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Steeped in steepening

By Jan Dehn

- Yields on long-end bonds in developed economies have been rising of late.
- This poses a far greater risk to developed market bonds than to EM bonds.
- The current steepening episode is technical in nature, in our view.
- EM investors should therefore add duration into any weakness.
- Longer-term, a return to bear steepening looks likely due to more debt financing and rising inflation amidst slowing growth. We expect long yields to be repressed, however, which means that developed market currencies will take the brunt of the pain; EM currencies stand to gain.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.8	–	-2.59%
MSCI EM Small Cap	11.8	–	-1.90%
MSCI Frontier	10.1	–	-0.50%
MSCI Asia	12.5	–	-2.49%
Shanghai Composite	12.6	–	-2.88%
Hong Kong Hang Seng	7.8	–	-3.98%
MSCI EMEA	9.6	–	-2.08%
MSCI Latam	13.4	–	-3.46%
GBI-EM-GD	6.26%	–	-1.06%
ELMI+	3.76%	–	-0.74%
EM FX spot	–	–	-0.96%
EMBI GD	5.17%	346 bps	-1.13%
EMBI GD IG	3.99%	222 bps	-1.37%
EMBI GD HY	6.83%	522 bps	-0.86%
CEMBI BD	5.02%	346 bps	-0.52%
CEMBI BD IG	3.90%	234 bps	-0.47%
CEMBI BD Non-IG	6.99%	541 bps	-0.61%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.1	–	0.59%
1-3yr UST	0.77%	–	0.05%
3-5yr UST	1.20%	–	0.12%
7-10yr UST	1.69%	–	0.05%
10yr+ UST	2.44%	–	-0.70%
10yr+ Germany	0.01%	–	-0.30%
10yr+ Japan	-0.04%	–	0.00%
US HY	6.48%	502 bps	-0.59%
European HY	4.34%	476 bps	-0.93%
Barclays Ag	–	243 bps	-0.24%
VIX Index*	15.15	–	-0.01%
DXY Index*	95.90	–	0.80%
EURUSD	1.1162	–	-0.65%
USDJPY	102.06	–	0.20%
CRY Index*	180.78	–	-1.75%
Brent	46.5	–	-3.87%
Gold spot	1318	–	-0.76%

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

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Yield at the long end of government bond curves in the QE economies has been going up of late. Why? And what does it mean for Emerging Markets (EM)?

Bear steepening – the tendency for yield curves to steepen led by rising long-end yields – is generally not good news. In today's QE inflated markets, bear steepening constitutes a pain trade with the potential to inflict significant losses, since investors have extended duration in the bond markets for years (and sometimes been forced to do so by their regulators). Yield curve flattening has been part of the broader complex of QE trades, so US equities, another beneficiary of QE, are also adversely impacted. Banks can in theory benefit from steeper curves, but central bankers do not like it when long bonds sell off due to the risks this poses to indebted economies. Remember it was bear steepening that prompted the then Fed Chairman Ben Bernanke to temporarily suspend Tapering in September 2013 after real 10 year yields rose 100bps and US mortgage applications began to collapse. Last year, a surprise 100bps rise in long bond yields in Germany led to some bloodletting in both US and Japanese bond markets. EM asset prices are also impacted at the margin.

What, then, is driving the current bear steepening of yield curves in the QE economies, how far will the move go and what does it mean for EM? And equally important, what does it tell us about the future, if anything?

There are likely to be technical drivers behind the current sell-off in long-end bonds in the QE economies. Selling began at yield levels that were very close to those reached ahead of the previous sell-offs in Germany, Japan and the US last year. Also, the long bonds have experienced a truly extraordinary rally on the back of extensive QE support in the past couple of years, so valuations and positioning are extremely stretched. Year to date alone, these bonds returned about 15% compared to just 3% for 5 year bonds. But the rally goes back

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even further. For example, German 30-year bond yields have fallen by a staggering 245bps to a low of just 35bps since 2013, while US 30-year bond yields dropped nearly 200bps to just over 2% over the same period. The returns have been amazing, given that these bonds have more than 20 years of duration. It makes sense to take some profit, given current portfolio positioning. The current price action is merely a correction, because there are no imminent policy changes or changes in fundamentals that warrant an immediate and sustained change in holdings.

