It's the currency, stupid

By Jan Dehn

It is wrong to blame the poor performance of the US economy on unfair trade practices abroad. The real culprit is the Dollar, which has become misaligned over the last few years due to massive capital inflows, low US productivity and US inflation has picked up significantly. The US benefited tremendously from the strong Dollar policy in the immediate aftermath of the crisis in 2008/2009, but today the US economy would do better with a weaker Dollar. This is because the US problem is no longer availability of finance, but growth in the real economy, particularly exports.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	0.42%
MSCI EM Small Cap	12.1	–	0.45%
MSCI Frontier	10.4	–	1.10%
MSCI Asia	12.2	–	0.24%
Shanghai Composite	12.1	–	0.99%
Hong Kong Hang Seng	7.7	–	-0.34%
MSCI EMEA	9.7	–	1.18%
MSCI Latam	12.4	–	0.59%
GBI-EM-GD	6.57%	–	1.28%
ELMI+	3.68%	–	0.63%
EM FX spot	–	–	0.72%
EMBI GD	5.44%	304 bps	0.68%
EMBI GD IG	4.25%	180 bps	0.87%
EMBI GD HY	6.94%	462 bps	0.47%
CEMBI BD	5.23%	296 bps	0.34%
CEMBI BD IG	4.32%	204 bps	0.40%
CEMBI BD Non-IG	6.69%	442 bps	0.25%

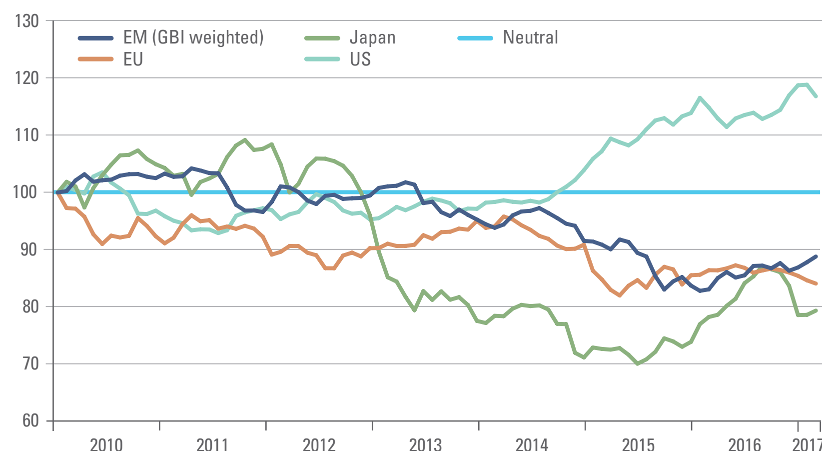
Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.2	–	-1.42%
1-3yr UST	1.24%	–	0.23%
3-5yr UST	1.89%	–	0.31%
7-10yr UST	2.36%	–	0.64%
10yr+ UST	2.97%	–	1.73%
10yr+ Germany	0.38%	–	0.48%
10yr+ Japan	0.06%	–	0.24%
US HY	6.07%	401 bps	-0.22%
European HY	3.53%	396 bps	-0.01%
Barclays Ag	–	242 bps	0.51%
VIX Index*	14.61	–	3.27%
DXY Index*	98.92	–	-1.49%
EURUSD	1.0900	–	1.50%
USDJPY	110.16	–	2.17%
CRY Index*	183.08	–	-1.71%
Brent	50.5	–	-2.27%
Gold spot	1260	–	2.05%

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

Emerging Markets

The Trump Administration blames the loss of US competitiveness on unfair trading practices abroad, but this is a dangerous misdiagnosis of the US problem. Firstly, trading practices have not changed materially. If anything, China has reduced the volume of counter-veiling duties against the US in recent years. Secondly, the real problem lies elsewhere, namely currencies. US companies are struggling to compete, because the Dollar has become misaligned, that is, too strong given sluggish American productivity growth and relative inflation rates. In short, the US real effective exchange rate (REER) has become overvalued.

Fig 1: **REERs (index January 2010=100)**



Source: Ashmore, BIS, Bloomberg.

