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Ashmore

Denial is a river in Africa

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We review a long list of economic and policy developments in Emerging Markets (EM) from the last seven days. Most of them are extremely encouraging. There is far more value than crisis in EM, even if denial seems to be the order of the day. Meanwhile, both the Fed and the Bank of England (BOE) came one step closer to openly admitting that they intend to inflate away their country's debts as they retreated from previous commitments to tightening monetary policy in the face of falling unemployment. This is the old tale of 'The Emperor's Clothes'. Soon a little innocent boy will be heard shouting: "They are going to inflate the debt away!" And then we will finally acknowledge that it is true.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	965		3.22%
MSCI EM Small Cap	1,011		2.14%
MSCI FM	613		0.85%
GBI-GD	7.02%		1.45%
ELMI+	3.06%		0.64%
EMBI GD	5.91%	337 bps	0.08%
EMBI GD IG	4.89%	218 bps	0.23%
EMBI GD HY	8.32%	609 bps	-0.22%
CEMBI BD	5.63%	333 bps	0.30%
CEMBI BD HG	4.69%	239 bps	0.36%
CEMBI BD HY	7.46%	521 bps	0.48%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1839	2.23%
VIX Index	13.57	-11.07%
5 year UST	1.53%	5 bps
10 year UST	2.74%	8 bps
DAX	9662	4.01%
10 year Bund	1.70%	2 bps
EURUSD	1.3701	0.40%
USDJPY	101.94	-0.31%
Brent	109.22	1.00%
Copper	332.66	-0.20%
Gold	1322.75	3.63%

Emerging Markets

Argentina's new inflation index

Argentina launched a new CPI index. It showed that inflation was 3.7% mom in January compared to 1.0% mom according to the old manipulated CPI index. While some have criticised the new index as incredible too – mainly because it showed lower inflation than the Buenos Aires CPI index – we think the new index is OK. The BA specific index gives greater weight to BA specific transport price hikes, which do not feature as strongly in the broader index. The real significance of the new index is a different one, however. Argentina is searching for ways to re-access global financing. There are two competing routes: One is via regaining access to global bond markets. The other is via re-accessing bilateral and multilateral funding. The CPI index is key to the latter. The IMF is due to evaluate the new CPI over the next few months. If the IMF gives its thumbs up then Argentina can do an Article IV report and thereby bring itself an important step closer to a Paris Club agreement, a key to unleashing funding from countries such as France (for example financing for the bullet train to Cordoba). Argentina's pursuit of an IMF Article IV report does not preclude a solution with holdout investors, but we think Argentina does not want to change fiscal policy much under this administration. Moreover, a solution with holdout investors is not entirely under Argentina's control. Hence, the priority, for now, is the path towards fresh, non-market funding.

Brazil's sluggish growth rates

Brazil grew 2.5% in real terms in 2013, twice as fast as in 2012, but well below potential. Growth was weak in H2 2013, but probably mainly for cyclical reasons. Retail sales were weaker than expected in December, rising only 4.0% yoy versus 5.0% yoy expected. Brazil's growth rate is running way below the country's potential growth rate. Brazil has no crisis, after all it has a primary surplus, a large stock of reserves, sustainable debt, and its macro adjustment in 2013 is nearing completion. Rather, Brazil's challenge will be how to get investment back and therefore achieve its potential. Investment could prove sluggish due to the heterodox policies pursued at the direction of Finance Minister Guido Mantega. Will this year's election change things? We expect President Dilma Rousseff to win another term. If she wants growth in her second term we believe she needs to change the direction of economic policy significantly. Specifically, policy needs to move back to the modern era from the 1960s.

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Indonesia's balance of payments surplus

Indonesia's balance of payments was in surplus to the tune of USD 4.4bn in Q4 2013 due to a 2.0% of GDP current account surplus and a capital account surplus of USD 9.2bn. FDI inflows were USD 1.6bn, portfolio inflows USD 1.8bn, and other investments USD 5.9bn. The current account surplus was driven by a trade surplus due to higher exports and lower imports. Like India, Indonesia's economy has responded rapidly to the policy changes undertaken last year (rate hikes, subsidy removal, and currency realignment). Bank Indonesia was, unsurprisingly, able to leave its policy rate unchanged at 7.5% in its meeting this week. The lessons are very clear: First, Indonesia, like the other so-called Fragile Five, never had a crisis, they only needed to do some modest macroeconomic adjustment following a period of excessively easy aggregate demand policies. Second, EM countries tend to restore equilibrium very quickly because their economies are flexible and not burdened by the deeper structural problems of Western Economies, notably debt.

