Ashmore

Summary

The clouds are gathering over global currency markets. So far we are only seeing minor skirmishes in a phony currency war. The outbreak of serious hostilities is further down the line. We believe it is the time to begin to accelerate the exit from HIDC (Heavily Indebted Developed Countries) bonds and currencies in favour of safer (and better yielding) Emerging Markets assets.

Global

Global sentiment became more unsettled over the past week as the US debt ceiling and the Italian election draw nearer. Both risks are specific to the HIDCs. US government bond yields fell from 1.89% to 1.83%, but US stock markets rallied 4bps over the same period. Spanish yields rose slightly, but EURUSD rallied following Draghi's hawkish stance last week to 1.3340 vs. 1.30 pre-Draghi. Indeed, the overriding focus in the global market place is currencies. All the big HIDC governments are basing their economic rescue efforts on monetary easing by their central banks (having run out of other policy instruments). Thus, the Fed is on QE 4.0, the BOE has moved to credit easing, Draghi is going to do "whatever it takes", and since the Japanese election we have seen extremely aggressive rhetoric from newly elected Prime Minister Shinzo Abe calling for higher inflation, and much more monetary stimulus, while his government has approved massive new fiscal stimulus. After moving lower recently, JPY stabilised this week as voices within Japan argued against further weakness (due in part to the resulting higher price of oil in Japan). But at the same time Germany announced its intention to bring back its gold from foreign central banks and at least one political party in the Netherlands demanded that Holland do the same. Fed Chairman Bernanke announced this week that the worst thing the Fed could do would be to raise interest rates prematurely. China responded by setting up an office specifically tasked with diversifying its FX reserves. We believe these are early skirmishes in what is still a phony currency war. So far, the extreme reliance on monetary easing has reduced tail risks in the HIDCs, though it has not created growth nor is it likely to do so. But extreme monetary easing is not a risk free strategy: The policy only works as long as the currency is credible, i.e. inflation expectations do not spiral out of control. Draghi knows this very well, which is why he is not cutting rates. The tricky balance, which central banks are trying to strike, is how to shift inflation expectations higher without losing control of inflation expectations. If central banks lose control government bond yields will rise and central banks will then be forced to print more money in a bid to bring yields down so as not to create a fiscal crisis (given high debt levels in the HIDCs). But this only worsens inflation expectations further. So the question is this: Is it possible to be reckless in a controlled fashion? Roosevelt successfully reversed deflation in the mid-1930s, but the Weimar Republic spectacularly failed. And when everything hinges on something as fickle and unpredictable as inflation expectations the risks in HIDC bond and currency markets are truly enormous. There is a real currency war lying in wait behind the thin veneer of today's phony currency war skirmishes.

Latin America

Brazil's COPOM monetary policy committee left policy rates unchanged as retail sales and broader activity measures were stronger than expected by the market consensus. Moody's, the ratings agency, cut the outlook for **Venezuelan** debt to negative over the continuing uncertainty surrounding President Chavez's health. Given the heavy concentration of power in the hands of the ailing president rather than in institutions, the business of government has ground to a halt following the deterioration in Chavez's health. **Peruvian** economic activity rose to 6.8% yoy, according to fresh data from the government. .

Continued overleaf

Asia

China announced that it is setting up a new government unit to help diversify the country's $3.3trn of FX reserves. Quotas limiting foreign inflows were relaxed, and the regulatory commission will let foreign companies issue in CNY. As China moves from export to domestic led growth the domestic bond market will assume greater importance as a transmission vehicle for monetary policy in the context of a more flexible exchange rate. China's CNY fixed at a new low of 6.2691 on Tuesday. Philippine manufacturing rose 9.6% yoy in November and remittances rose by a larger than expected 7.6% yoy in November. Indian inflation surprise - positive at 7.18% yoy vs 7.4% expected and the government took steps to remove uncertainties over the tax treatment of foreign investors.

Eastern Europe, Africa, and Middle East

Russia's President Putin noted that the greater flexibility of the Ruble has reduced macroeconomic risks in Russia (by insulating the fiscal from changes in dollar oil prices). South African retail sales beat expectations of 1.5% yoy growth by coming out at 3.4% yoy, but manufacturing was softer and industry continues to struggle with strikes. Qatar announced that it will lend $2.5bn to Egypt. Serbia and Bangladesh secured new financing from Russia in a further indication of the growth not just of South-South trade, but also South-South financing. Poland's inflation rose by a lower than expected 2.4% yoy. Romania was put on track for admission to JP Morgan's GBI local currency government bond index.

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