Back in black for EM FX reserves

By Jan Dehn

In aggregate EM FX reserves have declined in recent years, but this was caused by the fall in reserves in a small number of countries. In the vast majority of EM countries reserve levels have continued to rise despite lower commodity prices, a stronger Dollar, capital flight and Fed hikes. Reserves are now showing signs of stabilising in large oil countries and China. This Weekly also covers news from Venezuela, South Korea, Brazil and Kenya plus some index news, the snippets and a discussion of the main developments in the global backdrop.

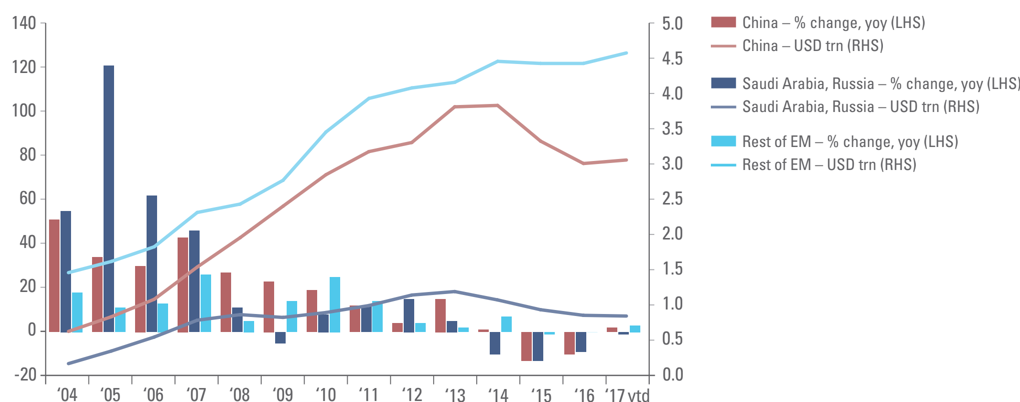
Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	0.45%
MSCI EM Small Cap	12.3	–	0.42%
MSCI Frontier	10.7	–	-1.73%
MSCI Asia	12.7	–	0.71%
Shanghai Composite	12.9	–	0.31%
Hong Kong Hang Seng	8.0	–	2.30%
MSCI EMEA	9.5	–	-0.76%
MSCI Latam	13.3	–	1.21%
GBI-EM-GD	6.08%	–	-0.08%
ELMI+	3.73%	–	0.00%
EM FX spot	–	–	-0.26%
EMBI GD	5.27%	299 bps	0.54%
EMBI GD IG	4.06%	175 bps	0.39%
EMBI GD HY	6.61%	439 bps	0.69%
CEMBI BD	5.03%	289 bps	0.22%
CEMBI BD IG	4.06%	193 bps	0.18%
CEMBI BD Non-IG	6.41%	427 bps	0.28%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.0	–	0.23%
1-3yr UST	1.36%	–	0.02%
3-5yr UST	1.82%	–	0.06%
7-10yr UST	2.27%	–	0.18%
10yr+ UST	2.84%	–	0.87%
10yr+ Germany	0.47%	–	1.50%
10yr+ Japan	0.07%	–	0.17%
US HY	5.41%	352 bps	0.05%
European HY	2.75%	313 bps	0.49%
Barclays Ag	–	249 bps	0.24%
VIX Index*	10.03	–	-0.26%
DXY Index*	93.38	–	0.52%
EURUSD	1.1789	–	-0.45%
USDJPY	110.71	–	0.41%
CRY Index*	180.68	–	-1.44%
Brent	52.3	–	-0.68%
Gold spot	1258	–	-0.88%

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

Emerging Markets

Fig 1: **EM FX reserves**



Source: Ashmore, Bloomberg, JP Morgan.

The stock of FX reserves controlled by EM countries has declined in aggregate in recent years, but the decline has mainly been due to falling (but now stabilising) reserves in a small number of large countries, including oil producers and China. By contrast the vast majority of EM countries have seen their FX reserve levels rise albeit at a slower pace. This increase has taken place in spite of lower commodity prices, a stronger Dollar, capital flight and Fed hikes. Reserves are now showing signs of stabilisation in large oil exporting countries and China, where reserves have now reached USD 3.08trn this morning, an increase from last month and from the low of USD 3.00trn in January 2017. This bodes well for overall EM FX reserve levels going forward. Emerging Markets (EM) central banks today control 76% of global FX non-gold reserves, or USD 8.5trn. This means that EM's share of global FX reserves has been unchanged from 2007 to this day despite the global financial crisis. Note that in the intervening period, EM's share of FX reserves briefly reached 80% before rapid accumulation of reserves in

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Switzerland and Japan due to FX interventions drove the EM share lower. The sharp decline in EM FX reserves from 2014 onwards was mainly due to lower oil prices hitting some large EM oil producers, including Saudi Arabia and Russia. Chinese reserves also dropped significantly around the time China abandoned the Dollar peg, although a significant part of China's reserve loss at the time was due to currency effects (since reserves are generally measured in Dollars and China has significant non-Dollar currencies within its reserve basket).