Even so, investors should certainly view the current correction in long bonds with serious concern. It is a warning. Bond markets in developed economies are extremely vulnerable and the potential losses are enormous. Yields are so low that they offer only a minimal amount of protection against capital losses. To illustrate this vulnerability, consider how many years an investor would have to hold a bond in order for the carry to make up for capital loss arising from surprise shifts in the curve. The table below shows how many years of carry would be wiped out, at current yields, as a result of a surprise 150bps move in 30-year bonds in the US, UK, Germany and Japan (we also show the impact on EM external debt, the longest duration asset class in EM, for purposes of comparison).

At current yields, a 150bps surprise shift in the 30-year bond yield would wipe out between 10 and 44 years of carry in developed markets. Or to put it another way; investors would have to hold, say, a German 30-year bond for the next 42 years in order to make up for the capital loss associated with a 150bps move in the German long yield. Now, given that the German 30-year bond yield is currently 64bps and that yields have averaged 4.4% since 1994 investors would have to hold the bonds for a mindboggling 106 years for the carry to make up for the capital losses associated with a return of yields to their long-term average.

Seen in this light, EM bonds are quite simply orders of magnitude safer. EM bonds also suffer capital losses when yield curves shift, but due to their higher yields the carry makes up for the capital losses far more quickly. In fact, investors in EM external debt would cover the capital losses associated with a 150bp shift in the yield curve some twenty times faster than German bondholders and five times faster than US bond holders!

Fig 1: **Years of lost carry for a 150bps shock rise in 30 year bond yields**

Bond market	Years of lost carry from a 150bps surprise shock
US	10
UK	15
Germany	42
Japan	44
EM sovereign debt	2.1

Source: Ashmore, Bloomberg.

Clearly, investors in QE bond markets are sitting on a time bomb. But what is the prospect for bear steepening in the future? Actually, we think risks are already rising significantly. The main reason is that developed economies are running out of policy options. Developed economies exploited fiscal policy heavily in the first few years after the Subprime Crisis before turning to aggressive monetary easing via zero-interest rates policies and QE, particularly in Europe after the European Debt Crisis and in Japan after Prime Minister Shinzo Abe's ascent to power. Now, there is talk of a return to fiscal policy, or, to call it by its proper name, debt financing.[1]

The return to debt financing is not entirely a comforting thought. Economic growth really ought to have come back by now, so that stimulus was not needed anymore. But it has not. In fact, growth is actually softening, while the underlying driver of growth – productivity – has turned negative in the US. Against this weak economic backdrop, if QE economies were to embark on another fiscal splurge their debt dynamics, which are already bad, would quickly worsen.

Also, the risk of inflation is rising, especially in the US. There are three reasons for this; the US economy is approaching full employment, household deleveraging is well advanced and negative equity is practically gone from the housing sector. It is reasonable to expect consumers to become more responsive to cheap and abundant money. A return of inflation amidst sluggish growth means stagflation. This is bad for stocks due to the effect on real income and on a macroeconomic level stagflation presents a major problem for the Fed. The brutal truth facing US policy makers is that unless growth miraculously picks up within a very short time – something we think is unlikely – then the Fed will find itself truly impaled on the horns of a dilemma of whether to fight emerging inflation by inflicting serious pain on an already weak economy or to protect weak growth by living with higher inflation.

As an aside, it is precisely this dilemma that recently led San Francisco Fed Chairman Williams to air a proposal to raise the inflation target. This was not just an empty intellectual gesture. The Fed would favour growth over inflation in the current conditions of weak growth, an over-valued US Dollar, and asset prices that have been

[1] See *"Beyond 'conventional unconventional' policies*, The Emerging View, April 2016.

