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China and the market for US Treasuries

By Jan Dehn

China's adoption of a more flexible exchange rate poses risks to developed bond markets, because a more flexible RMB means that China will need fewer reserves going forward. Moody's downgrade of Brazil sparks spread compression. Inflation was lower than expected in India. Turkey's central bank signals support for those with FX liabilities as the election draws nearer. Indonesia's President Jokowi promotes technocrats in a cabinet reshuffle. Costa Rica pushes its fiscal reform forward. Russia's economy shrinks. Ecuador is downgraded. Saudi Arabia prepares to issue debt. The global backdrop remains unsettled, which is not favourable to Emerging Markets assets.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.4	–	-2.31%
MSCI EM Small Cap	11.2	–	-2.11%
MSCI Frontier	9.1	–	-0.91%
MSCI Asia	10.8	–	-2.56%
China A shares	14.9	–	7.38%
China H shares	7.4	–	0.05%
MSCI EMEA	9.4	–	-2.07%
MSCI Latam	12.5	–	-2.45%
GBI-EM-GD	6.82%	–	-0.70%
ELMI+	5.39%	–	-1.09%
EM FX spot	–	–	-0.81%
EMBI GD	5.92%	370 bps	-0.13%
EMBI GD IG	4.61%	234 bps	-0.07%
EMBI GD HY	8.16%	609 bps	-0.21%
CEMBI BD	5.66%	366 bps	-0.21%
CEMBI BD HG	4.51%	249 bps	0.06%
CEMBI BD HY	7.92%	593 bps	-0.70%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.9	–	0.73%
2 year UST	0.73%	–	0.00%
5 year UST	1.58%	–	-0.08%
10 year UST	2.18%	–	-0.23%
30 year UST	2.82%	–	-0.47%
US HY	7.55%	609	-0.66%
European HY	4.72%	473	-0.06%
Barclays Ag	–	226	-0.26%
VIX Index*	12.83	–	-0.56%
DXY Index*	96.73	–	-0.43%
CRY Index*	1.1096	–	0.64%
EURUSD	124.51	–	0.05%
USDJPY	197.97	–	-0.35%
Brent	49.1	–	-2.52%
Gold spot	1117	–	0.91%

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

Emerging Markets

- **China:** The knee-jerk reaction of many analysts to China's move to a more flexible exchange rate last week was that it is good for bonds. The argument is that China has joined the global currency war and will export deflation to the rest of the world. This view is misguided. In our view it is clear that China is not entering any global currency war. Instead, it is pursuing a far more constructive, rational and forward-looking strategy. This strategy involves, amongst other things, achieving global reserve currency status in the near-term. For this reason, China has absolutely no interest in abusing its own currency via competitive devaluations. For discussion of the real motivation behind the move to a more flexible exchange rate see *"A few thoughts on China",* Market Commentary, August 2015.

As for the impact on global bond markets of China's adoption of a more flexible currency, it clearly increases rather than reduces risks to so-called 'risk free' government bonds issued by QE countries, especially the US treasury market. Firstly, the adoption of a more flexible exchange rate means that China will need fewer FX reserves going forward and, secondly, SDR inclusion – which the adoption of a more flexible exchange rate is intended to aid – will further reduce the share of US Treasuries within China's overall reserve pool.

A recent paper by John Davies at Standard Chartered Bank quantifies these effects.[1] Davies concludes that China will need to reduce its Treasury holdings by between USD 0.8trn to USD 1.3trn by 2020 if the RMB fully floats by 2020. If the RMB fully floats sooner, say by the end of 2016, US Treasury (UST) holdings would have to decline by USD 1.2-1.5trn of which USD 0.6-0.9trn would have to be sold actively rather than by just letting the portfolio mature without re-investment. Our view is that China will pursue an accelerated, albeit gradualist, approach to achieving global reserve currency status.

Davies also shows that if, in addition to China's own actions, the Fed ceases to re-invest its QE holdings from the end of 2016, then the amount of free-floating USTs (i.e. those not held by either Fed or China) would rise from 56.3% of total outstanding today to 82.3% of total outstanding by 2020.

[1] *"China: SDR inclusion and the potential UST fall-out"*, On the Ground, Standard Chartered Bank, 16 July 2015.

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Emerging Markets

Who is going to pick up this huge increase in free-float? Given that US Treasury yields are near all-time lows at the end of a 30 year rally, it seems reasonable to conclude that US government bonds are heading for major capital losses. Alternatively, something else could give. One possibility is that the Fed does not cease re-investment of its QE holdings after all, even though the economy picks up. This would be inflationary.

