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EM and the US dollar

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The decline in the Dollar versus Emerging Markets (EM) currencies began two years ago with more room to run, in our view. Last week the Dollar's decline received additional impetus from within the Trump Administration as US Treasury Secretary Mnuchin talked down the Greenback in a bid to head off protectionists within the Administration. Mnuchin's verbal intervention to weaken the Dollar is a wake-up call for those, who are still not positioned for further Dollar weakness. The unwinding of QE policies in the coming years will continue to weigh on the Dollar, in our view, and EM stands to benefit as capital inflows to EM ease important financial constraints. This should unleash stronger domestic demand and eventually more rate hikes than the Fed will deliver.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.3	–	3.29%
MSCI EM Small Cap	12.4	–	2.72%
MSCI Frontier	11.8	–	0.30%
MSCI Asia	12.8	–	2.66%
Shanghai Composite	12.0	–	2.03%
Hong Kong Hang Seng	8.0	–	4.13%
MSCI EMEA	10.5	–	3.65%
MSCI Latam	13.3	–	5.49%
GBI-EM-GD	6.06%	–	1.66%
ELMI+	3.56%	–	1.08%
EM FX spot	–	–	1.36%
EMBI GD	5.29%	263 bps	0.28%
EMBI GD IG	4.12%	144 bps	0.20%
EMBI GD HY	6.50%	385 bps	0.36%
CEMBI BD	5.13%	251 bps	0.10%
CEMBI BD IG	4.25%	163 bps	0.06%
CEMBI BD Non-IG	6.32%	369 bps	0.16%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.1	–	2.23%
1-3yr UST	2.14%	–	-0.06%
3-5yr UST	2.51%	–	-0.13%
7-10yr UST	2.70%	–	-0.15%
10yr+ UST	2.94%	–	0.01%
10yr+ Germany	0.65%	–	0.09%
10yr+ Japan	0.09%	–	0.20%
US HY	5.61%	311 bps	0.27%
European HY	2.40%	323 bps	0.03%
Barclays Ag	–	252 bps	0.06%
VIX Index*	11.08	–	-0.19%
DXY Index*	89.14	–	-1.26%
EURUSD	1.2408	–	1.19%
USDJPY	108.98	–	-1.76%
CRY Index*	200.52	–	5.02%
Brent	70.4	–	1.98%
Gold spot	1348	–	1.09%

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

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The sharp decline in the Dollar last week was an important wake-up call for investors with long Dollar positions. We believe that the decline of the Dollar versus EM currencies has deep roots. This latest move lower in the Dollar is only the latest manifestation of a move, which began some two years ago. We expect Dollar weakness versus EM currencies to continue for several more years, obviously with the odd reversal once in a while.

The roots of the ongoing Dollar decline go deep. From a longer-term perspective, the Dollar should decline versus EM currencies due to faster productivity growth in EM economies, which, under equilibrium conditions, requires EM currencies to rise in order to prevent higher wage gains from feeding into consumer prices (this is the so-called Balassa-Samuelson Effect). Over a slightly more medium-term horizon we also believe that EM currencies should appreciate, because EM countries have healthier economic fundamentals. For example, their fiscal policies are more sustainable, they have far less debt, their demographics are better, they are growing faster, they have a greater proclivity to tackle structural reforms and their central banks run normal monetary policies with positive real interest rates. The domestic financial markets in EM countries are also not trading at bubble valuations. Against this backdrop and taking into account technicals, we expect that the unwinding of Quantitative Easing (QE) policies in the US will continue to weigh on the Dollar versus EM currencies.

In addition to these drivers, the Dollar is now also very sensitive to policy statements as evidenced by the responsiveness of the currency to Mnuchin's comments. Why did Mnuchin suddenly change US exchange rate policy? The answer is that he was likely forced to do so to counter the announcement from elsewhere within the Trump Administration about fresh tariffs on US imports of solar panels and washing machines.