Hungarian inflation: What inflation?

CPI inflation dropped to zero in January from 0.4% yoy in December. The market expected positive inflation of 0.2% yoy. The low rate of inflation is partly due to low domestic demand caused by debt service costs in households with large exposure to foreign currency denominated mortgages. The weaker Forint thus weakens domestic demand, offsetting pass through to inflation from a weaker currency. Given these opposing economic forces, the low overall rate of inflation, and a broad backdrop of deleveraging among consumers, the central bank is likely to maintain its dovish bias, provided that the currency does not weaken excessively. On the other hand, when EM currencies begin to rally again the central bank will be inclined to cut further, in our view. In a related development, the European Court of Justice opined (not ruled) that Hungarian courts will have considerable flexibility to change the terms of FX denominated Hungarian mortgages. At the margin, this is bad news if you are a foreign bank that has lent money to Hungarian households. But it is good news if you are exposed to Hungarian domestic growth and sovereign debt.

China inflation under control, strong trade number and reforms again

China's CPI inflation rate was 2.5% yoy in January, up 0.3% mom. China's very moderate inflation rate is due to the government's pursuit of mildly restrictive monetary policies, FX appreciation, and structural reforms intended to shift the economy from export to domestic demand led growth. Inflation has dropped from a 6% handle over the last few years. China is undertaking deep and bold reforms intended to prepare the economy for the world of tomorrow, that is, a world where inflation returns to developed economies with big debts and lots of money printing. China's leaders know that such policies inevitably result in strengthening of its own currency and hence the government is moving fast to develop the bond market so that it can rely on interest rate management instead of currency manipulation as the main instrument of economic temperature regulation.

China's January exports accelerated sharply to 10.5% yoy from 4.3% yoy in December. The market had expected a flat reading. The result was particularly impressive given the early arrival of the Chinese New Year this year. China's trade surplus rose to USD 32bn in January from USD 26bn in December, boding well for continuing reserve accumulation (USD 3.82trn). We think China's robust trade performance is due to two factors: Solid growth in EM and a moderate rebound in growth in Europe. The former is sustainable. The latter is uncertain.

In another example of the enormous contrast between policy making in China and policy making in developed economies, China this week announced that it is scrapping long-standing policies of food self-sufficiency. The policy will be implemented gradually. Still, this means that China will begin to import more grain, raising questions about a very widely held view that China's structural reforms will be detrimental to commodities. The liberalisation of the grains market in China will also improve the government's already strong fiscal balance, and improve the overall economic efficiency of the country. By contrast, Europe and Japan continue to protect immensely inefficient agricultural sectors at huge cost to the economy and other economies (due to dumping of excess produce).

Venezuelan currency dalliances

Venezuela launched the nth reincarnation of its FX auction system. Having effectively destroyed most economic activity in the country the Venezuelan government has created a country where the only source of Dollars is exports of oil. Meanwhile, the government stimulates demand at full tilt. The result is excessive domestic demand, which can only be met with imports. The resulting demand for Dollars puts the government in a privileged position to supply Dollars at any rate it chooses. The extreme profits that can thus be made in currency trading in Venezuela means that FX trading has de facto become the only game in town. This is both

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good and bad. It is bad because there is no real development in the country. The market becomes as myopic as the currency market (very myopic). On the other hand, government officials have such a big personal stakes in the FX game that they have no incentive to ever make it stop. There are few countries on earth where the discrepancy between the private interest of public officials and the broader interest of the country are more at odds than in Venezuela.

India's declining inflation and improving trade balance

The January CPI print was much better than expected. Consumer prices rose 8.8% yoy in January, down from 9.9% yoy in December and 11.2% in November. Core inflation was 8.2%. India's wholesale price index also dropped sharply from 6.2% in December to 5.1% in January. Core WPI inflation was stable at 3.0% yoy. Economic activity also surprised to the positive side as industrial production rose 0.8% mom (sa). We think India has the potential for an even stronger upswing, but we do not expect a serious pickup in economic activity until after May's elections. India's trade deficit narrowed from USD 10.1bn in December to USD 9.9bn in January. Lower oil prices are helping, but the real reason is the set of macro adjustments undertaken by the government since last year. Domestic demand is softer and the currency more competitive. India's current account deficit was close to USD 35bn in March 2013; today it has been cut in half.