Another – complementary – possibility is that financial repression increases materially in the coming years to force existing institutional investors to not sell or even to add to their existing holdings of long-dated government bonds. By forcing down nominal bond yields at the long end of the curve as inflation gradually returns, financial repression would push down real yields. That, in turn, would be negative for the Dollar.

In short, the adoption of a more flexible exchange rate increases the likelihood of losses on Treasuries, but mainly due to currency effects rather than rising real yields. This, of course, is why China is exploiting the current USD euphoria to introduce currency flexibility. By doing so at this very point in time, China cuts the link to currency trading at bubble levels, while at the same time furthering its objective of becoming the next global reserve currency (by satisfying certain technical criteria demanded by the IMF). The world will be in sore need of the RMB as soon as the existing reserve currencies deflate under the weight of widespread QE among the big four reserve currency providers (UK, Japan, Europe and the US).

In other news, China's macroeconomic indicators continue to soften gently at the margin. Household lending declined from RMB 458bn in June to RMB 275bn in July, while corporate lending also slowed (to RMB 313bn from RMB 860bn).

- Brazil: The ratings agency Moody's downgraded Brazil's sovereign rating to Baa3 from Baa2 with stable outlook. Brazilian sovereign debt rallied. The downgrade was expected, but the stable outlook was a positive surprise to the market, where many had expected a negative outlook. One of the two main risks facing Brazil right now is that two or more of the 'oligopolistic triumvirate' of ratings agencies (Standard & Poor's, Moody's, and Fitch) will downgrade Brazil's sovereign credit rating to sub investment grade. Standard & Poor's (S&P) recently downgraded Brazil to BBB-, one notch above junk, with negative outlook, suggesting a downgrade from investment grade in early 2016. On the other hand, Moody's decision to adopt a stable outlook means that the ratings agency will likely have to make two independent moves before Brazil goes into the junk category. Fitch has Brazil on two notches above investment grade with a negative outlook. By the time Brazil is downgraded, if it happens, it will already be fully priced, in our view. That is why we would view such an event as a buying opportunity (buy a near-IG credit at HY prices). IGP-M inflation, an index that takes a weighted average of wholesale, consumer and construction prices rose 0.1% in H1 August. This was lower than expected (0.45%) and lower than in July (0.56%).

For the third time this year, Brazilians took to the streets to call for the removal of President Dilma Rousseff from power. In a clear sign that there is no widespread popular backing – nor strong legal grounds – for Dilma's removal, the protests were attended by fewer people than similar protests in March. Popular anger is directed of much at the wider political establishment than at the president, not least due to the so-called 'Lava Jato' corruption scandal, which is implicating politicians from across the entire political spectrum.

- India: The latest macroeconomic data releases from India were significantly better than expected. Most importantly, CPI inflation surprised sharply to the downside at 3.78% yoy in July versus 4.4% yoy expected and 5.4% yoy in June. At the same time, industrial production surged 3.8% yoy in June compared to 2.5% yoy in May. Markets had expected a weaker print of 3.5% yoy. The rate of wholesale price inflation declined to -4.05% versus -2.9% yoy expected. Consistent with stronger economic activity India's trade deficit widened to USD 12.8bn in July from USD 10.8bn in June.

- Turkey: The Turkish central bank responded to rising uncertainty ahead of a likely election later this year by easing conditions for foreign currency borrowing for Turkish banks. The major political parties in Turkey last week failed to reach agreement on a coalition government. Though talks will continue, the most likely scenario is fresh elections, provided polls continue to show gains for President Erdogan's AK party. FX liquidity remains very adequate, so this is mainly a signalling tool. Meanwhile, the current account deficit was USD 3.4bn in June versus USD 3.2bn expected. The 12 month moving average current account balance has gradually narrowed to USD 3.7bn from more than USD 5bn in late 2014. In early 2014, Turkey raised rates by 400bps and demand began to weaken, while the currency adjusted. This adjustment has contributed to the improvement in the external deficit, in our view.

- Indonesia: President Joko Widodo re-shuffled his Cabinet to bring in some seasoned technocrats to run the economic program. Darmin Nasutin, a former central bank governor and finance ministry tax expert, will coordinate economic policy.

