Issued: 20 March 2017

WEEKLY INVESTOR RESEARCH

Ashmore

Beyond capacity

By Jan Dehn

It is customary to measure economic slack using indicators that mainly focus on quantities, such as unemployment and output gaps, but in developed economies today with their deep structural problems and excessive reliance on policies that target asset prices and currencies it may be more appropriate – prudent even – to measure the business cycle using real exchange rates. Based on real exchange rates EM economies are cheap with clear room to grow, while macroeconomic risks may be rising in the US.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	4.29%
MSCI EM Small Cap	12.1	–	3.60%
MSCI Frontier	10.3	–	1.36%
MSCI Asia	12.3	–	4.04%
Shanghai Composite	12.0	–	0.77%
Hong Kong Hang Seng	7.9	–	4.41%
MSCI EMEA	9.6	–	4.90%
MSCI Latam	12.3	–	2.63%
GBI-EM-GD	6.66%	–	2.62%
ELMI+	3.73%	–	1.67%
EM FX spot	–	–	1.87%
EMBI GD	5.53%	302 bps	0.81%
EMBI GD IG	4.35%	180 bps	0.83%
EMBI GD HY	7.00%	458 bps	0.80%
CEMBI BD	5.29%	292 bps	0.41%
CEMBI BD IG	4.38%	201 bps	0.46%
CEMBI BD Non-IG	6.73%	437 bps	0.34%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.4	–	0.28%
1-3yr UST	1.32%	–	0.18%
3-5yr UST	2.02%	–	0.32%
7-10yr UST	2.50%	–	0.68%
10yr+ UST	3.12%	–	1.21%
10yr+ Germany	0.46%	–	1.10%
10yr+ Japan	0.08%	–	0.47%
US HY	5.94%	382 bps	0.22%
European HY	3.50%	397 bps	0.03%
Barclays Ag	–	241 bps	0.43%
VIX Index*	11.61	–	0.26%
DXY Index*	100.29	–	-1.02%
EURUSD	1.0755	–	0.96%
USDJPY	112.84	–	1.81%
CRY Index*	183.89	–	0.73%
Brent	51.2	–	-0.21%
Gold spot	1232	–	2.30%

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

Emerging Markets

Do conventional business cycle indicators give accurate signals in unconventional business cycles? This question is gaining in relevance, because the US economy is by common consensus finally approaching what one might call full employment after years of running with significant spare capacity. Macroeconomic risks tend to rise as economies move closer to full capacity, both because inflation risks rise, but also because recessions are never closer than when economies are running at full tilt. The US business cycle is therefore slowly becoming a greater source of uncertainty and potentially risk not just to US investors, but also to investors elsewhere in the world economy, including Emerging Markets (EM). This means that it is now very important that policy-makers and investors alike are measuring the business cycle in the right way.

As far as we can tell, very little attention has been paid to the question of how to measure the business cycle following the 2008/2009 crisis. The overwhelming consensus among policy-makers and most market participants is that capacity utilisation is best gauged using traditional methods. That is by means of conventional business cycle indicators, such as unemployment, output gaps, labour participation rates, core PCE inflation and inflation expectations. These indicators, which have in common that they all seek to measure capacity in the domestic real economy, are currently signalling that the real economy may be moving closer to full capacity, but there are, as yet, no grounds for urgency when it comes to tightening policy. The Fed itself reinforced this perception last week when the FOMC failed to raise its projections for future rate rises (the so-called dot plot).

Yet, this relaxed attitude about the state of the US business cycle may be misplaced, because there are good reasons to believe that conventional business cycle indicators are not picking up the warning signs. Conventional business cycle indicators focus nearly exclusively on the real economy, including factor markets and growth-related variables, but the real economy is growing far slower than normal due to structural drags, so this may not be where the problem sits. More importantly, overheating may be present in a completely

Continued overleaf

Emerging Markets

different part of the economy, which is not usually considered in the context of the business cycle. If that is the case then the impression from conventional business cycle indicators that everything is fine is simply wrong and the business cycle could be further along the path towards overheating than most people believe.

