What if?

By Jan Dehn

The global backdrop section of this report outlines the likely implications of a return to higher inflation in the United States. While US core inflation so far remains benign below 2% it is nevertheless prudent to contemplate the alternative inflationary scenario. Indeed, we believe that the US and other excessively indebted developed economies will eventually have to inflate and devalue their way back to sustainable debt burdens and greater productivity. The Weekly also covers stock market developments in Saudi Arabia, the latest macroeconomic news in China, improved relations between the two Koreas, the cyclical upswing in Brazil, Thailand's fiscal stimulus, inflation in Argentina, political developments in Venezuela plus the snippets.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.9	–	0.60%
MSCI EM Small Cap	12.2	–	0.83%
MSCI Frontier	11.6	–	2.64%
MSCI Asia	12.5	–	0.68%
Shanghai Composite	11.6	–	1.10%
Hong Kong Hang Seng	7.5	–	2.11%
MSCI EMEA	10.4	–	0.26%
MSCI Latam	12.6	–	0.62%
GBI-EM-GD	6.07%	–	0.67%
ELMI+	3.77%	–	0.38%
EM FX spot	–	–	0.58%
EMBI GD	5.28%	272 bps	-0.36%
EMBI GD IG	4.10%	153 bps	-0.41%
EMBI GD HY	6.50%	396 bps	-0.32%
CEMBI BD	5.09%	258 bps	-0.05%
CEMBI BD IG	4.21%	171 bps	-0.07%
CEMBI BD Non-IG	6.27%	377 bps	-0.04%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.9	–	1.61%
1-3yr UST	2.00%	–	-0.04%
3-5yr UST	2.35%	–	-0.15%
7-10yr UST	2.55%	–	-0.51%
10yr+ UST	2.85%	–	-0.71%
10yr+ Germany	0.58%	–	-0.89%
10yr+ Japan	0.08%	–	-0.27%
US HY	5.62%	323 bps	-0.04%
European HY	2.52%	327 bps	-0.19%
Barclays Ag	–	252 bps	-0.12%
VIX Index*	10.16	–	0.94%
DXY Index*	90.81	–	-1.55%
EURUSD	1.2217	–	2.09%
USDJPY	110.79	–	-2.03%
CRY Index*	196.06	–	2.61%
Brent	69.8	–	3.01%
Gold spot	1342	–	1.66%

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

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- **Saudi Arabia:** MSCI, an important equity index provider, aims to include Aramco in the MSCI Saudi Arabia index at the time of the expected IPO of the national oil company later this year. MSCI will also decide in June whether to upgrade MSCI Saudi Arabia to Emerging Markets status, which would significantly increase the demand for Saudi stocks given the larger number of investor who track MSCI EM versus MSCI Frontier. Aramco is the world's largest oil company. The Saudi Arabian government has steadily been reforming its USD 500bn domestic stock market in order to meet the eligibility requirements for MSCI EM inclusion. Whether Saudi Arabia is admitted, is difficult to predict on objective criteria, because as with all EM indices index inclusion, it is conditional upon meeting important subjective criteria, which are entirely outside the control of individual EM countries. EM indices are clearly public goods – in the sense that it is in the interest of the market as a whole to have the broadest possible representation of EM within the indices. Sadly, private provision is fraught with market failures, which is why EM indices are so poor. Due to the existence of market failures, provision of EM indices ought to be undertaken by some international financial institutions, such as the IMF, IFC or, say, the World Bank. However, these institutions are far too removed from financial markets to recognise the opportunity to increase their own relevance, which the provision of proper comprehensive indices could present.
- **China:** The People's Bank of China (PBOC) has changed the instructions for how banks are to calculate the fix for currency contracts. This change means that CNY will now become more market determined. Meanwhile, monetary conditions tightened in December as PBOC withdrew liquidity, pushing down new RMB loans and M2 growth for the month relative to expectations. Both developments point to confidence in the economy at senior government level, in our view. Indeed, Premier Li Keqiang indicated that he expects China's real economy to have expanded about 6.9% in 2017. Also, the trade surplus in December was much larger than expected (USD 54.7bn versus USD 37.0bn expected), driven in part by higher than anticipated exports. The stronger than expected trade numbers will push up the growth number for Q4 2017, all else even. Meanwhile, the rate of CPI inflation was lower than expected in December with prices rising at a rate of 1.8% yoy versus

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1.9% yoy expected. In other news, SAFE, the agency managing China's FX reserves, issued a flat denial of a story published by Bloomberg News that China will slow or halt purchases of US Treasuries. SAFE emphasised the obvious fact that China manages its reserves in a professional manner. Yet, many investors continue to harbour negative biases against China, so false media reports of this kind are an easy sell. Sadly, when false reports are proven wrong this is either ignored or afforded far less attention than the original false story.