Philippines: The gift that keeps on giving

December's exports rose a whopping 15.8% yoy versus 10.4% yoy expected. Exports to the US softened, but exports to China picked up.

Turkey current account

Turkey's external balances are still very weak. Turkey began to address its own self-inflicted macroeconomic imbalances much later than, say, Indonesia, India, South Africa, and Brazil. Only this year did the central bank depart from its highly heterodox monetary policy and raise rates materially. This delay was due to the great sensitivity of the domestic economy to rising rates plus a busy political calendar. Sadly for Turkey, this delay means that it is only now embarking on the adjustment that the other so-called 'Fragile Five' economies have now largely completed. Turkey will therefore continue to see pass-through from a weak currency to its inflation rate for some time, and the economy can look forward to a significant slowdown ahead of an eventual significant improvement in the current account. Data issued last week shows that the current account deficit in Turkey widened from USD 3.9bn in November to USD 8.3bn in December. However, we believe that slower domestic demand, fading inflation pass through, and better terms of trade will begin to reduce the external imbalance over the coming 6-12 months. Like Brazil, Turkey's main challenge is not going to be to avoid a crisis – the economy is much too strong for that – but rather how to restore investment demand. The real cost of the central bank's experiment with heterodoxy is that it has undermined the credibility of the central bank in Turkey. And a good reputation once lost is tough to restore. This is why the sooner Turkey gets through its political season the better. This will free up the government to take the steps it must take to restore the credibility at the central bank. Whether it opts to do so remains to be seen.

Malaysian growth

Malaysia clocked up a decent 4.7% real GDP expansion in 2013 and looks set to grow even faster in 2014. Economic activity accelerated in Q4 to 5.1% yoy, well above the market expectation of 4.8%. Public spending is declining outright as driver of growth, while investment is rising, a very healthy tendency. The external accounts in Q4 were also very positive as the current account surplus rose to 6.1% of GDP in Q4 from 3.9% of GDP in Q3. IP also rose 4.8% yoy in December, up from 3.8% yoy in November.

South African manufacturing

Manufacturing activity picked up sharply in South Africa in December, rising 0.4% mom versus the consensus expectation of a 0.6% mom decline. The pickup bodes well for Q4 GDP growth. Activity was positively impacted by the end of several strikes in South Africa and in the coming quarters manufacturers will likely to benefit from a very competitive exchange rate. Despite this cyclical pickup, we are not overly bullish on South African growth. We expect the ANC to win this years' election, but we are not expecting the deep reforms South Africa requires to raise its growth rate to its true potential.

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Ratings changes

- Fitch lowered the outlook on Croatian foreign currency debt from stable to negative citing worsening public finances. Croatia's challenge is to restore growth. This requires reforms, but the government has not done any reforms. Fiscal deterioration as a result of continuing weak growth has now prompted this ratings outlook move. Still, Fitch continues to rate Croatian sovereign debt BB+, one notch below investment grade.
- Moody's raised the outlook for Jamaican sovereign debt to positive from stable citing improvements in fiscal and debt metrics plus the recent commitment of the government to a new IMF program.

Global backdrop

The Emperor is still stark naked. In the past week both Janet Yellen at the Fed and Mark Carney at the BOE explained to their various constituencies that they would maintain very low interest rates for the foreseeable future despite recent sharp declines in unemployment rates. Not many months ago the same central banks indicated that these unemployment rates could be regarded as thresholds for more decisive monetary policy changes. While both Yellen and Carney pointed to still material slack in their economy (e.g. underemployment) we think those arguments suffer from serious errors of omission: The real reason why the Fed and the BOE are veering away from their previous commitments to tightening monetary policy is that debt levels in both the US and the UK are far too large, in our view. They cannot raise rates without seriously impeding the recovery. The markets and the most media observers blithely continue to ignore this debt problem. After all, as long as real rates are close to zero the debt does not cost anything and so it is invisible.. But in our view inflation will return long, long before the debt is gone, and this will force central banks in HIDCs (Heavily Indebted Developed Economies) to choose: Allow inflation to exist, or kill growth by raising real rates. We think they will opt for inflation, negative real rates, and, as a result, currency depreciation.