Where, then, are the risks of overheating emerging? Two obvious areas are financial asset prices and the Dollar. Both have experienced extremely rapid appreciation in the past 5-6 years from very low starting points. For example, in the immediate aftermath of 2008/2009 the Dollar was trading at an eleven year low in real terms, while asset prices had dropped disastrously. Understandably, the US government adopted policies that were intended to give a strong boost to asset prices and to shore up the Dollar. The US banking system was collapsing. Bringing capital into the financial system was essential in order to avoid depression, because the US financial system needs to roll debt equivalent to about 70% of GDP every single year. Between them, Quantitative Easing (QE) and a strong Dollar policy helped to create and attract capital from abroad and both the Dollar and US asset prices began to rise spectacularly.

Unfortunately, the enthusiasm in policy cycles for inflating asset prices and maintaining a strong currency did not extend to structural reforms and deleveraging. This imbalance has over time created major distortions between valuations in financial and currency markets and the state of the underlying economy. US stock prices today far exceed pre-crisis levels despite sharply lower trend growth rates, while US Treasury yields dropped below the rate of core CPI inflation along every segment of the yield curve as recently as July 2016, despite above target core CPI inflation. In currency markets the Dollar is now so strong that US companies are seriously struggling to compete against businesses in other countries.

Notice that it need not have come to this. If policy-makers had used the extremely supportive monetary conditions adopted in the aftermath of the crisis to address the underlying debt and productivity problems then trend growth rates would have been higher today and the valuations of stocks, bonds and the Dollar would have looked a lot more reasonable. Sadly, politics got in the way. No one expressed a desire to pass tough reforms as long as stock prices were rising and there was no appetite whatsoever to deleverage while the government's borrowing costs kept coming down.

Today, the structural problems remain unresolved, while asset prices are extremely elevated. The result is a freakish business cycle dynamic, where extreme misalignments of valuations are concentrated in currency and financial markets more so than in the real economy. There may even be some destructive feedback loops at play, whereby the growing risk of macroeconomic dislocations due to the overvaluation of both financial asset prices and the Dollar undermine the recovery in the real economy. There may also be a feedback loop, whereby loss of competitiveness due to the overvalued Dollar is exploited by US politicians to justify trade protection, which clearly will ultimately come back to hurt the US economy.

If conventional business cycle indicators have lost relevance in the current very unconventional business cycle then what is the best way to gauge macroeconomic risks? We think the single best indicator in today's conditions is the real effective exchange rate (REER). As a stationary variable, the REER measures the feasible range for currencies within which economies tend to thrive, adjusted for domestic and foreign inflation. The REER is therefore a business cycle indicator much like unemployment and output gaps with the important difference that REERs measure the state of the business cycle using prices and nominal exchange rates instead of quantities. This is far more appropriate and prudent in an environment where asset prices and currencies have become such important policy instruments and where governments abhor structural reforms.

Today, the both the US REER and asset prices are sending clear messages: based on their valuations there is far less slack than what the conventional indicators suggest. The US REER is currently at its most appreciated level since the height of the Dotcom Boom, when markets wrongly priced a productivity miracle into the price of the Dollar only to discover that the productivity miracle was in fact a bubble. When the Dotcom Bubble burst the real Dollar then fell for eleven years straight and only began its recovery in 2011. By now, however the real Dollar is so expensive that the US economy only managed to eke out 1.6% real GDP growth last year (of which more than half was due to population growth) despite negative real yields across the entire yield curve, massive funding from overseas, fiscal deficits and trillions in outstanding QE. Real GDP growth is tracking an even slower rate of just 1.2% qoq annualised so far this year, which means that 2017 may well be yet another year without the elusive 'exit velocity'.