- South Korea: North and South Korea used an agreement over North Korea's participation in the Winter Olympics in South Korea to have face to face talks over military matters. Needless to say, this reduces tensions between the two countries, for now at least. US President Donald Trump's decision to reduce US influence in Asia opens the door for a potential re-unification of the two Koreas. China would likely support re-unification if the US agrees to withdraw its military presence in South Korea. Trump and Xi Jinping would probably be given Nobel Peace Prizes and the only two remaining challenges in implementing re-unification would be opposition from Japan and the need to remove North Korean strongman Kim Jong Un. Both these challenges are surmountable, in our view. Our main worry is that Trump is not smart enough to understand the opportunity in front of him. In other news, the rate of unemployment in South Korea was 3.6% in December, down from 3.7% in November.

- Brazil: Inflation fell to 2.9% yoy in December, which is the lowest year-end inflation print since the introduction of inflation targeting in Brazil. Broad retail sales picked up briskly in November, rising 2.5% mom. Core retail sales also picked up strongly (0.7% mom). This means that yoy broad and core retail sales are now rising at rates of 8.7% and 5.9%, respectively. Brazil's services sector also expanded at a healthy rate of 1.0% mom sa in November, up from -0.8% mom sa in October, and industrial production forged ahead at a rate of 4.7% yoy in November versus 3.8% yoy expected. Meanwhile, the government will present a bill for parliament to approve privatisation of Electrobras in November, according to local media reports. Electrobras is Brazil's national electricity company. In a classic after-the-fact move, the S&P ratings agency downgraded Brazil's sovereign credit rating from BB to BB- in line with expectations and put the outlook to stable from negative. The market did not care.

- Thailand: The government announced a supplementary budget of 0.9% of GDP to support low income households and rural dwellers. This will support GDP growth, but there will also be political implications, since low income and rural voters have traditionally supported the populist government, which was ousted by the current military government.

- Argentina: Mere weeks after the government relaxed its inflation target, inflation surprised to the upside. The 3.4% mom inflation print for Greater Buenos Aires in December took the yoy inflation rate to 25% from 22.4% in November. The looser inflation target at the same time allowed the central bank to cut the policy rate by a modest 75bps to 28%, less than had been expected.

- Venezuela: Government and opposition delegates met in the Dominican Republic to try to hammer out an agreement to have a presidential election sometime in H1 2018. In other news, the convention for trading Venezuelan sovereign bonds was changed in recognition of the delay in payments on sovereign debt. Liquidity improved immediately and the prices of Venezuelan bonds rose.

Snippets:

- Angola: The government has moved from a fixed exchange rate regime to a managed float regime. This will introduce a much needed and much delayed devaluation following the fall in oil prices in 2014. The devaluation should also pave the way for fresh IMF funding.
- Chile: Based on press statements by the World Bank's current Chief Economist, Paul Romer, it would seem that the World Bank biased its business rankings against Chile during the time Augusto Lopez-Claros, a Chilean economist opposed to President Michelle Bachelet, was in charge of constructing the World Bank's business conditions index.
- Colombia: CPI inflation was higher than expected in December (0.38% mom versus 0.28% mom expected). This means that inflation in 2017 was 4.09%, which is outside the target range of the central bank (3% +/- 1%). The failure to achieve the inflation target can be attributed to a late adjustment to lower oil prices as the Colombian government focused on achieving a peace agreement with FARC rebels.
- Croatia: Ratings agency Fitch upgraded Croatia's sovereign credit rating to BB+ Stable (from BB positive).
- Czech Republic: Retail sales picked up in November, rising 3.1% in the month. In yoy terms, retail sales expanded at a brisk pace of 7.8% (10.7% yoy for core retail sales). The yoy rate of inflation meanwhile declined to 2.4% yoy in December from 2.6% yoy in November.
- India: November industrial production was very strong at 8.4% yoy versus 4.4% yoy expected. CPI inflation in December was 5.2% yoy compared to 4.9% yoy in November. Wholesale prices inflation was 3.58% yoy in December versus an expectation of 4.00% inflation.
- Indonesia: Imports of capital goods rose sharply in December 2017, implying a pick-up in investments in Indonesia in the periods ahead. Exports softened leaving a trade deficit of USD 270m in December compared to a surplus of USD 220m in November.