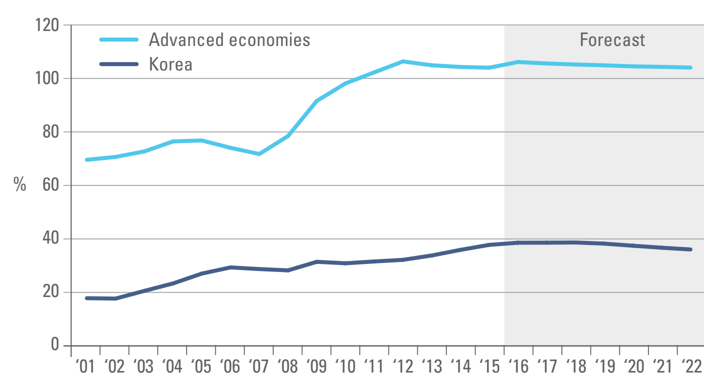
- Venezuela: Local and foreign revulsion at the Maduro regime's recent power grab has increased, though, so far, without triggering regime change. In fact, events in recent days may have further strengthened Maduro's position. The government crushed an alleged coup in the city of Valencia and is now likely to exploit this episode as a pretext for further repression. The members of a controversial Constituent Assembly were sworn in and immediately removed Public Prosecutor Louisa Ortega, a major critic of the government, from office. The Constituent Assembly ranks above the National Assembly, Venezuela's parliament. The Maduro Administration also showed largesse by saying it might not dissolve the National Assembly and by releasing opposition leaders Leopoldo Lopez and Antonio Ledezma from prison and putting them back into house arrest. These moves may be aimed, perhaps, at forestalling further US sanctions.

A muddle-through scenario accompanied by plenty of volatility, but also continuing debt service looks like the most likely outcome. Following last week's Constituent Assembly election the political dynamics in Venezuela have quickly reverted to a familiar pattern, where the Opposition tries to pressure the Maduro Administration into talks by marching through the streets of Caracas, while the government offers concessions in order to exploit divisions within the Opposition only to renege later and take ever more power. Venezuela is to all intents and purposes an oil company with a country attached. Unless and until the country as a whole gets serious about taking back power from President Nicolás Maduro's increasingly autocratic government these dynamics are unlikely to change much. All else even, this should be OK for bond holders, since the one thing that could unseat the Maduro Administration would be a default, which would result in a collapse in oil exports as working capital credit lines to PDVSA, the state oil company, would be cut.

The US imposed personal sanctions on President Nicolás Maduro, but has so far shied away from oil and financial sanctions. Personal sanctions on Maduro make a great deal of sense, because they do not hurt an already weakened population. They also do not wrongly target bond holders, who, after all, are merely trading bonds in the secondary market and not providing new financing for the government, since the primary market for Venezuelan debt has been closed for some time. Further sanctions cannot be ruled out, especially in light of evidence that the government tampered with the referendum result. Oil sector sanctions would be very disruptive, but Venezuela could still re-route oil to Asia. Financial sector sanctions would be even more serious, in our view. Even trading with Asia would be challenging without Dollars and Venezuela would in any case not be able to acquire the Dollars required to meet its debt service obligations. However, broad sanctions on the Venezuelan oil industry would also impact the US oil and gas companies operating in Venezuela and US refiners, which import nearly 800k barrels of Venezuelan crude per day. Some two thirds of Venezuelans, including leaders of the Opposition, currently disapprove of any form of economic pressure against the country. US National Security Adviser H.R. McMaster appears to be sensitive to these arguments: last week he said that the US would not impose sanctions which hurt the Venezuelan population. Meanwhile, Russian energy giant Rosneft has agreed to help PDVSA by making early payments for oil supplies and says it stands by its investment plans in Venezuela. It is possible that US sanctions against Russia have made the latter keener to support countries, which irritate the US, such as Venezuela.