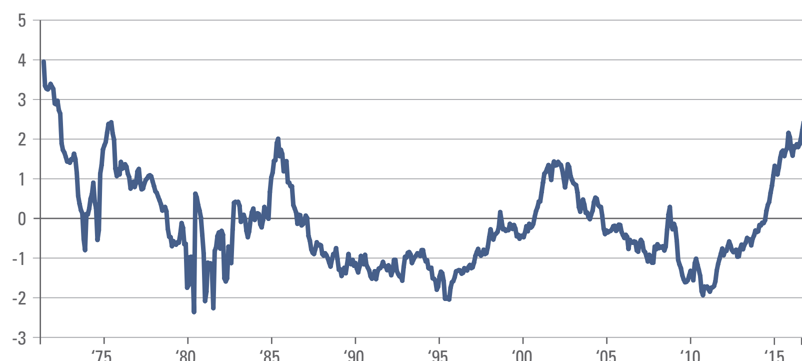
As if the current mismatch between asset prices and the Dollar on one hand and the sluggish state of the real economy due to neglect of reforms on the other was not enough, the outlook is becoming more worrisome. The Fed is still raising interest rates at a very moderate pace despite the fact that the Fed funds rate is deep within negative territory in real terms (the real Fed funds rate is -155bps, which is equivalent to 6.2 hikes of 25bps below neutral). The Trump Administration and Congress are preparing the ground for more fiscal stimulus, including major tax cuts and, if they can agree on the specifics, a trillion Dollar infrastructure program. These policies will only appreciate the REER even further.

Continued overleaf

Ashmore

Emerging Markets

Fig 1: **Icarus Index for the US**



Source: Ashmore, BIS, Bloomberg.

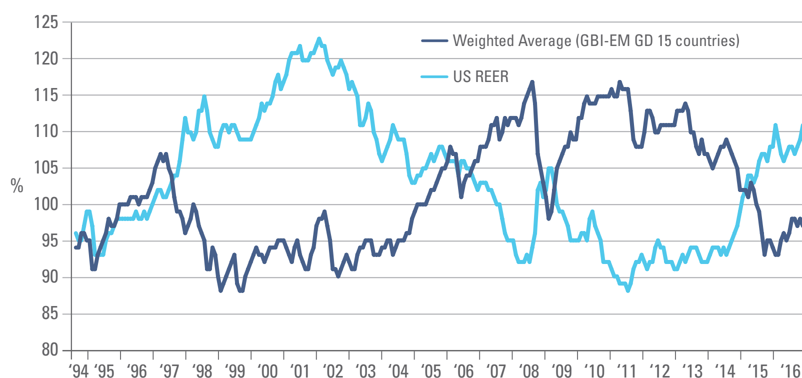
In the Weekly last week, we introduced the Icarus Index to illustrate the scale of the problem.[1] We have replicated the chart above. The Icarus Index is a price-based measure of capacity utilisation adjusted for the current monetary policy stance. The index thus measures both the extent to which the REER is in disequilibrium and the extent the Fed is contributing to demand. According to the Icarus Index, the US economy is now in an uncomfortable constellation, where the economy is running out of room to grow due to real exchange rate overvaluation yet the Fed is still pushing on demand with a highly stimulatory stance. Unfortunately, the Fed would, if it sought to remove the policy slack, likely push the economy into recession. On the other hand, if the Fed does not hike rates then inflation will slowly begin to push the real exchange rate even higher, which then increases the risk of some macroeconomic dislocation. We are worried that US policy-makers literally never discuss the real exchange rate. This suggests that they are not recognising the risk, which is therefore almost certainly not adequately priced.

This is concerning, because there should be no doubt whatsoever that REER overvaluation can be just as dangerous to macroeconomic stability as conventional wage or consumer prices inflation. Corrections of REER misalignments are typically accompanied by highly disruptive capital flight episodes, which often have dire consequences for the real economy and the credibility of policy-makers. One wonders, therefore, whether the Fed's reluctance to normalise monetary policy sooner and faster is due to fear that by doing so it might prick the very bubbles it has created?

