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Ashmore

A peak into the future

By Jan Dehn

If you are looking for a crystal ball to help you form a view about the future look no further than Japan and Korea. Both countries offer a great insight about the currency dynamics that are likely – within a few years – to play out on a far larger scale between the HIDCs (Heavily Indebted Developed Countries) and Emerging Markets (EM). We also take a look at the IMF's recently released World Economic Outlook database, which shows that EM is now 56% of global GDP en route to a 60% share by 2020. It continues to be a source of amusement, frustration and sheer incredulity that the global financial markets continue to view EM as fragile and vulnerable. In fact, EM represents a large and highly diverse group of countries that, on average, have massively stronger fundamentals than the HIDCs. We discuss the better than expected third quarter growth numbers out of Russia and other Eastern European countries, changes in China's tax treatment of users of the Shanghai-Hong Kong Stock Connect and other country specific goodies.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	987	–	-1.05%
MSCI EM Small Cap	1,024	–	-0.51%
MSCI FM	647	–	0.03%
GBI EM GD	6.42%	–	-0.40%
EM FX spot	–	–	-0.54%
ELMI+	3.68%	–	-0.63%
EMBI GD	5.35%	301 bps	-0.10%
EMBI GD IG	4.34%	196 bps	0.03%
EMBI GD HY	7.46%	527 bps	-0.32%
CEMBI BD	5.29%	319 bps	-0.27%
CEMBI BD HG	4.34%	222 bps	-0.19%
CEMBI BD HY	7.35%	529 bps	-0.44%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2040	0.13%
VIX Index	13.31	1.45%
5 year UST	1.59%	-6 bps
7 year UST	1.99%	-7 bps
10 year UST	2.29%	-7 bps
US HY	6.27%	-0.23%
European HY	5.04%	-0.08%
EURUSD	1.2496	0.55%
USDJPY	116.25	1.30%
Brent	77.13	-5.12%
Copper	313.09	0.51%
Gold	1187.84	2.26%

Additional benchmark performance data is provided at the end of this document.

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Fig 1: **KRWJPY**

Source: Bloomberg.

Developments in Japan and Korea are extremely interesting, because they give us potentially valuable insights about the broader future relations between EM and HIDCs. In particular, we see Japan as slightly ahead of the other HIDCs in that its government has now reached the point where its frustration with the failure to generate a proper economic recovery has led it to go for fully fledged currency debasement and inflation. Korea is equally interesting because it is on the receiving end of Japan's currency manipulation and hence finds itself in the position that many other EM countries will occupy in a matter of just a few years from now when the other HIDCs also begin to inflate and debase their currencies (particularly when they realise that raising interest rates

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materially is not easy when you have massive debt overhangs). The value of the Korean won has appreciated dramatically against the Japanese yen. KRWJPY has increased by a whopping 65% since 2011 (see chart above). While Japan is just serving narrow national self-interest – as other HIDCs will do in due time – Korea is facing a tougher set of questions about its appropriate policy response. One option is that Korea engages in competitive currency debasement. But, in doing so, it would soon create inflation, because Korea does not have the same structural obstacles to inflation as Japan. Inflation in turn would undermine confidence in the government's management of the economy and ultimately get the government into serious trouble. The smarter move would be to recognise that Korea's currency shock is an external shock to which Korea has little alternative but to adjust. The loss of export competition arising from appreciation of the Won can be offset if productivity is raised. Higher domestic productivity would not only help to preserve the competitive edge in the export sector, but would also make it possible to raise domestic demand without inflation and worsening the trade balance. During the reforms phase fiscal policy can support growth.

Our view is that many EM countries are going to face similar challenges to Korea's over the next few years as inflation resurfaces in the HIDCs, starting with the US in 2016. One important difference between Korea's situation versus Japan and the coming broader EM experience versus HIDC currencies, particularly the USD, in the coming years is that JPY is not a major global reserve currency. This limits the 'upside' to Japan's currency manipulation to exporters. By contrast, a weaker USD would also debase the real value of the huge proportion of US government debt held by EM countries as foreign exchange reserves. It is likely that the resulting losses will force EM central banks to actively diversify away from USD. This means that KRW's appreciation versus JPY understates the eventual currency appreciation that EM's largest reserve holders will experience versus the USD once inflation resurfaces in the US and the markets realise that the Fed is powerless to stamp it out on account of a large debt overhang, low trend growth due to lack of reforms, and huge volumes of QE that cannot quickly be soaked up.

To us, today's Korea-Japan situation offers two very important lessons for the world of tomorrow.

