impacts on currencies. If, on the other hand, inflation becomes a problem then this too would challenge the monetary authorities due to stretched economic and financial conditions. Forced to choose between disinflation and growth – having both at the same time seems impossible due to low productivity – the monetary authorities would likely opt to protect growth. Again, there would be serious spill-overs to currencies.

This is why the growing obsession with currencies among G7 countries is warranted. The currency obsession ultimately reflects broad economic weaknesses, a lack of other policy options, too much debt, weak productivity, overvalued financial markets and already stretched currencies. Investors are led to believe that these are risk free markets and therefore would assume that there is nothing to worry about.

In contrast with Europe and Japan, EM countries would generally welcome stronger currencies. The last few years of USD strength precipitated a giant global portfolio shift, whereby global asset allocators took additional exposure in the QE markets, which they financed by reducing exposure to non-QE markets, including EM. While challenging at first, the resulting weaker EM currencies and higher domestic yields eventually helped to restore EM external competitiveness. This is now evident in much-improved external balances. Rising EM currencies would take back some of this competitiveness, but also bring in fresh capital inflows, which in turn would finance consumption and investment leading to stronger growth.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-3.69%	2.36%	-17.32%	-4.86%	-4.18%
MSCI EM Small Cap	-3.81%	-1.42%	-18.89%	-3.95%	-2.63%
MSCI Frontier	1.92%	3.96%	-8.18%	0.31%	2.16%
MSCI Asia	-1.73%	-0.92%	-17.57%	-0.88%	-0.40%
Shanghai Composite	-3.83%	-20.13%	-37.83%	9.61%	3.35%
Hong Kong Hang Seng	-3.30%	-10.50%	-36.92%	-3.35%	-4.64%
MSCI EMEA	-7.15%	8.91%	-15.58%	-8.09%	-7.20%
MSCI Latam	-9.84%	13.91%	-15.16%	-14.04%	-11.53%
GBI EM GD	-5.48%	7.64%	-4.89%	-7.04%	-3.13%
ELMI+	-2.83%	3.38%	-3.84%	-4.51%	-3.18%
EM FX Spot	-4.88%	1.75%	-10.63%	-11.55%	-9.63%
EMBI GD	-0.16%	6.73%	4.48%	3.56%	5.99%
EMBI GD IG	-0.43%	6.56%	2.75%	2.99%	5.10%
EMBI GD HY	0.15%	6.77%	6.70%	4.26%	7.26%
CEMBI BD	0.22%	5.91%	2.50%	3.31%	4.92%
CEMBI BD IG	0.19%	4.54%	2.67%	3.51%	5.21%
CEMBI BD Non-IG	0.27%	8.28%	1.90%	2.70%	4.40%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.89%	3.66%	1.05%	10.63%	11.90%
1-3yr UST	-0.16%	0.90%	0.78%	0.59%	0.61%
3-5yr UST	-0.27%	2.04%	2.05%	1.90%	1.83%
7-10yr UST	-0.09%	4.34%	4.63%	3.43%	4.97%
10yr+ UST	0.72%	8.14%	8.71%	7.16%	9.41%
10yr+ Germany	1.95%	9.71%	5.89%	9.96%	10.97%
10yr+ Japan	0.43%	13.03%	17.85%	9.58%	7.50%
US HY	0.81%	8.06%	-1.41%	2.56%	5.73%
European HY	0.30%	4.29%	1.60%	6.06%	8.93%
Barclays Ag	0.09%	4.53%	3.37%	3.49%	4.88%
VIX Index*	-16.43%	-27.95%	-5.20%	-9.70%	-17.90%
DXY Index*	2.82%	-2.96%	-1.23%	14.80%	28.23%
CRY Index*	0.83%	5.67%	-16.60%	-34.40%	-46.25%
EURUSD	-2.78%	2.51%	1.84%	-14.39%	-22.71%
USDJPY	4.49%	-7.37%	-10.87%	10.69%	36.42%
Brent	3.14%	33.15%	-24.28%	-50.55%	-57.47%
Gold spot	-6.31%	14.13%	1.87%	-12.72%	-21.13%

*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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