Emerging Markets

The chart above illustrates this point. The chart shows the US real effective exchange rate alongside REERs in the other major regions, which trade with the US, Europe, Japan and Emerging Markets (EM). Between 2010 and February 2017, the US REER appreciated by 20% while REERs depreciated by 10-20% in the other regions. The primary reason why the US REER has appreciated so much is the nominal exchange rate. The Dollar has rallied dramatically, mainly due to massive capital inflows. US inflation has picked up relative to the other regions over this period, for example, the average rate of inflation in EM declined by about 20% over this period from just over 5% in 2010 to 4% today. US productivity growth has also declined. While capital inflows could have contributed to strong supply-side growth, ultimately it did not. Most of the capital flowing into the US from the rest of the world went into US financial markets, which may even have contributed to lower productivity growth to the extent that rising stock prices diverted funds away from the real economy (contrary to the rationale for Quantitative Easing).

It is well-known that overvalued REERs can cripple growth. The US economy is so far only tracking 1.0% qoq annualised real GDP growth in Q1 2017, according to the latest Atlanta Fed's GDPNow estimate. The main detractor from US growth is unsurprisingly international trade. While US survey data has been stronger than the components that go into GDP survey data, it is notoriously sensitive to stock market sentiment, which has been exuberant since Trump's election. The latest developments, including the failure last week to repeal Obamacare, suggest that the Trump Administration and Congress may find it difficult to implement meaningful supply-side reforms that can boost real GDP growth to offset the crippling effect of the strong Dollar.

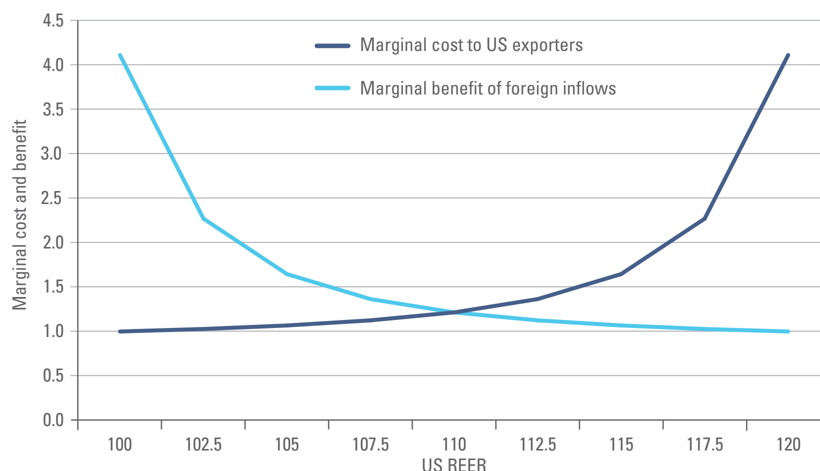
If so, the Dollar is overvalued relative to fundamentals and should decline. This begs the question how a weaker Dollar will impact the global economy? In our view, a weaker Dollar would be very beneficial for both US and global growth prospects for several reasons. Specifically, a weaker Dollar would:

a. Deflate dangerous asset bubbles in the US by shifting the marginal unit of capital away from overvalued markets and into other markets that are not mispriced.

b. Increase US exports by increasing the competitiveness of US companies in overseas markets

c. Ease financial conditions in EM and other countries, which would be positive for growth and increase demand for US exports

Fig 2: **The marginal cost and benefit of a strong Dollar – a stylised chart**



Source: Ashmore.

A few years ago the US very much needed a strong Dollar policy, because it needed to attract capital inflows from abroad in order to prevent a financial disaster. Today, however, the US has plenty of capital and instead needs to grow its economy. The strong Dollar policy has outlived its purpose and today a weaker Dollar would actually improve the health of the US economy. To see why, consider the simple stylized illustration above. In the immediate aftermath of the crisis in 2008/2009 the US economy found itself on the left side of the chart. The Dollar was trading at an eleven year low in real terms and financial system desperately needed capital from abroad in order be able to refinance the roughly 70% of GDP worth of debt, which falls due every year. Hence, at that time the marginal benefit of capital inflows was sky-high, while the marginal cost to exporters of a rising Dollar was very low. The red line was far above the blue line, so in net terms the rising Dollar was very positive for the US economy. Today, however, the US economy sits towards the right hand side of the chart. A huge amount of capital has flowed into US financial markets from the rest of the world to the point where the marginal benefit of inflows (for financing purposes) is now very low, even, perhaps, negative due to the risk of bubbles and sudden capital outflows. Meanwhile, exporters are now suffering directly due to the strong Dollar. Hence, the marginal cost to the US economy is now much higher than the marginal benefit and the US would therefore do better with a weaker currency.