- South Korea: The new Korean government is targeting a more even distribution of income. To this end, the government last week raised taxes on the rich, corporates and owners of stocks in a move, which should increase government revenues by some USD 5bn. The government also hiked the minimum wage and took steps to reduce speculation in the housing market. The economy is doing well. Trade expanded very strongly in July with exports up 19.5% and imports rising 14.5%, both in yoy terms, while core inflation remains low at 1.5% yoy. Does Korea have room to increase government spending? The answer is yes. Korean gross government debt was 38.6% of GDP in 2016 compared to an average of 106.5% in advanced economies, according to the IMF.

Fig 2: **Gross government debt to GDP**



Source: Ashmore, IMF.

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Emerging Markets

- **Brazil:** President Michel Temer won a vote to dismiss corruption charges, thus paving the way for a resumption of key reforms. Rodrigo Maia, who presides over the Lower House, said that there should be no need to water down pension reform, though Temer himself has indicated that a further dilution of the bill may be necessary. Either way, we think the government, which will take office after the next elections in 2018 will have to make further reforms to the unsustainable pension system. In other news, the minutes of the central bank's monetary policy committee (COPOM) were dovish. In our view, the odds that the central bank will cut rates will increase even further if the Temer Administration manages to pass the pension reform. Finally, industrial production rose at a solid 3.5% qoq pace in Q2 2017.

- **Kenya:** Political noise is increasing ahead of Kenya's general election scheduled for 8 August with the murder of a prominent election official and a public spat between political groups and the Judiciary. Kenyan elections often descend into violence since the two main political groupings are closely aligned with the two main ethnic groups, Luos and Kikuyus. Polls are very close, which suggest a run-off between incumbent President Kenyatta and challenger Raila Odinga.

- **Index news:** The JP Morgan EMBI GD index of sovereign Dollar-denominated government bond issuers in EM now consists of 66 countries following the addition of Belarus, which returned to the index on 31 July. In the local currency GBI EM GD index the number of index countries has now increased to 18 following the inclusion of Uruguay on 31 July.

Snippets:

- **Colombia:** The CPI inflation rate declined to 3.4% yoy in July from 3.99% in June.
- **Czech Republic:** The Czech National Bank hiked its benchmark interest rate by 20bps to push EURCZK down through 26. CZK has rallied steadily since the central bank abandoned the EUR peg in March of this year.
- **Ecuador:** President Moreno's 2017 Budget proposal cuts the fiscal deficit by one fifth to a still material 4.7% of GDP. Moreno stripped his vice-president Jorge Glas of his political powers following allegations of corruption against the latter.
- **Egypt:** PMI recovered further to 48.6 in July from 47.2 in June.
- **India:** The key repo policy rate was cut by 25bps to 6.0% in response to declining inflation. Services PMI dropped below 50 in July (49.5) due to the disruptions associated with the formal launch of GST, a value added tax system. The business expectations index rose to a new local high of 62.3 in a sign that the GST-related disruption is seen as operational and temporary.
- **Indonesia:** The Indonesian economy grew at a 5.0% yoy pace in Q2 2017, unchanged from Q1 2017.
- **Iraq:** The Iraqi government successfully issued a USD 1bn sovereign bond without explicit guarantees from foreign sovereigns. The bond was some seven times oversubscribed. Moody's assigned a Caa1 rating to Iraqi debt.
- **Malaysia:** The trade surplus was MYR 9.9bn in June versus MYR 5.7bn expected, mainly due to lower imports.
- **Mexico:** Ratings agency Fitch revised Mexico's foreign currency credit rating outlook to stable from negative (BBB+).
- **Pakistan:** Pakistan has appointed a new prime minister following the resignation of Nawaz Sharif. Finance Minister Ishaq Dar continues in post.
- **Philippines:** The rate of CPI inflation was 2.8% yoy in July, in line with consensus expectations.
- **Russia:** Russian inflation undershot significantly in July. The inflation rate was just 3.9% yoy versus 4.3% yoy expected. Meanwhile, FX reserves keep ticking higher. FX reserves reached USD 419bn last week from USD 415bn the previous week.
- **Sri Lanka:** The central bank left the policy rate unchanged at 7.25%.
- **Thailand:** The trade surplus increased to USD 2.9bn in June 2017 from USD 2.2bn in May, which helped to current account surplus to reach USD 4.3bn, up from USD 1.1bn in May. The overall balance of payments swung into a surplus of USD 2bn from a deficit of USD 1.6bn in May.
- **Turkey:** The yoy rate of inflation was 9.8% in July versus 9.9% yoy expected.