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- **Hungary:** The rate of CPI inflation declined to 2.1% yoy in December from 2.5% yoy in November.
- **Malaysia:** Industrial production was stronger than expected in November (5.0% yoy versus 4.6% yoy expected).
- **Mexico:** Domestic demand was soft in October, where consumption declined 0.8% mom and investment fell by 1.0% mom, both seasonally adjusted. Industrial production was also weak in November (-1.6% yoy sa). CPI inflation was 0.59% mom in December, close to the market consensus expectation of 0.58% mom. Mexico is currently labouring under two clouds: NAFTA negotiations and the upcoming election later this year.
- **Peru:** The central bank cut the policy rate by 25bps to 3.0% with a neutral bias. President Pedro Pablo Kuczynski formed a new cabinet following the mini political crisis over the Christmas period.
- **Philippines:** The trade deficit widened to USD 3.8bn in November, up from USD 2.8bn in October. The widening of the trade deficit reflects imports of capital goods as part of a major infrastructure investment push in the Philippines.
- **Poland:** The monetary policy committee of the central bank left the policy rate unchanged at 1.5%.
- **Qatar:** The current account surplus was USD 2.2bn in Q3 2017, equivalent to 5.3% of GDP. This is the largest current account surplus in two years.
- **Romania:** CPI inflation was 3.3% yoy in December, in line with market expectations, while industrial production increased at a strong yoy pace of 9.5%. The National Bank of Romania hiked the policy rate by 25bps to 2%.
- **Russia:** The yoy rate of inflation was 2.5% yoy in December, unchanged from November. Core inflation was 2.1% yoy.
- **South Africa:** Manufacturing output surged well ahead of expectations in November, rising at a rate of 2.3% yoy versus 0.5% yoy expected. Newly elected ANC president Cyril Ramaphosa spoke strongly against corruption in his first speech as party president. Corruption investigations are the obviously way to weaken South African President Jacob Zuma, who is widely suspected of being corrupt.
- **Taiwan:** Exports beat expectations by rising at a rate of 14.8% yoy in December. This took the trade surplus to a whopping USD 6.1bn in the month of December alone.
- **Turkey:** The current account deficit widened to USD 4.2bn in November, which was more than the expectation in the market (unchanged at USD 3.7bn).

Global backdrop

Both the European Central Bank and Bank of Japan signalled gradual tightening of monetary policies in the past week. This reflects stronger economic performance in both regions. Most EM currencies trade versus the US Dollar and most foreign currency-denominated bonds in EM trade as a spread over US Treasuries. As such, Europe and Japan are only marginally important from an EM perspective. However, strength in both regions could lead to outperformance of their currencies against the US Dollar, which may indirectly favour some EM currencies. Positive news on German coalition talks and news that the Bundesbank has decided to include CNY as part of its FX reserves is also helpful.

Meanwhile, in the US December core CPI inflation increased marginally to 1.8% yoy from 1.7% yoy in November. Inflation therefore remains benign. However, the US economy is at full employment, the Fed policy rate is negative in real terms and President Donald Trump has cut taxes at the top of the cycle. Inflation is therefore something to be vigilant about.

Re-emergence of inflation would impale developed markets central banks on the horns of a dilemma: whether to fight inflation and risk recessions from which they would struggle to re-emerge, or to live with higher inflation in a bid to avoid intractable recession. This dilemma is particular acute in the Quantitative Easing (QE) economies, because global asset allocators have piled so much money into stocks and bonds that removing monetary stimulus rapidly would risk a violent unwind of very pregnant positions in a number of markets. Moreover, if violent unravelling was to occur the QE central banks simply do not have enough room to cut rates to ameliorate the economic fallout. For example, the average rate cut in a recession in the US in the past 40 years has been more than 500bps, but the Fed currently only has 150bp of hikes on its books. These constraints are not likely to go away anytime soon.

In light of these constraints the QE central banks will therefore be hoping that inflation remains benign. If their hopes are fulfilled their top priority in terms of monetary policy will be to continue to scale back their QE programs rather than hiking rates per se. By scaling back their QE programs they can gradually reduce the bubbles in their own financial markets, so that future rate hikes can be undertaken without the fear of creating major financial crashes. In the meantime, rate hikes per se will only be done on a strictly opportunistic basis, that is, when they are fully priced in. Rate hikes which are fully priced in are unlikely to trigger adverse reactions in the market or the economy. As QE is scaled back there will gradually be fewer and fewer new market and economic highs and thus the scope for opportunistic hikes should decline in the US. This means that the outlook for rate hikes in the US does not pose a major threat to EM, where bond markets have priced in far more hikes than the Fed will deliver for a long time.

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But what if the US suddenly experiences more serious inflation? A sudden spike in core CPI in the US would force the Fed to choose between hiking to crush inflation, but thereby also risk pushing stocks and the economy into downturn from which they would struggle to re-emerge, or not to hike as much as expected in a bid to avoid recession at a cost of higher inflation. Tolerance for higher inflation is much their likelier outcome, in our view, but this is not necessarily the market's expectation. A nasty inflation surprise could therefore set in motion a protracted period of market turmoil as the market adjusts expectations.