Unpleasant as the Icarus Index may be, is there a solution or way out of the constellation of REER overvaluation and a too easy monetary stance? The good news: it is possible to both support the sluggish economy, while at the same time gradually reduce bubble risks. The way to do this is to let the Dollar slide. The marginal cost of the strong Dollar to the US economy is greater today than the marginal benefit in terms of drawing in capital from abroad, so the Dollar can decline and while doing so, actually improve the economic situation. After all, the US has attracted more capital than it needs. A lower Dollar would also ease America's productivity and competitiveness problems in a far cheaper way than by imposing protectionism. Outflows would remove froth from US capital markets and as the capital flows into other countries, their consumption and investment would go up, which will increase demand for American goods and services.

If the Dollar is to slide then it is important that it is done in a reasonably coordinated manner. Positioning and valuations are both heavily skewed at this point in time. A negotiated and orderly decline of the Dollar would be vastly preferable to a disorderly collapse. Direct engagement between US policy-makers and EM central banks, which control about 80% of global FX reserves, seems key to avoid a rout.

Fig 2: **EM and US REERs**



Source: Ashmore, Bloomberg, BIS.

[1] *'The Icarus Index'*, Weekly Investor Research, 13 March 2017.

Continued overleaf

Emerging Markets

Where do EM countries sit in in REER terms? As the chart above shows they are in exactly the opposite situation as that of the US. EM REERs are at 13 year lows. EM current account balances are continuing to improve sharply as a result. Only last week, Poland, India, Indonesia, Singapore and Colombia all recorded large upside surprises on their current account and/or trade balances (see Snippets section below). It is important to understand, however, that the improvement in external balances in EM goes far beyond just a few individual countries. Rather, it is a broad-based trend, which rooted in the massive shifts in exchange rates versus the Dollar for nearly all EM countries in recent years.[2] The drop in EM nominal exchange rates of 40% since 2010and with inflation rates declining by one fifth over the same period has depreciated EM real exchange rates by a massive 20%, rendering them far more competitive than they were in 2010. No wonder the EM growth premium is picking up!

In conclusion, real exchange rates are today's best cyclical indicators, because the real economy is sluggish and because overheating is showing up in asset prices and exchange rates. The former has been rendered sluggish by lack of structural reforms and deleveraging and the latter have been unnaturally inflated by policy-makers. REER misalignment is just as risky, if not more risky, than conventional overheating, because corrections are often accompanied by large cross-border movements of capital. Given the overheating of US asset prices, the Dollar investors would be wise to diversify their portfolios in other directions. EM offers an attractive destination for capital because EM is on the other side of the US trade. EM real exchange rates are very competitive, so countries have room to grow, while asset prices are attractively priced after years of headwinds.

Snippets:

- Argentina: Unemployment declined to 7.6% in Q4 2016 versus 8.0% expected.
- Brazil: The economy created jobs in net terms for the first time since March 2015. A total of 36K jobs were created net of job losses versus 26K expected. Moody's changed the outlook for Brazilian sovereign debt to stable from negative.
- Chile: The central bank cut the policy rate by 25bps to 3.0%.
- China: House price inflation was down 0.4% mom in February, which reduced the yoy rate to 12% from 12.4% in January. China: PBOC tightened liquidity conditions by raising reverse repo rates for 7 days, 14 days and 28 days by 10 bps each to 2.45%, 2.6% and 2.75%, respectively. This is prudent. The economy is picking up, so liquidity conditions do not need to be so lax. Industrial production rose to a five-month high of 6.3% yoy. Fixed asset investment accelerated to 8.9% yoy compared to 6.5% yoy in December 2016. Retail sales slowed somewhat to 9.5% yoy from 10.9% in December 2016.
- Colombia: The current account deficit declined sharply to 4.4% of GDP in 2016 from 6.5% of GDP in 2015.
- El Salvador: The real GDP growth rate hit 2.42% in December 2016 compared to 0.97% in the same month the year before.
- India: The trade deficit narrowed significantly to USD 8.9bn in February from USD 9.8bn in January due to strong exports, including solid engineering goods exports. Headline CPI inflation was up 3.7% yoy in February versus 3.2% yoy in January due in the main to higher than expected food prices.
- Indonesia: Bank Indonesia left the policy rate unchanged at 4.75%. The trade surplus increased to USD 1.4bn in February, which was higher than expected (USD 1.3bn). Both exports and imports rose at a rate of about 11% yoy.
- Mexico: In a sign of renewed confidence following a torrid period of persecution from hostile US President Donald Trump the Mexican government issued a 10 year benchmark bond in the international market last week. Advisor to the White House on trade issues Peter Navarro last week pointed to a cooperative stance vis-à-vis Mexico.
- Peru: The real economy expanded at a rate of 4.8% yoy in January versus 4.5% expected and 3.3% yoy in December. The real economy has now expanded for 90 consecutive months.
- Philippines: Remittances to the Philippines from workers overseas declined by a modest 1.0% mom sa in January, but remain 8.6% higher than a year ago at USD 2.17bn
- Poland: Retail sales, industrial production and construction output were softer than expected in February, but the current account surplus expanded to EUR 2.5bn in January 2017 versus EUR 0.3bn expected.
- Russia: S&P revised the outlook for Russian sovereign debt to positive from stable.
- Singapore: Non-oil domestic exports rose at a rate of 21.5% yoy versus 12.5% yoy expected. This translated into 10.9% mom sa real growth.
- South Africa: Retail sales were dismal in January, declining 1.2% in the month after seasonal adjustment. This follows a large month decline of 2.5% sa in December. Manufacturing was up 0.8% yoy in January, which was lower than expected (1.6% yoy).
- Turkey: The central bank lifted the rate payable for short-term liquidity beyond what the market had expected, so TRY reacted positively. However, the central bank maintains a heterodox policy stance, which is undermining confidence in the medium-term macroeconomic outlook. Moody's changed the outlook on Turkish sovereign debt from stable to negative.

[2] *'Keep calm and carry on in China'*, Weekly Investor Research, 6 March 2017.

Continued overleaf

Global backdrop

The Fed hiked the policy rate by 25bps to 75bps (lower bound). The rate hike was priced and the statement surprised slightly on the dovish side of expectations. The Dollar fell. Janet Yellen has less than a year to go until she retires as Fed Chairwoman, so she will likely not risk a recession on her watch. We do not expect any major surprises from this Fed in 2017. In Europe, Dutch voters defused one of three potential political landmines this year by voting in favour of mainstream parties rather than supporting anti-immigrant Geert Wilders. Attention now shifts to the French election and later in the year to Germany. The rise of populism across the Western world is due to the 40% fall in developed markets growth rates post-2008/2009 plus a sharp rise in inequality due to policies that have pushed up asset prices sharply, including QE. Populists are taking advantage of widespread discontentment with mainstream politicians, who have failed to make things better for the majority of voters. The populists are blaming the current economic woe on immigrants. Immigrants are obviously not to blame – in fact they are mainly a neutral to positive force in Western societies – so the policies of scapegoating foreigners will not actually fix the underlying problems. Rather, policies to persecute foreigners, such as Brexit in the UK will likely turn out to be self-defeating. In the US, a clampdown on immigration could reduce already subpar real GDP growth rates by as much as a quarter. Longer-term, the danger facing investors in Western economies is that as the populists run out of immigrants and other scapegoats within their own economies they will turn on each other, i.e. geopolitical risks will rise.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.21%	12.19%	21.40%	3.59%	0.88%
MSCI EM Small Cap	2.24%	12.59%	16.90%	2.32%	2.44%
MSCI Frontier	2.22%	8.64%	13.47%	-0.51%	5.88%
MSCI Asia	3.40%	13.51%	20.87%	6.08%	4.71%
Shanghai Composite	-0.12%	4.32%	13.75%	19.66%	8.80%
Hong Kong Hang Seng	2.09%	11.91%	24.97%	8.07%	2.64%
MSCI EMEA	4.10%	6.41%	16.68%	-1.55%	-3.03%
MSCI Latam	0.36%	11.89%	25.11%	-0.04%	-6.31%
GBI EM GD	1.97%	6.15%	7.06%	-1.94%	-1.72%
ELMI+	0.96%	4.52%	4.10%	-2.21%	-1.53%
EM FX Spot	1.10%	3.37%	-0.29%	-8.87%	-7.95%
EMBI GD	-0.26%	3.20%	9.12%	6.58%	5.58%
EMBI GD IG	-0.48%	2.65%	4.75%	5.14%	4.10%
EMBI GD HY	-0.04%	3.81%	14.25%	7.96%	7.49%
CEMBI BD	-0.30%	2.34%	9.14%	5.43%	5.37%
CEMBI BD IG	-0.32%	1.79%	5.20%	4.57%	4.73%
CEMBI BD Non-IG	-0.25%	3.20%	15.75%	6.51%	6.40%