Firstly, it is extremely important that investors are not side-tracked by short-term herd dynamics in the currency markets. Momentum trades can move markets in the short term, but macroeconomics ultimately determines the destination. The fundamental foundations behind the USD 's recent violent surge against all other currencies (EUR and JPY more so than EM FX) are flimsy, in our view. Global macroeconomic fundamentals remain remarkably unchanged. For example, the US economy will grow about 2% this year, unchanged from 2013, while monetary policies are also likely to remain extremely easy for the foreseeable future. Even as the Fed moves towards its first rate hike it will be forced to move extremely slowly: the lesson from the Fed's tapering U-turn in 2013 is that even modest real rate increases in the US can sink the housing market. The USD surge in the last few months is mainly driven by heavy front-running of expected Japanese pension flows, which may not be realised for many months. Year-end positioning is also a short-term driver which is likely to reverse early next year. A heroic set of expectations of European sovereign QE are probably also priced in by now, though QE is by no means a done deal (and even if sovereign QE were to materialise it would not create inflation in the Eurozone, just as US QE failed to create inflation in the US due to household deleveraging). Besides, the Fed is likely to shift its forecast for the first rate hike further into the future (the so-called 'dots') at its 19 December FOMC meeting. All this should concern late comers to the USD rally as positioning in the Greenback has now reached its highest level since at least 2010, according to CFTC USD net non-commercial futures positions.

Secondly, there will be ever more differentiation across EM countries – both in terms of investment and fundamental economic performance – over the next few years. EM cannot escape adjustment and the more USD assets their central banks have bought the more they will 'pay'. The good news is that some EM countries are ahead of events and have already been preparing themselves for years. Colombia, Mexico, Peru, Chile, Uruguay, Romania, the Baltic states, Panama, Russia, India, Indonesia, China, Malaysia, Thailand, the Philippines and many others have and continue to reform precisely to enable them to sustain growth without inflation in the tougher world of tomorrow. Others have yet to realise the importance of adjusting, including countries such as Turkey, Brazil and South Africa. Others still are in total denial. There is still time to change – after all US inflation is still a couple of years away. We expect more and more EM countries to reform in the coming months and years, not least because EM countries are never given the benefit of the doubt. But the main implication for investors is that the current trend towards passive management – always a bad idea in EM in our view– will become far more unadvisable in the future. Passive management misses all these nuances;the only allocation criterion is the size of a country's market cap in the index.

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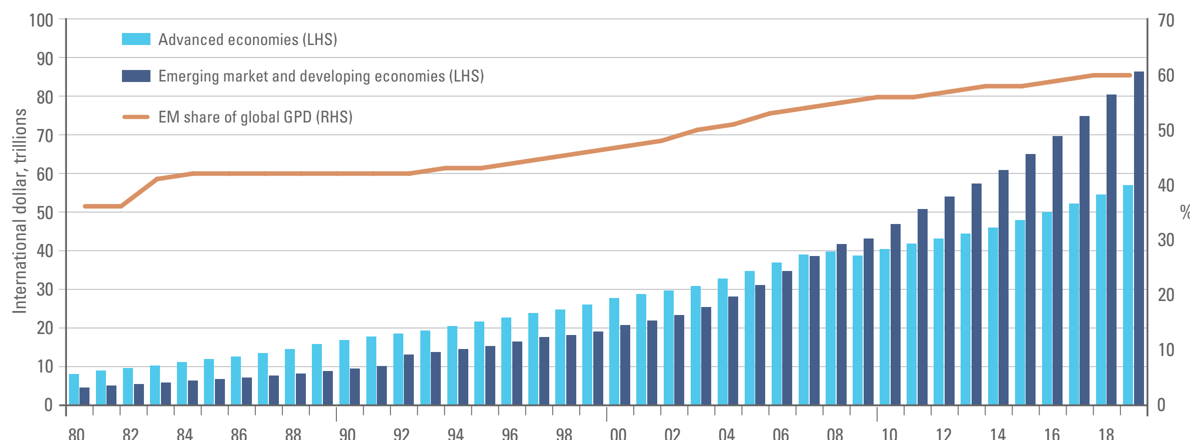
Fig 1: **EM share of global GDP (current international USDs) – forecasts are from the IMF**



Source: IMF World Economic Outlook October 2014, Ashmore.

Emerging Markets now account for 56% of global GDP. The October release of the IMF's World Economic Outlook shows that EM has once again sharply increased its share of global GDP. The IMF measures and compares GDP for 189 countries by adjusting for purchasing power parity and converting national GDP numbers into to a single currency called international current Dollars. According to the IMF's own projections, EM's share of global GDP will now reach 60% of global GDP by 2019 as the chart above shows.