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pushed far into bubble territory. They would favour growth not just because hiking materially would weaken productivity growth even further and create a recession, but also because meaningful tightening could easily trigger a major sell-off in QE-inflated equity and bond markets with negative feedback to the real economy via wealth effects. A bit of inflation is clearly preferable and Williams knows it. The Fed would therefore do its own reputation a great favour by preparing the market for higher inflation well ahead of time. It would then be in a position to say that it is making progress towards its objective as prices rise rather than being perceived to be behind the curve.

How far could the double-threat to the long-end of yield curves posed by debt dynamics and rising inflation push bond yields? Clearly, if the market was left to its own devices, yields could rise a great deal. But this is not the reality we live in today. Enormous wealth is tied to low bond yields and central banks are huge holders. A material sell-off in long bonds would soon trigger strong counter-measures from regulators and central banks in a bid to contain the selling pressures, in our view. The 'only' problem is that the established method for supporting long bonds – QE purchases from the secondary market – is becoming less effective as fewer and fewer bonds remain in private hands. That is precisely why Helicopter Money – primary issuance of bonds to central banks – is on its way. The fiscal stimulus made possible by such issuance would obviously create a temporary boost to growth, but also pile yet more debt on top of an already excessive debt mountain. If yields continue to be repressed, as we expect, amidst rising debt, rising inflation and declining productivity, then something else has to give, namely currencies. In short, the coming pressures expected in the bond markets are likely, instead, to be shunted into currency markets by virtue of the repression of yields at the hands of central banks and regulators.

The implications for EM investors are clear:

- The current steepening episode is temporary, technically driven and should not pose a major risk to EM investors. In fact, EM investors should use whatever temporary nervousness arises to add exposure. We see no strong and immediate directional drivers of currencies for the time being, so investors should buy duration during the current bout of volatility in long bonds in developed economies.
- Looking ahead to the fiscally driven debt expansion and rising inflationary pressures in the US in particular, we expect yield curves to come under renewed steepening pressure only to quickly become heavily manipulated in order to limit the economic and market damage. Helicopter Money will enter stage left, and the main casualty of the next wave of financial repression will be currencies as explained above. Hence, EM local markets will offer the best safe haven and the greater upside will be in FX rather than rates.
- It is important to bear in mind the starting point for global currencies. The Dollar is 20% overvalued on a trade-weighted basis, according to the IMF. The Dollar is up about 40% or more against most other currencies in the world. EM currencies in particular are extremely cheap. A weaker Dollar would be good for US growth and EM growth alike. Investors like to have money invested in currencies that go up, so rising EM currencies would reverse the financial tightening endured by EM countries in last recent years, thus aiding growth. In turn, this would usher in stronger global growth. EM equities and corporate credit should do well too in that scenario.

Snippets:

- Argentina: The government's fiscal target was revised significantly higher, consistent with the view that Argentina will lean on fiscal policy, including more debt issuance, while it gradually reins in excessively loose monetary policies. Finance Minister Prat-Gay revised the 2017 primary deficit target to 4.2% of GDP from 3.3% of GDP previously, blaming recognition of previously unknown pension liabilities. The silver lining is that inflation is now declining decisively; in August CPI inflation was up 0.2% mom versus 0.5% mom expected. In July, the mom rate of inflation was 2.0%.
- Brazil: Former President Lula has been charged with corruption. Lula's prosecution is long-term positive, because it reduces the odds that he (and the PT party) will return to power in the general election of 2018. On the other hand, the spectacle of Lula's trial could detract attention away from important fiscal and pension reforms. Meanwhile, the government launched further asset sales, including airports, railways, gas reserves as well as electricity distribution and generation companies. Domestic economic weakness continues with retail sales declining 0.3% mom in July.
- Chile: The central bank left policy rates unchanged at 3.5% as expected.
- China: The economic data is improving, making it very difficult for punters to sell the idea that China is having a hard landing (though we would expect them to continue to try). Both credit and monetary data was strong in August. Fixed asset investment stabilised and industrial production increased more than expected. Retail sales also beat expectations (10.6% yoy versus 10.2% yoy expected). Property prices rose 1.0% in August with broad-based increases in prices in all tiers.
- Colombia: Retail sales declined at a pace of 3.3% yoy in July. The decline was specifically due to large ticket items, mainly vehicles. The remaining bit improved at a pace of 3.2% yoy.