Consider the following. Suppose core inflation suddenly spikes. The likely initial Treasury market reaction would be a sharp sell-off in 2yr Treasury yield, a rise in the Dollar and a fall in stock prices. Soon, however, the early bear flattening of the US curve would give way to bear-steepening as markets price in an inflation premium in response to the revelation of the Fed's true preference for protecting the economy. Higher long-dated yields are not a pleasant prospect either, however, because they clearly hurt housing, the household's most important asset. Bear steepening therefore forces the Fed and possibly regulators to come up with ways to contain term yields, which they can do using twist operations or financial repression. Only after all these changes does the long term outlook under high inflation become clear for all to see: the Fed will allow inflation to rise faster than bond yields, which in turn implies lower real yields and a lower Dollar.

Finally, a word on the current weakness in the Dollar: the Greenback has been falling for some time despite record highs in the US stock market, the Trump tax cut, Fed hikes, rising Treasury yields and good economic numbers in the US. All these factors ought to support the Dollar. However, those investors who are puzzled by the weakness of the Dollar ought to consider two things. Firstly, they should ask themselves which currency investors have bought more of than any other currency in the past 6-7 years? Answer: the Dollar. There may simply not be very many buyers left in which case the conventional fundamental drivers lose clout. Secondly, what is the prospect for further gains in the factors, which drove the Dollar so high over the last few years? The prospect for stock market returns and US growth are clearly not quite as rosy as they were a few years ago.

Incidentally, the exact opposite can be said of EM currencies. EM currencies are supported by very strong technicals, attractive valuations and improving fundamentals. This is why they are not only rallying, but also proving very resilient in the face of risk-off events. QE itself may not have much of a direct effect on currencies, but the behaviour of global asset allocators in response to QE created massive distortions in currency markets. With easy money now becoming a thing of the past the speculative longs in the Dollar will go elsewhere. If this is true then there is still a very, very long way for the QE currency trades to unwind until technicals are once again in balance. This should provide a healthy tailwind for EM currencies and headwinds for the Dollar for the foreseeable future.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	4.31%	4.31%	37.92%	11.04%	5.21%
MSCI EM Small Cap	3.67%	3.67%	35.03%	9.67%	5.60%
MSCI Frontier	4.89%	4.89%	33.04%	7.71%	9.30%
MSCI Asia	4.19%	4.19%	41.59%	12.22%	8.66%
Shanghai Composite	3.68%	3.68%	12.19%	3.96%	11.48%
Hong Kong Hang Seng	6.49%	6.49%	33.38%	5.08%	5.05%
MSCI EMEA	2.60%	2.60%	25.09%	7.64%	0.16%
MSCI Latam	5.68%	5.68%	25.63%	7.23%	-2.43%
GBI EM GD	2.46%	2.46%	16.90%	3.25%	-1.15%
ELMI+	1.40%	1.40%	12.43%	3.04%	-0.39%
EM FX Spot	1.86%	1.86%	7.51%	-3.47%	-6.68%
EMBI GD	0.16%	0.16%	8.70%	7.37%	4.67%
EMBI GD IG	-0.29%	-0.29%	7.05%	4.88%	3.28%
EMBI GD HY	0.58%	0.58%	10.40%	10.40%	6.31%
CEMBI BD	0.19%	0.19%	7.15%	6.32%	4.47%
CEMBI BD IG	0.00%	0.00%	5.41%	4.28%	3.71%
CEMBI BD Non-IG	0.46%	0.46%	9.71%	9.67%	5.51%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	4.28%	4.28%	25.18%	13.50%	15.98%
1-3yr UST	-0.15%	-0.15%	0.20%	0.47%	0.53%
3-5yr UST	-0.41%	-0.41%	0.33%	0.81%	0.95%
7-10yr UST	-0.98%	-0.98%	0.87%	0.65%	1.44%
10yr+ UST	-1.81%	-1.81%	4.60%	0.77%	3.45%
10yr+ Germany	-1.04%	-1.04%	-2.56%	1.03%	5.53%
10yr+ Japan	-0.35%	-0.35%	0.33%	3.04%	5.20%
US HY	0.69%	0.69%	7.07%	6.53%	5.64%
European HY	0.38%	0.38%	6.03%	5.77%	6.72%
Barclays Ag	-0.32%	-0.32%	4.91%	3.35%	3.77%
VIX Index*	-7.97%	-7.97%	-9.53%	-54.62%	-25.02%
DXY Index*	-1.43%	-1.43%	-10.25%	-1.67%	13.83%
CRY Index*	1.13%	1.13%	0.78%	-11.06%	-34.13%
EURUSD	1.77%	1.77%	15.24%	5.02%	-8.18%
USDJPY	-1.69%	-1.69%	-2.99%	-4.63%	24.76%
Brent	4.41%	4.41%	25.92%	46.47%	-36.70%
Gold spot	3.02%	3.02%	11.61%	6.31%	-20.07%

*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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