Continued overleaf

Ashmore

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.73%	6.72%	19.05%	10.86%	13.49%
1-3yr UST	-0.07%	0.07%	0.31%	0.56%	0.63%
3-5yr UST	-0.18%	0.19%	-0.15%	1.50%	1.27%
7-10yr UST	-0.49%	0.25%	-2.17%	2.98%	2.46%
10yr+ UST	-1.70%	0.00%	-5.67%	6.03%	4.18%
10yr+ Germany	-2.67%	-2.73%	-1.73%	8.65%	7.42%
10yr+ Japan	-0.49%	-1.30%	-2.75%	5.67%	5.58%
US HY	-0.88%	2.02%	15.87%	4.50%	6.66%
European HY	-0.20%	1.35%	9.31%	5.24%	8.98%
Barclays Ag	-0.81%	0.51%	4.34%	3.85%	4.37%
VIX Index*	-10.14%	-17.31%	-17.19%	-20.04%	-25.48%
DXY Index*	-0.82%	-1.88%	5.47%	25.06%	26.00%
CRY Index*	-3.53%	-4.48%	4.28%	-38.60%	-41.72%
EURUSD	1.69%	2.26%	-4.32%	-21.95%	-18.68%
USDJPY	-0.06%	3.65%	-0.79%	-9.26%	-25.82%
Brent	-7.83%	-9.82%	24.37%	-51.86%	-58.72%
Gold spot	-1.32%	7.37%	-0.94%	-7.21%	-25.37%

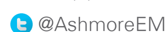
*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more 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.

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

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

Other locations
Lima
Shanghai

Bloomberg page
Ashmore <GO>

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

No part of this article may be reproduced in any form, or referred to in any other publication, without the written permission of Ashmore Investment Management Limited © 2017.

Important information: This document is issued by Ashmore Investment Management Limited (Ashmore), which is authorised and regulated by the Financial Conduct Authority. The information and any opinions contained in this document have been compiled in good faith, but no representation or warranty, express or implied, is made as to accuracy, completeness or correctness. Save to the extent (if any) that exclusion of liability is prohibited by any applicable law or regulation, Ashmore, its officers, employees, representatives and agents expressly advise that they shall not be liable in any respect whatsoever for any loss or damage, whether direct, indirect, consequential or otherwise however arising (whether in negligence or otherwise) out of or in connection with the contents of or any omissions from this document. Past performance is not a reliable indicator of future results. This document does not constitute and may not be relied upon as constituting any form of investment advice and prospective investors are advised to ensure that they obtain appropriate independent professional advice before making any investment.