- Costa Rica: The government is sending a fiscal reform to Congress that would raise taxes by 2% of GDP, but also replace inefficient sales taxes with broad-based VAT. While the reform would shore up government revenues, the problem in Costa Rica is also that expenditures are too high. Raising taxes without cutting spending increases the sustainability of the public finances, which is positive, but it also increases the role of the state within the overall economy. Ratings agencies have been clear that their main concerns are on the spending side, not on the revenue side.

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Emerging Markets

- **Russia:** GDP growth slowed further in Q2 to -4.6% yoy compared to -2.2% yoy in Q1. This is the result of aggressive demand management by the central bank in response to lower oil prices. The central bank has let the currency fall and pushed up interest rates in response to weaker oil prices, thus forcing a major reduction in domestic demand. This is good for bond holders as the public finances and the balance of payments remain healthy.

- **Ecuador:** S&P downgraded the long term foreign currency rating of Ecuador by one notch to B with a stable outlook, citing deteriorating terms of trade. Curiously, S&P downgraded Ecuador despite predicting the fiscal deficit to decline from 5.3% of GDP this year to 3.0% of GDP next year. Ecuador was this week removed from the Financial Action Task Force's list of countries doing too little to fight money laundering.

- **Argentina:** The 2nd U.S. Circuit Court of Appeals ruled that passive holdout investors that had previously hoped to piggy-back on an eventual successful ruling in favour of active holdout investors will now have to pursue their own cases. This is widely regarded as a ruling in favour of Argentina because it limits the scope of U.S. District Judge Griesa's previous ruling. However, the ruling pertains to a relatively minor case. Our view is that the holdout issue is likely to be resolved next year regardless of who wins the election later this year. Last week's primary elections gave a commanding lead to Daniel Scioli over Mauricio Macri and Sergio Massa, but not strong enough to guarantee a first-round victory for Scioli on 25 October. The winner must win with at least 45% of the total vote or achieve 40% of the vote with at least a 10% clear lead over the second-best placed candidate. Macri has indicated that he is 'prepared to talk' to Massa although election rules prohibit a formal alliance at this stage in the electoral process.

- **Saudi Arabia:** Having used the last decade of high oil prices to pay down its debt stock to a tiny 2% of GDP, Saudi Arabia now looks set to begin to issue debt again. Reports suggest that Saudi Arabia could issue up to SAR 100bn (USD 26bn) of 5, 7 and 10 year bonds (about 10% of GDP). Of all the oil producers, Saudi has more scope for counter-cyclical fiscal policy due to its sound management of public finances in the past. Bond issues should reduce the need for drawdown of government deposits and reserves as means of financing spending.

Snippets:

- **Angola:** Angola's sovereign debt rating was affirmed by S&P at 'B+', but the outlook was changed to negative.
- **Chile:** The Central Bank of Chile left policy rates unchanged at 3% and the statement accompanying the decision indicated no imminent changes.
- **Malaysia:** Industrial Production was in line with expectations at 4.3% yoy in June, but USDMYR rose sharply as the central bank indicated that it intends to build reserves, which recently dropped below USD 100bn.
- **Mexico:** Industrial production rose 1.4% yoy compared to 1.1% yoy expected.
- **The Philippines:** Exports rose 14.6% mom in June after a decline of 4.3% mom in May.
- **Slovakia:** Fitch left Slovakia's sovereign currency rating unchanged at A+ with stable outlook, citing robust institutions.
- **South Korea:** Job markets strengthened in July as unemployment dropped to 3.7% of the labour force (versus 3.9% expected).
- **Thailand:** Q2 GDP expanded by 0.4% in the quarter (in seasonally adjusted terms) compared to 0.2% expected. In yoy terms, real GDP growth was 2.8% in Q2.
- **Uruguay:** IP rose 5.9% yoy in June, which takes year to date growth in IP to 7.1% yoy. Much of the activity stems from Uruguay's modern pulp and paper sector.

Global backdrop

A pick-up in non-farm productivity in Q2 to 1.3% means that productivity is now tracking 0.1% annualised for H1 2015. Recent revisions to US GDP also show that productivity growth in the US has been weak through the entire 'upswing' (there hasn't really been an upswing because growth has been 2% per year for several years now). Specifically, productivity growth was 0.1% in 2011, 0% in 2012, 1.2% in 2013, 0% in 2014 and now 0.1% annualised in H1 2015.