There is clearly a deep division within the Trump Administration over macroeconomic policy. This divide pits 'macro' guys, such as Mnuchin against protectionists, such as Wilbur Ross and Robert Lighthizer. These two groups have diametrically opposed interests: Mnuchin's remit is to look after the overall health of the US economy and the state of the public finances, which naturally ensures that he is in favour of free trade and free

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movement of labour and against state aid for inefficient American companies, whether by means of tariffs or other instruments. By contrast, Ross and Co. have a much narrower focus, namely uncompetitive US industries. The protectionists measure their success in the terms of the amount of protection they can secure for such industries and they are less concerned about the impact of their policies on public finances or the health of the wider US economy. By weakening the Dollar Mnuchin hopes that he can take the pressure off US exporters and thereby also weaken the influence of the protectionists within the Trump Administration.

There is no doubt that on the substance of the matter Mnuchin's position is the right one. Even kindergarden-level economists know that protectionism is damaging for the economy in many ways. For example, tariffs keep uncompetitive American producers alive at the expense of American consumers. They undermine rather than improve productivity by dulling incentives to improve performance. In fact, protectionism often turns inefficient companies into extremely efficient rent-seekers, whose entire existence eventually hinges on maintaining or even increasing protection.

Mnuchin is also right to try to weaken the Dollar. US companies are not the victim of a sudden resurgence in bad trade practices among America's trading partners. Rather, American companies are struggling to compete mainly because the Dollar is too strong. A strong Dollar was advantageous in the aftermath of the 2008/2009 crisis, because the Dollar strength encouraged capital inflows at a time when the US economy badly needed overseas capital. Today the strong Dollar is hurting large sections of American business in addition to contributing to clear bubble-like valuations in US financial markets.

Despite the strength of Mnuchin's case in favour of a lower Dollar and against protectionism, it is unclear if he will succeed in stopping the protectionists. Trump does not appear to understand macroeconomics very well, so he may simply not appreciate the damage he does to America by supporting Ross and Co. Besides, even a significantly weaker Dollar will take time to help American exporters, so there will be plenty of time for Ross and Co. to convince President Donald Trump that further protectionism is warranted. Regardless of who wins, however, we think the trajectory of the Dollar will still be lower. If Mnuchin wins, the Dollar will continue to weaken as investors the world over take on board that the US government wishes for this to happen. If Ross and Co. win the ultimate loser will still be the US economy, so the Dollar must fall regardless.

However, as we argued above, there are other forces weighing on the Dollar too. The most important of these is the unwinding of QE. During the QE era investors took the view that the US economy would grow fast and that the Fed would hike rates. Since relative growth and relative interest rates tend to drive currencies, the Dollar rallied dramatically against most other currencies in the world between 2010 and 2015, especially against EM currencies, which never benefitted from QE purchases. However, already as far back as early 2015 there were signs that the Dollar was becoming overvalued.[1] By H2 2015 the FOMC began to make specific mention of this fact in its minutes. Today the most obvious manifestation of the overvaluation of the Dollar is its remarkable unresponsiveness to fundamental developments, which would ordinarily support the Dollar, such as strong growth, Fed hikes, new highs in the stock market, tax cuts designed to repatriate overseas pools of capital and protectionist measures. In fact, the Dollar is not just unresponsive; it is falling outright despite these supportive fundamentals . We think this reflects extreme positioning in the Dollar and that it will take years to unwind these pregnant Dollar positions.

Ashmore described the Dollar's path under QE in a landmark publication from September 2015 called *"The View from Kilimanjaro: EM FX in a QE World"*.[2] This report not only predicted the peak of the Dollar rally versus EM currencies in late 2015/early 2016, but also the stagnation of the Dollar versus EM currencies in 2016 and the start of the Dollar's longer-term decline in 2017.