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Global backdrop

Stable labour market data in the US enabled the US dollar to pull back from the precipice it had reached following a sharp decline in 2017. Attention will now turn to the evolution of inflation and markets will also be paying attention to comments from Fed speakers this week. On the policy front, President Donald Trump gave support for a new immigration policy, which would reduce immigrant numbers by half and favour rich and English-speaking immigrants over others. This policy may please Trump's political base, but by making it harder for the 'hungriest' and hardest working immigrants (mainly from Latin America and Africa) to enter the US the US economy will suffer. In another lurch towards bad economic policies, the Trump Administration threatened action against China over trade imbalances and alleged Chinese inaction over North Korea. As far as trade imbalances are concerned we think it is a serious misdiagnosis to blame the existence of a trade imbalance exclusively on Chinese trade practices. Rather, we think the imbalance is a macroeconomic phenomenon. High savings rates in China and high consumption rates in the US naturally generate trade surpluses in the former and trade deficits in the latter. Chinese productivity is also improving faster than US productivity, mainly because China is investing far more and undergoing reforms, while the US is just stimulating consumption. Finally, the US Treasury is still encouraging the view that a strong Dollar is in the US interest. A strong Dollar encourages large capital inflows to the US. This certainly helped to buoy the stock market in recent years, but inflows have also undermined American exports by causing real effective exchange rate appreciation. A lurch towards protectionist measures against China would further distort the real exchange rate and inflict costs on everyone else in the US economy. Besides, protectionism is nothing other than 'social security' for inefficient and unsustainable companies, so it provides very bad incentives to increasing productivity. Productivity problems lie at the heart of the US sluggish growth performance. One of the big insights from Friday's payroll number is that it shows how US retailers are, in effect, becoming couriers and messengers. This is de-skilling. Lower skills imply lower productivity, which in turn requires lower wages. While lower wages make for stable macroeconomic conditions they also worsen the income distribution, undermine trend growth rates and ultimately sow more social discontentment.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.14%	25.91%	25.04%	2.67%	5.12%
MSCI EM Small Cap	0.11%	20.38%	16.13%	1.95%	6.07%
MSCI Frontier	-0.64%	17.18%	20.29%	-3.65%	8.61%
MSCI Asia	0.17%	29.78%	27.83%	6.02%	9.10%
Shanghai Composite	-0.30%	7.09%	11.65%	15.83%	11.53%
Hong Kong Hang Seng	1.62%	21.44%	26.96%	3.54%	6.74%
MSCI EMEA	-0.16%	11.34%	13.16%	-3.19%	-0.81%
MSCI Latam	0.99%	20.66%	19.02%	-4.41%	-2.33%
GBI EM GD	-0.02%	12.63%	7.80%	-1.73%	-0.88%
ELMI+	-0.02%	8.92%	6.04%	-1.46%	-0.34%
EM FX Spot	-0.17%	5.88%	1.45%	-8.35%	-6.71%
EMBI GD	0.45%	7.57%	5.17%	5.85%	5.07%
EMBI GD IG	0.29%	7.03%	2.28%	4.76%	3.43%
EMBI GD HY	0.60%	8.19%	8.51%	6.57%	7.29%
CEMBI BD	0.14%	5.99%	6.05%	5.22%	5.21%
CEMBI BD IG	0.09%	5.14%	3.30%	4.34%	4.33%
CEMBI BD Non-IG	0.22%	7.28%	10.45%	6.31%	6.79%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.30%	11.93%	16.82%	10.81%	14.62%
1-3yr UST	0.00%	0.67%	0.12%	0.75%	0.64%
3-5yr UST	0.05%	1.64%	-0.73%	1.77%	1.21%
7-10yr UST	0.20%	2.98%	-3.40%	2.87%	1.58%
10yr+ UST	0.95%	5.87%	-7.66%	5.27%	2.39%
10yr+ Germany	1.31%	-3.07%	-10.02%	5.85%	5.26%
10yr+ Japan	0.19%	-0.45%	-4.16%	5.34%	4.82%
US HY	0.04%	6.14%	10.92%	5.50%	6.66%
European HY	0.44%	4.73%	8.04%	5.46%	8.88%
Barclays Ag	0.24%	4.15%	2.36%	4.05%	4.20%
VIX Index*	-2.24%	-28.56%	-11.94%	-39.80%	-37.27%
DXY Index*	0.56%	-8.64%	-2.93%	14.54%	13.59%
CRY Index*	-1.07%	-6.14%	-0.61%	-38.35%	-40.54%
EURUSD	-0.45%	12.06%	6.32%	-11.79%	-4.92%
USDJPY	0.41%	-5.38%	8.06%	8.44%	40.85%
Brent	-0.68%	-7.97%	18.12%	-50.41%	-53.31%
Gold spot	-0.88%	9.20%	-5.77%	-4.14%	-21.95%

*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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