Why is productivity so low? Some 95% of all profits by US firms are either used for buy-backs or dividend payments, leaving almost nothing for investment. Most of the little investment that has taken place has occurred in the shale sector, which is now being pressured by lower oil prices. In addition, there has been no effort to address the economy's overall indebtedness and the last four administrations have also done nothing to reform the medium term fiscal outlook. Finally, QE has driven up the USD by nearly 40% against major currencies and trade partners since 2011. American style 'Dutch Disease' is now hurting exports and rapidly becoming the most important determinant of Fed policy at the margin. In short, the exuberance about the US economy has been even more impressive than its actual performance.

Global investor sentiment remains strongly vested in further USD appreciation. But the DXY – the USD versus other major currencies – is down nearly 4% since March. Another popular QE trade – long European core bonds – has also stopped delivering with yields for 30 year German bonds 86bps higher since April. Finally, US stocks are down since February.

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Global backdrop

This is concerning. After four years of remorseless rallies, positioning in these QE markets is heavy; they look very expensive and appear to offer little upside other than moving further into outright bubble territory.

The global backdrop is therefore understandably characterised by some nervousness. Not typically a friend of Emerging Markets (EM), nervousness will nevertheless make some investors turn to other markets in search of value. And they will find it in EM, which, unlike developed economies, have not had the benefit of central bank QE sponsorship in the past few years, but have survived the experience without major crises.

In Japan, Q2 GDP contracted 1.6% qoq seasonally adjusted annual rate, slightly better than consensus expectations of a 1.8% slide. Underlying growth was worse as private consumption and exports fell sharply, resulting in a further rise in inventories.

In Europe, the political establishment appears to have found agreement on a Greek bailout. Proposals will now go to various European parliaments for approval.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-4.07%	-7.93%	-17.24%	-1.35%	0.26%
MSCI EM Small Cap	-2.01%	-2.06%	-10.34%	3.89%	1.62%
MSCI Frontier	-0.23%	-6.51%	-17.60%	10.77%	5.34%
MSCI Asia	-3.70%	-4.77%	-9.70%	4.37%	4.35%
China A shares	7.96%	23.91%	77.73%	24.70%	10.22%
China H shares	-0.30%	-3.44%	3.86%	9.31%	3.20%
MSCI EMEA	-4.11%	-4.83%	-20.45%	-5.70%	-1.51%
MSCI Latam	-6.49%	-19.65%	-35.67%	-13.48%	-8.80%
GBI EM GD	-2.45%	-9.59%	-19.08%	-6.20%	-1.20%
ELMI+	-2.03%	-5.64%	-13.66%	-3.85%	-1.67%
EM FX Spot	-2.24%	-12.05%	-22.98%	-10.81%	-7.56%
EMBI GD	-0.58%	1.58%	0.06%	2.91%	5.46%
EMBI GD IG	-0.35%	0.58%	1.46%	1.89%	4.70%
EMBI GD HY	-0.89%	2.86%	-2.95%	4.52%	6.58%
CEMBI BD	-0.39%	3.26%	1.86%	4.09%	5.33%
CEMBI BD HG	-0.08%	2.49%	2.77%	3.93%	5.40%
CEMBI BD HY	-0.97%	4.68%	-0.21%	4.63%	5.38%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.45%	2.88%	9.18%	16.64%	16.56%
2 year UST	-0.12%	0.47%	0.51%	0.45%	0.67%
5 year UST	-0.25%	1.48%	2.11%	1.27%	1.77%
10 year UST	-0.11%	1.60%	4.10%	1.66%	4.14%
30 year UST	1.37%	0.25%	9.42%	2.99%	7.42%
US HY	-1.44%	0.55%	-2.44%	5.29%	7.84%
European HY	-0.38%	3.17%	3.73%	10.27%	10.72%
Barclays Ag	-0.20%	-0.11%	1.51%	3.59%	4.52%
VIX Index*	5.86%	-33.18%	-2.43%	-4.61%	-47.27%
DXY Index*	-0.62%	7.16%	18.80%	17.11%	17.64%
CRY Index*	-2.27%	-13.91%	-31.72%	-34.77%	-26.73%
EURUSD	1.02%	-8.30%	-16.96%	-10.04%	-13.81%
USDJPY	-0.50%	-3.75%	-17.63%	-36.10%	-31.32%
Brent	-5.88%	-14.29%	-52.54%	-56.78%	-36.12%
Gold spot	1.92%	-5.98%	-13.98%	-30.90%	-8.93%

*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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