IMF's forecasts for EM growth imply that living standards will continue to catch up strongly with those in the heavily indebted, reform-bucking and slower growing developed countries. EM's per capita income is set to reach 25% of the level of per capita GDP in developed countries by the year 2019 compared to just 12% in 1990.

The new IMF data also highlights the profound discrepancy that still exists between EM's growing economic dominance and the market's outdated perceptions of EM as a bunch of fragile and vulnerable countries. EM's share of global tradable debt (government and corporate) is just 12%, so with EM's share of global GDP higher than 50% it does not take a genius to see that EM is fundamentally less sensitive to higher global interest rates than the HIDCs. Even so, the lingering discrepancy between perception and reality means that EM asset price volatility can be expected to continue to be excessive relative to EM's stronger fundamentals. The single biggest source of price volatility is investor behaviour, which remains firmly focused on Fed rate hikes next year. Our view is that the Fed will not raise rates to levels that in any way could pose a genuine threat to EM's economic fundamentals in the vast majority of EM countries. In other words, markets appear to be missing the point - fretting over uncertainty surrounding the timing of the Fed rather than the more relevant question of whether the hikes will actually be damaging for EM.

- Growth in Eastern Europe: Eastern European countries grew more than expected in Q3. Notably, Russia's Q3 growth number was more than twice as good as anticipated at 0.7% yoy versus 0.3% expected. Romania's economy accelerated sharply in Q3 to 1.9% yoy from -0.3% yoy in Q2. The Q2 print was itself revised up significantly from -0.9% yoy. Hungarian Q3 real GDP growth also beat expectations. Hungary's economy expanded by 3.2% yoy in the third quarter compared to 2.9% yoy expected. Poland's economy also beat expectations by expanding 3.3% yoy in Q3, while Q2 growth was revised up from 3.3% yoy to 3.5% yoy. Slovakian GDP growth was in line with expectations in the third quarter at 2.4% yoy. This implies a 0.6% qoq increase in the size of the economy – one of the highest rates of growth in the quarter in Europe. On the other hand, growth in the Czech Republic slowed marginally from 2.5% yoy in Q2 to 2.3% yoy this quarter. Sequential growth accelerated in Bulgaria, where GDP rose 0.5% qoq in Q3 from 0.3% in Q2, though on a yoy basis growth slowed marginally to 1.6% from 1.8% in Q2.
- China: The Shanghai-Hong Kong Stock Connect (SSE-HK Connect) opened today. By 2pm local time, the full day's buy quota of CNY 13bn had been utilised. The Ministry of Finance has waived capital gains taxes for foreign investors in mainland stocks via the SSE-HK Connect, thus removing an important uncertainty for some investors looking to enter China (most existing investors have operated on the assumption that the tax is payable). *For more detail on the SSE-HK Connect please see "The 'Through Train' arrives", Ashmore's Occasional View, November 2014.* In other Chinese developments, the broad economic picture indicated by various data releases over the past week has not changed. China's economy is chugging along a path of gradually slowing growth amidst passive financial tightening. Fixed asset investment, retail sales and industrial production were broadly in line with expectations, while new loans, social financing and broad monetary aggregates expanded more slowly than expected, mainly because the government is actively suppressing activity via the shadow

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banking system. China's gradual deceleration is pushing down inflation rates against a backdrop of broadly unchanged monetary policy. This amounts to implicit liberalisation of real interest rates. The obvious way to play a slowdown in growth, falling inflation and a stronger currency is to receive rates, in our view. This is now possible via the Renminbi Qualified Foreign Institutional Investor program. China's real rates are high and the technical position is extremely compelling. *For more details, see "Probably the best bond market in the world", Ashmore's Emerging View, September 2014*.