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- **Hungary:** S&P upgraded Hungary's sovereign credit rating to investment grade (BBB-, stable) from BB+. The country will therefore be re-instated in the EMBI Global Diversified IG sub-index on 31 October 2016. An upgrade by Moody's following its review of the credit in early November would also trigger Hungary's entry to the local currency IG only sub-index of the GBI EM GD index.
- **India:** The trade deficit narrowed marginally to USD 7.7bn in August from USD 7.8bn in July. We think rumours of a devaluation of the INR are unfounded. The current account position is improving, at USD 342bn India's FX reserves are 5% higher and the rumour emanated from the commerce ministry and was immediately denied by the finance ministry. Wholesale prices inflation was lower than expected in August (3.7% yoy versus 4.0% yoy anticipated). In a negative development, industrial production softened in July.
- **Indonesia:** Revenues recovered via a tax amnesty have now reached IDR 21trn (0.2% of GDP). A similar amount is likely to be in the pipeline, in our view. Exports bounced back much more strongly than anticipated in August (0.74% yoy versus -10.6% yoy expected). Imports picked up strongly too, so the trade surplus came down to USD 294m, below expectations (USD 500m).
- **Israel:** Inflation declined 0.7% yoy in August, softer than -0.6% yoy in July.
- **Paraguay:** The fiscal deficit in the first eight months of 2016 was 0.6% of GDP compared to 0.8% of GDP in the same period last year. Paraguay is complying with a fiscal responsibility law, so the debt burden is very low (19.7% of GDP).
- **Peru:** The trade deficit narrowed to just 0.2% of GDP in the first seven months of 2016 compared to 1.3% of GDP in the same period of 2015.
- **Philippines:** A tax reform proposal sent to Congress could raise net revenues by as much as 2% of GDP. The package includes a number of tax efficiency measures that more than offset cuts in corporate and income taxes. Hence, the reform should enable the Philippines to grow faster, if approved.
- **Russia:** The central bank cut rates by 50bps to 10% and indicated that there would be no further rate cuts this year. United Russia, President Vladimir Putin's political party, won 54.3% of the seats in the State Duma election (based on 85% of the votes counted). This is no surprise, but impressive given the slowdown in growth as a result of falling oil prices and a strong policy response from the central bank in the last few years. S&P, the ratings agency, raised Russia's sovereign outlook to stable from negative, while maintaining the BB+ rating.
- **Singapore:** Non-oil domestic exports were stronger than expected (0% yoy versus -3.3% yoy expected).
- **South Africa:** Retail sales weakened in July. Retail sales dropped 1.9% mom, reflecting ongoing political paralysis amidst a power struggle at the heart of the ruling ANC party.
- **Thailand:** The Bank of Thailand left the policy rate unchanged at 1.5%.
- **Ukraine:** IMF approved disbursement of a USD 1.0bn loan tranche to the government. The disbursement unlocks additional resources from other international financial institutions and bilateral lenders. The National Bank of Ukraine responded by immediately cutting policy rates by 50bps to 15%.
- **Venezuela:** The government is offering to buy bonds maturing in 2017 and swap them with longer bonds with a sweetener in the form of share in CITGO (a chain of petrol stations in the US owned by Venezuela). Even modest participation in the transaction would materially reduce near-term default risk, in our view, calling into question the rationale for the extremely wide spread for Venezuelan sovereign bonds (Venezuela's sovereign spread according to JP Morgan is currently 23.92% over US treasuries).