Continued overleaf

Emerging Markets

The Trump Administration is considering protectionist measures to help US exporters. This would be a dangerous policy mistake. Protectionism at this point would materially worsen the US REER problem by undermining productivity, pushing inflation higher and appreciating the nominal exchange rate further. Most EM investors are intimately familiar with the impact of protectionism on growth and they understand that protectionism backfires badly. Let us hope that the Trump administration gradually acquires the same insight. If not, the Dollar becomes an even stronger sell over the medium term.

- Brazil: The Lower House last week approved a reform that increases flexibility of the labour market. This is very positive news, in our view, because the rate of unemployment is still very high and informality remains a big problem. By making the formal labour market more flexible the economy can recover from recession more quickly and companies will have stronger incentives to tap talent from the large pool of informal labour. In other news, the government has agreed to exclude state and municipality civil servants from a key pension reform. The exclusion of local government employees means that local governments will now be responsible for their own pension liabilities. Though this is a dilution of the pension reform, it does not rip out the guts of the reform, which we expect to pass in July. In other news, Brazilian meat exports were suspended by a number of countries following breaches of health and sanitation standards. The effect on the Brazilian economy will be marginal and temporary, in our view. We expect rapid action on the part of Brazilian authorities to re-establish confidence in the quality of Brazil's meat exports. Indeed, a number of important importers, including China, South Korea, Chile and Egypt have already lifted restrictions on imports. Turning to the public finances, Finance Minister Henrique Meirelles announced last week that new fiscal measures will be introduced this week to address a worse than expected fiscal outturn attributable to the still very soft economy. On the plus side, the rate of inflation declined to 4.73% yoy in mid-March from 5.02% yoy in mid-February and the current account deficit was USD 0.9bn in February compared to USD 1.9bn in the same month last year.

Snippets:

- Argentina: The real economy expanded by 0.47% in the fourth quarter and Q3 growth was revised marginally higher. The return to positive growth in Q4 was positive, but growth for 2016 as a whole was -2.3%. The central bank left the policy rate unchanged at 24.75%.
- Chile: The current account deficit narrowed to USD 700m in Q4 2016 versus USD 1.2bn expected. This took the deficit for 2016 to 1.4% of GDP from 2.0% of GDP in 2015. Growth slowed to 0.5% yoy in Q4 2016.
- Colombia: The current account deficit narrowed to 4.4% of GDP in 2016 from 6.4% yoy in 2015. The central bank cut rates by 25bps to 7%. Inflation has been declining steadily for more than half a year.
- China: The Asian Infrastructure Investment Bank (AIIB) has increased its membership to 70 countries with the addition of 13 new members. The new members include: Canada, Belgium, Ethiopia, Hungary, Ireland, Peru, the Republic of Sudan, Venezuela, Hong Kong, Afghanistan, Armenia, Fiji and Timor Leste.
- Ecuador: Government candidate Lenin Moreno has taken over the lead in the polls ahead of the 2 April runoff vote for the office of president. Moreno's share of voting intentions rose to 52.4% compared to 47.6% for Guillermo Lasso, according to the poll from Cedatos.
- India: The current account deficit narrowed to 0.5% of GDP in 2016 compared to 1.1% of GDP in 2015.
- Malaysia: Headline inflation in February rose sharply to 4.5% yoy versus 3.9% yoy expected. This increase was due to fuel price hikes. Core inflation rose more modestly from 2.3% yoy in January to 2.5% yoy in February.
- Mexico: Core inflation rose 31bps in H1 March compared to 0.23% in H2 February. Real GDP expanded 2.4% yoy in Q4 2016 compared to 2.1% yoy in Q3 2016. Retail sales declined 1.1% in the month of January versus -0.6% expected.
- Russia: The central bank cut the interest rates by 25bps to 9.75%.
- South Africa: The rate of core inflation declined to 5.2% yoy in February compared to 5.5% yoy in January. The current account deficit narrowed to 1.7% of GDP in Q4 2016 from 3.8% of GDP in Q3 2016.
- South Korea: Exports rose 14.8% yoy in the first 20 days of March versus 8.2% yoy in the same period in February.
- Sri Lanka: The central bank raised interest rates by 25bps to 8.75%
- Taiwan: The central bank left the policy rate unchanged at 1.375%, while industrial production rose at a material rate of 10.6% yoy in February.
- Thailand: Exports declined 2.8% yoy in February versus -4.0% yoy expected.
- Venezuela: The government appears to have approved an increase in fuel exports in order to increase Dollar income even at the expense of inflicting gasoline shortages on the country's population. Gasoline costs less than water in Venezuela. The increase in exports should eventually give the government the means to pay for further imports of gasoline, thus alleviating the shortages, in the short term at least.