As a wider perspective, we think the process of normalisation of monetary policy in the HIDCs will happen in three distinct phases:

We are in Phase 1 now. This involves a very gentle scaling back of money printing against a backdrop of still very weak fundamentals due to deleveraging, and thus low inflation rates. Marginally rising nominal yields against a backdrop of low inflation means that real rates are rising, but only very modestly. There are strict limitations on how far real rates can rise due to the debt problem. In fact, the world witnessed this limit last summer, when the Fed was forced to U-turn on tapering after a mere 100bps rise in real rates. The rises in real rates during Phase 1 do not pose any real threat to EM countries, which already finance in local markets at rates closer to 7%.

Phase 2 begins when inflation re-emerges in developed economies. It is likely to last a decade, in our view. Inflation is certain to return, in our view, because the world has never printed so much money and most central banks hold so much government debt and mortgages that they cannot really sell assets to soak up the liquidity. Besides, Western economies need the inflation to erode away their debts. Rising inflation against a backdrop of still moderate nominal yields pushes real yields sharply lower into negative territory as inflation rises. The decline in real yields changes the outlook for global currencies dramatically. The dollar begins a decade long decline versus the world's surplus currencies. The last time this happened the dollar lost 50% of its value against the then surplus currencies, the Deutschmark and the Japanese Yen. Today the problem is the same except for two differences: One is that the surplus currencies are in EM. The other is that the imbalance problem is twice as big.

Phase 3 starts when the HIDCs have succeeded in replacing their excessive debts with excessive inflation. A new Fed chair will then restore the institutions credibility and crush inflation by sharply raising real rates. The new Fed can do this only once debt stocks have been eroded away by inflation, because this is the only way to raise rates without killing the economy.

Turning from policy issues to the data, the US economy continues to disappoint. This time it was the turn of retail sales, which dropped 0.4% in January against an expectation of 0%. The disappointment follows hot on the heels of a very weak manufacturing print and two horrible payroll prints in recent weeks. It prompted several investment banks to sharply revise down US growth expectations for Q1 2014. Many still cling on to bad weather as a convenient excuse, but it is clearly not the whole story. Internet sales dropped sharply, while there were strong gains in purchases of construction materials, for example. This is hardly the consumer behaviour one would expect from people trapped in their homes due to inclement weather. Claims for unemployment also rose marginally and the number of new job openings weakened in December relative to November. As we explained at some length in this publication last week we think the US is in the middle of an inventory adjustment following very strong inventory accumulation in the last two quarters of 2013. This is not

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Global backdrop

detrimental to growth, but does create a soft patch. It also underlines the much ignored fact that US consumers still have about 25% more deleveraging to go through before household debts are back to pre-Greenspan Bubble debt levels.

Japan also disappointed those who still believe that it is possible to use fiscal and monetary stimulus to solve a country's structural problems (in Japan's case 200% debt to GDP, horrible demographics and associated unfunded future liabilities, structural rigidities, and deflation expectations). Last week we reported on the return of deflation. This week we note that machinery orders plunged nearly 16% in December. The market had only expected a 4.0% decline.

Meanwhile, economic activity in Europe was positive at the margin. French GDP in Q4 came at 0.3% qoq versus 0.2% qoq expected and investment rose for the first time in seven quarters. Germany's economy also grew faster than expected at 1.4% yoy in Q4 2013, up from 0.6% in the previous quarter. The main drivers of German growth were exports and investment. We expect a weak cyclical upswing in France due to banking problems, excessive debt, a government with low credibility, and structural rigidities. By contrast, we expect somewhat stronger performance from Germany. European industrial production also rose 0.3% qoq in Q4. Finally, Italy's Prime Minister Enrico Letta resigned and Matteo Renzi may take over the job. Volatility in Italian politics is nothing new. It is amusing to observe how political upheaval in developed economies is largely ignored, while it is given huge weight in EM. We think approximately 10 per cent of any group of countries experience some kind of political or economic upheaval at any one point in time. The fact that media and markets assign so much more weight to EM political problems is an expression of de facto apartheid that still exists in financial markets. Risk in Emerging Markets. Risk-free in Developed Markets. And the wine was amazing!

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