Global backdrop

Lael Brainard, a Fed governor, lived up to her dovish reputation by pouring copious volumes of ice cold water on prospects of a September rate hike. Just as well. US data – a key determinant of Fed rhetoric – weakened last week. Retail sales were softer than anticipated, while producer prices rose relative to consumer prices, so corporate profit margins are getting eroded. The bad economic news was exactly the medicine US stimulus-addicted markets needed in order to regain some traction, but there was a fly in the ointment too in the shape of a higher than expected CPI inflation, which rose from 2.2% yoy to 2.3% yoy in August. The FOMC starts its 2-day rate setting meeting on Wednesday of this week and is expected to do nothing. The market currently has odds of a September hike at 20% and the odds of a December hike at 55%. The Bank of Japan also undertakes a 'comprehensive assessment' of monetary policy this week. In other news, Deutsche Bank was served a claim for USD 14bn by the US Department of Justice in the latest manifestation of Western governments' ongoing stealth taxation of banks; perceived by the broader public as the perpetrators of the Developed Market Crisis of 2008/2009 banks are being targeted by governments in ever more innovative ways in order to extract their surpluses. As a result, banks are taking less risk and becoming ever poorer market makers. Fortunately, this trend is mainly one that applies to banks in developed countries. Finally, Sterling had a bad week as the UK's Chancellor of the Exchequer said Britain was ready to leave the European single market in order to control immigration.

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Ashmore

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.76%	13.90%	10.61%	-1.36%	0.85%
MSCI EM Small Cap	-0.45%	7.31%	9.10%	1.19%	2.25%
MSCI Frontier	0.33%	-0.05%	-3.99%	-0.61%	3.12%
MSCI Asia	0.11%	11.01%	12.02%	2.77%	4.91%
Shanghai Composite	-2.67%	-13.47%	-1.56%	12.84%	6.51%
Hong Kong Hang Seng	0.76%	3.60%	3.15%	0.68%	3.02%
MSCI EMEA	0.37%	15.34%	0.81%	-7.72%	-3.22%
MSCI Latam	-4.20%	27.93%	15.44%	-8.88%	-6.90%
GBI EM GD	0.08%	14.84%	12.76%	-3.11%	-1.35%
ELMI+	-0.17%	6.26%	5.18%	-2.98%	-1.78%
EM FX Spot	-0.44%	4.17%	0.45%	-9.91%	-8.03%
EMBI GD	-1.09%	13.06%	12.61%	8.10%	6.65%
EMBI GD IG	-1.64%	11.48%	10.91%	7.28%	5.38%
EMBI GD HY	-0.46%	14.73%	14.44%	8.87%	8.39%
CEMBI BD	-0.46%	10.44%	9.92%	6.50%	5.91%
CEMBI BD IG	-0.52%	8.21%	8.27%	6.43%	5.56%
CEMBI BD Non-IG	-0.37%	14.28%	12.58%	6.32%	6.66%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.37%	6.34%	9.60%	10.30%	14.37%
1-3yr UST	0.09%	1.44%	1.36%	0.74%	0.63%
3-5yr UST	0.07%	3.18%	3.18%	2.62%	1.56%
7-10yr UST	-0.51%	6.22%	6.92%	5.77%	3.44%
10yr+ UST	-3.54%	12.19%	15.25%	12.15%	6.54%
10yr+ Germany	-2.24%	14.22%	15.74%	13.16%	8.94%
10yr+ Japan	-1.58%	10.17%	13.53%	8.04%	6.40%
US HY	-0.55%	13.72%	8.21%	4.94%	7.38%
European HY	-0.87%	7.14%	6.07%	6.67%	11.33%
Barclays Ag	-0.95%	7.69%	8.28%	5.69%	5.40%
VIX Index*	12.89%	-16.80%	-32.00%	15.12%	-53.71%
DXY Index*	-0.13%	-2.77%	1.09%	19.32%	24.30%
CRY Index*	0.32%	2.63%	-6.90%	-37.77%	-44.13%
EURUSD	0.04%	2.82%	-0.24%	-17.50%	-18.44%
USDJPY	-1.32%	-14.99%	-15.34%	2.62%	33.26%
Brent	-1.25%	24.60%	-2.15%	-57.29%	-57.44%
Gold spot	0.67%	24.14%	16.26%	-3.56%	-25.92%

*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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