Continued overleaf

Global backdrop

What does it take to miss a 3-feet putt? A lot, but that appears to be exactly what the Trump Administration and the Republicans in Congress achieved last week, when they failed to repeal and replace Obamacare. The failure will have implications for the centre-piece of Trump's reform agenda, tax cuts. This is because savings have to be identified elsewhere in order to finance a large tax cut. The repeal of Obamacare and replacing it with much leaner provisions was supposed to deliver those savings. The other proposal being considered in Congress – to tax foreigners instead of hardworking American families via the so-called Border Adjustment Tax – also seems to face considerable opposition in Congress. The implications for EM are significant, if indirect. Without a big tax cut, growth and inflation will be lower. This in turn means fewer Fed hikes. And with fewer Fed hikes and lower growth what will support the Dollar? Moreover, the Trump Administration will be back to Square One: how to stimulate growth and help American businesses compete? In the end a weaker Dollar may not only be the easiest, but also the least painful way to achieve both.

In other global news, the UK is set to trigger Brexit on 29 March. The country thereby starts the process of cutting itself off from the largest free trade area in the world without any obvious plan for how to replace it. Moreover, Brexit is being implemented just as the Eurozone is picking up, judging by recent data, including strong PMIs. France, meanwhile, is likely to move further away from extreme nationalist populism following a victory for presidential candidate Macron over Le Pen in the first presidential election debate.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.64%	12.65%	22.32%	3.32%	1.37%
MSCI EM Small Cap	2.70%	13.10%	17.42%	2.50%	2.97%
MSCI Frontier	3.35%	9.84%	13.93%	-0.61%	5.96%
MSCI Asia	3.65%	13.78%	20.76%	6.05%	5.13%
Shanghai Composite	0.86%	5.35%	12.69%	19.22%	9.52%
Hong Kong Hang Seng	1.75%	11.53%	25.58%	6.59%	3.62%
MSCI EMEA	5.33%	7.66%	20.78%	-1.07%	-2.13%
MSCI Latam	0.95%	12.55%	29.33%	-1.64%	-5.83%
GBI EM GD	3.27%	7.50%	9.93%	-1.43%	-1.38%
ELMI+	1.59%	5.18%	5.50%	-1.99%	-1.40%
EM FX Spot	1.83%	4.11%	1.62%	-8.56%	-7.73%
EMBI GD	0.41%	3.90%	9.74%	6.72%	5.78%
EMBI GD IG	0.39%	3.54%	5.56%	5.49%	4.28%
EMBI GD HY	0.43%	4.29%	14.64%	7.72%	7.74%
CEMBI BD	0.04%	2.69%	9.04%	5.50%	5.44%
CEMBI BD IG	0.08%	2.20%	5.28%	4.69%	4.78%
CEMBI BD Non-IG	0.00%	3.46%	15.34%	6.48%	6.52%

Continued overleaf

Ashmore

Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.70%	5.20%	17.60%	10.36%	13.28%
1-3yr UST	0.16%	0.30%	0.54%	0.64%	0.66%
3-5yr UST	0.12%	0.50%	0.11%	1.85%	1.32%
7-10yr UST	0.14%	0.89%	-1.55%	3.36%	2.50%
10yr+ UST	0.01%	1.74%	-4.12%	6.21%	4.18%
10yr+ Germany	-2.20%	-2.26%	-2.30%	8.72%	6.90%
10yr+ Japan	-0.26%	-1.07%	-3.11%	5.67%	5.50%
US HY	-1.10%	1.80%	15.76%	4.34%	6.64%
European HY	-0.21%	1.34%	8.99%	5.12%	9.07%
Barclays Ag	-0.31%	1.03%	4.42%	4.00%	4.40%
VIX Index*	13.08%	4.06%	-0.88%	-0.07%	-6.29%
DXY Index*	-2.17%	-3.21%	2.89%	23.48%	25.15%
CRY Index*	-3.96%	-4.90%	6.33%	-39.77%	-41.96%
EURUSD	3.06%	3.64%	-2.64%	-20.67%	-18.13%
USDJPY	2.37%	6.17%	2.99%	-7.24%	-24.50%
Brent	-9.25%	-11.21%	24.75%	-53.21%	-59.81%
Gold spot	0.89%	9.77%	3.10%	-2.46%	-25.06%

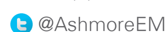
*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more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