Mnuchin also said that that US exporters will benefit from a weaker Dollar. He is right about that too, but the timing matters a great deal. Exports tend to pick up slowly in response to weaker currencies. In the short term, outflows via the capital account can have a more immediate negative effect on domestic demand. Investors in the frothy US stock market should therefore pay close attention to the Dollar. When capital flows out of a country in fear of currency losses the associated loss of risk-willing capital can be bad for business sentiment, domestic investment and even consumption. These effects are more immediate than the positive effect on exports, because when sentiment deteriorates companies find it harder to access the financing they require to re-structure their businesses towards exports. Rising import prices can also undermine real wages in the near-term. This is why big currency declines are often associated with recessions prior to resurgence in exports.

The drop in the Dollar should therefore be regarded as a wake-up call for investors, especially central banks, which, over more than half a decade, have built and still maintain very large Dollar longs. It is prudent to scale back these positions, because the Dollar will likely weaken further in the future, possibly in a disorderly fashion. Besides, there are much better investment opportunities in other currencies. Currency adjusted returns in Europe and EM are already very strong and likely to improve further, in our view. Domestic demand in these countries will pick up in response to capital inflows long before their exports become challenged by currency appreciation.

[1] See *"The Dollar Bubble"*, Weekly investor research, 26 January 2015.

[2] See *"The View from Kilimanjaro: EM FX in a QE world"*, The Emerging View, September 2015.

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EM countries in particular passed important robustness tests between 2010 and 2015, when they had to cope with a sharp rise in the Dollar, a halving of commodity prices, a Taper Tantrum and pricing in Fed hikes. EM exports have been picking up strongly for a couple of years now, but capital finally began to flow back to EM in H2 2017. Inflows should usher in stronger domestic demand as financial conditions ease. In turn, this will prompt EM central banks to hike rates. Indeed, we expect EM central banks to hike faster, by more and for longer than the Fed over the coming years as their economies pick up strongly. The combination of strong growth and higher rates will interact to further support EM currencies just as they supported the Dollar a few years ago. Sadly, the US never made good use of the inflows. EM countries are unlikely to make the same mistake, so investors should, for now, sit back and enjoy the ride.

- Brazil: An appeal court upheld criminal convictions of money laundering and passive corruption against former President Lula and increased his sentence from 9 years and 6 months to 12 years and 1 month. Lula has more appeal options, but the ruling significantly diminishes the probability that he will be able to run in this year's presidential election. Both stock and currency markets responded positively to the news. In other news, the current account deficit for 2017 was just USD 9.8bn compared to foreign direct investment of more than USD 70bn, while mid-month consumer prices inflation was lower than anticipated (0.39% mom versus 0.43% mom expected).

- Argentina: Real GDP growth was 3.9% yoy in November versus 4.0% yoy expected. The trade deficit was USD 847m in December 2017 compared to a surplus of USD 33m in the same month of the previous year. The central bank cut the policy rate by 75bps to 27.25%.

- Venezuela: The government announced that the presidential election will be held before the end of April 2018. Presidential terms are six years. At least one important opposition politician has announced his participation (Henry Falcon of Lara State). Talks with the opposition are due to take place in Dominican Republic today and tomorrow, according to Dominican Republic sources.

- Russia: Real GDP growth was 1.0% yoy in December, up from 0% yoy in November and Moody's upgraded Russia's sovereign credit rating outlook to positive from stable (rating is Ba1). The US government sanctioned 21 Russians for their alleged involvement in Russian support for Crimea. The US Treasury is due to announce its assessment of a ban on Russian sovereign debt today.