- Malaysia: The economy grew a solid 5.6% in Q3 (in line with expectations), while the rate of growth for Q2 was revised higher from 6.4% yoy to 6.5% yoy. The supply-side of the economy slowed over the past quarter, but consumption – government as well as private sector – picked up. Malaysia continues to run a substantial current account surplus of 2.8% of GDP, though it narrowed somewhat in Q3 due to rising erratic components in the balance of payments. Malaysia is likely to produce a current account surplus this year of about 5%-6% of GDP, in our view. Net total investment flows remain positive despite portfolio outflows (mainly due to strong FDI inflows).
- Argentina: The government successfully issued a second USD-linked bond with maturity in 2018. Total receipts were USD 650m. Despite a ruling by a New York court that prevents Argentina's debt service payments to be released to bond holders, the country continues to be able to access local and international finance by issuing debt under local law. The government has also secured financing from China, advanced exports of soybeans, and raised foreign currency from the auction of 4G licences. There is also talk of reactivating a billion plus USD credit line with the Bank of France. The next notable development on the question of New York law debt relates to the expiry of the so-called RUFO clause in the New Year. The RUFO clause prevents the government from offering better terms to holdout investors than the terms offered to exchange bonds in previous exchanges.
- Turkey: The current account balance widened marginally to USD 2.2bn in September from USD 2.15bn in August. Among the more than 60 EM countries in the EMBI Index, Turkey is one of the countries that stand to benefit the most from declining oil prices. We think the government will continue to err on the side of excessive domestic policy stimulus, which should keep the current account balance well into the red for the foreseeable future.
- Poland: The annual rate of inflation dropped to -0.6% in October from -0.3% in September, well below expectations. Given Poland's strong growth print the economy finds itself in a Goldilocks moment (not too hot, not too cold). Core inflation also turned negative (-0.2% from +0.1% in September). Poland's central bank has stated that deflationary factors are likely to be temporary (caused by commodity prices and other external factors). Local elections in Poland at the weekend provided a win for the opposition Law and Justice party (PiS). Presidential and then parliamentary elections are scheduled for spring and autumn 2015, respectively. Based on exit polls, PiS scored 31.5% compared to the ruling Civil Platform (PO) party with 27.3% and the government's coalition partner PSL at 17%. The leftist SLD party scored 8.8%. The PO party recently replaced its leader Donald Tusk in favour of Ewa Kopacz.
- Hungary: Inflation declined at a slower rate in October, but remains negative. October CPI inflation was -0.4% yoy compared to -0.5% yoy in September. Core inflation is extremely well contained at 1.8% yoy.
- Thailand: Real GDP expanded 0.6% yoy in Q3 2014. Inventories, capital spending and private consumption contributed positively to growth, but government spending and net exports were drags. Thailand's government is yet to activate a large infrastructure investment program that has been on hold for several years due to political instability.
- Hong Kong: Hong Kong grew more than expected in Q3. The economy expanded 2.7% yoy versus 2.0% yoy expected. Both private and government consumption increased, but investment and trade volumes were softer. The healthy growth number suggests that broader business conditions have not been impacted by recent pro-democracy protests.
- India: The rate of inflation is falling sharply, while the economy continues to show better momentum. Thus, in the past week CPI inflation declined to 5.5% in October from 6.5% in September, while industrial production rose 2.5% yoy versus 0.5% yoy the previous month. Wholesale prices rose by just 1.8% yoy in October, well below the 2.4% rate of wholesale prices inflation in September. These macro dynamics continue to support bullish views of both fixed income and equities in India. It is remarkable – and a testament to the superficiality of much of the coverage of EM by banks and in parts of the media – that only a year ago India was labelled as a "Fragile Five" country facing major structural impediments. We think declining bond yields in the local market to bring closer the day when the government decides to open India's fixed income markets to foreign investors.
- The Philippines: Exports rose strongly in September (15.7% yoy versus 10.5% yoy in August).

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- **Romania:** In a result that went against most recent polls, centre-right opposition leader Klaus Johannis defeated Prime Minister Victor Ponta in the second round of the presidential election. Johannis ran on a platform of anti-corruption and rule of law. Johannis and Ponta are now likely to face a showdown over control of parliament, although both sides strongly support the IMF-EU program adopted by the Ponta administration, so major changes in economic policy seem unlikely.
- **Ghana:** The country continues to suffer from the consequences of entirely self-inflicted macroeocnomic difficulties. Thus, inflation rose to a whopping 16.9% in October, which was well above expectations. The Bank of Ghana raised interest rates to 21% from 19%, but the country has strong fiscal dominance and one of the worst election business cycles on earth. Thus, there is a limit to the effectiveness of rate hikes in terms of bringing domestic demand in line with supply.
- **Russia-Ukraine:** The re-escalation of tensions in Eastern Ukraine is leading to fears of more sanctions, but we think Europe and Russia both recognise that additional meaningful economic sanctions will only hurt both economies, but do little to solve the problems in Ukraine. As such, we expect few if any sanctions against important economic entities. Instead, further sanctions would target specific individuals. It appears that policy makers involved in the conflict as well as markets are slowly realising that the tensions in Eastern Ukraine per se have little chance of generating are likely confined to the conflict zone. Thus, the main risk is not the conflict itself, but rather the measures and counter-measures it induces on the part of the Russians, the Americans and the Europeans.