Snippets:

- China: Industrial profits were 10.8% higher yoy in December, down from 14.9% yoy in November.
- Colombia: The trade deficit in November 2017 was USD 0.8bn compared to a deficit of USD 1.2bn in the same month of 2016.
- India: The government announced details of the plan to recapitalise public sector banks, including front-loading of capital infusions.
- Malaysia: The central bank hiked the policy interest rate by 25bps to 3.25%. This followed headline inflation of 3.5% yoy in December (in line with consensus).
- Mexico: The trade deficit for 2017 was USD 10.9bn, down from USD 13.1bn in 2016. Retail sales softened (-1.5% yoy) in November, but overall economic activity was up 0.7% mom in the same month.
- Philippines: Real GDP growth was 6.6% yoy in Q4 2017.
- Saudi Arabia: FX reserves rose to USD 496bn in December following a third consecutive month of increases.
- Singapore: Industrial production declined at a rate of 3.9% yoy in December and inflation slowed to 0.4% yoy from 0.6% yoy in November.
- South Africa: ANC President Cyril Ramaphosa ruled out investment in nuclear power due to fiscal constraints. Finance Minister Gigaba also ruled out financial support for ESKOM, a major utility.
- South Korea: Real GDP growth was 3.0% yoy Q4 2017, down from 3.8% yoy in Q3 2017.
- Taiwan: Industrial production was 1.2% yoy higher in December, in line with expectations.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	9.92%	9.92%	42.19%	11.73%	6.40%
MSCI EM Small Cap	7.24%	7.24%	37.10%	10.44%	6.50%
MSCI Frontier	6.62%	6.62%	31.38%	8.33%	9.33%
MSCI Asia	8.79%	8.79%	44.65%	12.56%	9.75%
Shanghai Composite	7.60%	7.60%	14.96%	3.63%	11.83%
Hong Kong Hang Seng	17.21%	17.21%	44.84%	7.86%	6.79%
MSCI EMEA	8.97%	8.97%	31.48%	8.68%	1.25%
MSCI Latam	14.71%	14.71%	31.48%	9.12%	-0.97%
GBI EM GD	4.69%	4.69%	19.21%	3.56%	-0.76%
ELMI+	3.02%	3.02%	13.61%	3.71%	-0.12%
EM FX Spot	3.74%	3.74%	9.45%	-2.66%	-6.31%
EMBI GD	0.25%	0.25%	9.21%	6.94%	4.63%
EMBI GD IG	-0.31%	-0.31%	7.78%	4.32%	3.27%
EMBI GD HY	0.75%	0.75%	10.63%	10.19%	6.20%
CEMBI BD	0.19%	0.19%	7.06%	6.12%	4.42%
CEMBI BD IG	-0.07%	-0.07%	5.57%	3.97%	3.65%
CEMBI BD Non-IG	0.54%	0.54%	9.20%	9.69%	5.47%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	7.55%	7.55%	27.59%	14.12%	16.21%
1-3yr UST	-0.29%	-0.29%	0.05%	0.39%	0.51%
3-5yr UST	-0.82%	-0.82%	0.11%	0.61%	0.91%
7-10yr UST	-1.75%	-1.75%	1.04%	0.20%	1.39%
10yr+ UST	-2.80%	-2.80%	5.64%	-0.08%	3.50%
10yr+ Germany	-0.87%	-0.87%	0.38%	0.36%	5.46%
10yr+ Japan	-0.18%	-0.18%	1.68%	3.55%	5.07%
US HY	0.89%	0.89%	6.91%	6.51%	5.55%
European HY	0.54%	0.54%	5.72%	5.40%	6.81%
Barclays Ag	-0.50%	-0.50%	5.31%	3.09%	3.81%
VIX Index*	0.36%	0.36%	4.73%	-40.94%	-16.75%
DXY Index*	-3.24%	-3.24%	-11.33%	-5.95%	12.03%
CRY Index*	3.43%	3.43%	3.66%	-5.70%	-33.57%
EURUSD	3.36%	3.36%	16.02%	9.61%	-8.03%
USDJPY	-3.29%	-3.29%	-4.22%	-7.87%	20.13%
Brent	5.28%	5.28%	26.80%	43.29%	-38.44%
Gold spot	3.46%	3.46%	12.77%	7.22%	-18.97%

*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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