Global backdrop

New York Fed President William Dudley argued that the downside risks to wrongly hiking early are greater than the downside risks of hiking too late. This is consistent with earlier comments that he would like to see the economy "a little hot" before hiking rates. Fed officials have different degrees of influence in the FOMC. We think Dudley is very influential. At the same time, Fed officials have to act a cheerleaders for the markets and the economy and would like to secure a tangible foothold in the process of monetary policy normalisation by dispatching the first rate hike. However, the likelihood of rapid and meaningful monetary policy tightening remains remote, in our view. US jobless claims rose marginally, but the rate of 'hires and quits' improved (this can be interpreted to measure the confidence of workers in securing a new job if they let go of their existing one. US retail sales improved in October and were revised higher in September, while consumer confidence improved, according to the University of Michigan survey. We think the US economy will perform better than Europe and Japan due to early bank recapitalisation and successful household deleveraging, but we do not think this means imminent lift-off for the economy, which still groans under huge debt loads. Besides, a better economic performance does not necessarily translate into better returns for the USD based investors over the medium term due to the higher risk of inflation in the US than in Europe and Japan.

Third quarter Eurozone growth was better than expected. GDP prints in both France and Germany beat expectations, while Italy was in line and Portugal fell short of expectations. Greek growth bounced back strongly at 1.7% yoy versus 0.7% yoy expected. This means that the much hyped case for sovereign QE by the ECB has weakened somewhat. To put the case for sovereign QE into context, Europe has two basic problems: First, it has a banking sector that does not intermediate for which targeted credit QE seems appropriate (in the absence of proper reform). Secondly, Europe faces another periphery debt crisis if policy interest rates rise materially in the US. We think this is unlikely in the near-term, but it makes sense for the ECB to keep the sovereign QE 'powder' dry precisely to cope with such an eventuality rather than to expend it now.

Though still to be officially confirmed, speculation is mounting that the Japanese government is about to be dissolved in order to have quick elections. This means that a planned tax hike will be postponed. The government's approval rating has been declining. Q3 GDP was poor at -1.6% qoq sa versus +2.2% qoq sa expected (with a downwards revision of Q2 growth from -7.1% qoq sa to -7.3% qoq sa). An early tax hike would only further worsen the economic and political outlook. Hence, the desire for a quick election, in our opinion. The challenges facing Japan are considerable. Attempts to fix the fiscal deficit have huge growth implications on account of the country's enormous debt burden. Prime Minister Abe's elusive 'third arrow' has now become even more elusive. The Bank of Japan's policy to push stock prices higher is likely to continue, however, meaning that the gap between Japan's long-term fundamental health and its asset prices will now widen further. We expect the market to focus on the short-term flow implications rather than long-term economic arguments and thus to inflate the equity bubble in Japan even further.

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Global backdrop

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.8%	1.2%	2.7%	3.4%	3.4%
MSCI EM Small Cap	-1.8%	4.2%	6.0%	6.2%	5.2%
MSCI FM	-3.3%	12.7%	17.4%	13.9%	7.9%
S&P 500	1.23%	12.34%	16.26%	20.22%	15.67%
GBI EM GD	-1.94%	-0.42%	-1.58%	0.95%	3.63%
ELMI+	-1.76%	-3.90%	-4.02%	-0.39%	0.02%
EM spot FX	-2.13%	-8.02%	-9.15%	NA	NA
EMBI GD	-0.64%	9.17%	10.10%	6.66%	8.02%
EMBI GD IG	-0.21%	9.92%	10.10%	5.30%	6.83%
EMBI GD HY	-1.39%	7.89%	10.35%	8.96%	9.83%
5 year UST	0.15%	3.20%	1.74%	1.09%	3.38%
7 year UST	0.24%	6.12%	3.96%	1.84%	4.90%
10 year UST	0.32%	10.23%	7.92%	2.96%	6.03%
CEMBI BD	-0.28%	6.91%	7.56%	6.71%	7.27%
CEMBI BD HG	-0.11%	7.76%	8.18%	6.23%	6.91%
CEMBI BD HY	-0.63%	5.10%	6.27%	8.07%	8.45%
US HY	-0.33%	4.43%	5.89%	9.88%	10.69%
European HY	0.47%	5.34%	7.03%	14.85%	12.78%
Barclays Agg	-0.72%	0.92%	0.41%	0.64%	2.28%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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