Revisiting the EM FX pass-through hypothesis

By Jan Dehn

The election-related Dollar rally in 2018 presents an opportunity to revisit the FX pass-through hypothesis in EM. The experience show that FX pass-through is only a serious risk in EM countries with ineffective central banks. The two countries, which clearly experienced higher inflation due to weaker currencies, Turkey and Argentina, do not have credible central banks. FX pass-through risks may rise in developed economies in the coming years due to the absence of a powerful deflationary feature, which is only present in EM countries.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.3	–	-2.04%
MSCI EM Small Cap	3.5	–	-0.68%
MSCI Frontier	10.6	–	-0.51%
MSCI Asia	10.8	–	-2.29%
Shanghai Composite	9.5	–	-2.90%
Hong Kong Hang Seng	7.3	–	-2.40%
MSCI EMEA	8.6	–	0.13%
MSCI Latam	11.3	–	-3.61%
GBI-EM-GD	6.68%	–	-0.13%
ELMI+	5.47%	–	-0.33%
EM FX spot	–	–	-0.31%
EMBI GD	6.81%	361 bps	-0.05%
EMBI GD IG	5.16%	195 bps	-0.10%
EMBI GD HY	8.69%	551 bps	0.00%
CEMBI BD	6.30%	316 bps	0.21%
CEMBI BD IG	5.18%	204 bps	0.05%
CEMBI BD Non-IG	7.83%	469 bps	0.42%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.5	–	2.21%
1-3yr UST	2.93%	–	0.02%
3-5yr UST	3.04%	–	0.03%
7-10yr UST	3.18%	–	0.18%
10yr+ UST	3.39%	–	1.07%
10yr+ Germany	0.41%	–	0.39%
10yr+ Japan	0.12%	–	-0.07%
US HY	6.81%	361 bps	0.11%
European HY	3.80%	456 bps	0.17%
Barclays Ag	2.25%	-93 bps	-0.04%
VIX Index*	17.36	–	-2.15%
DXY Index*	97.39	–	1.11%
EURUSD	1.1276	–	-1.16%
USDJPY	114.16	–	0.86%
CRY Index*	188.45	–	-3.85%
Brent	71.6	–	-2.17%
Gold spot	1206	–	-2.06%

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

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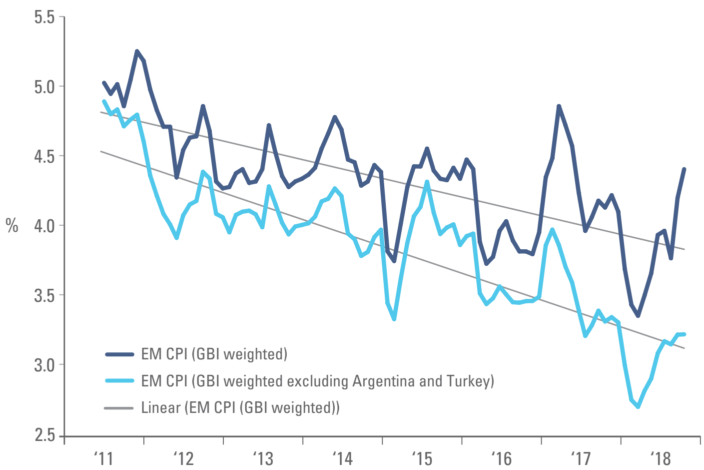
Revisiting FX pass-through

The election-related Dollar rally of 2018 offers an opportunity to revisit the hypothesis of so-called FX pass-through, that is, the reaction of Emerging Markets (EM) inflation to currency weakness. The FX pass-through hypothesis holds that weaker currencies push up inflation rates in EM countries. If weaker currencies push inflation rates higher, then central banks need to tighten policies, which in turn undermines growth and therefore the case for investing in EM stocks and bonds, especially during dips in currencies.

Fig 1: **EM inflation (June 2011 to September 2018)**



Source: Ashmore, Bloomberg, JP Morgan.

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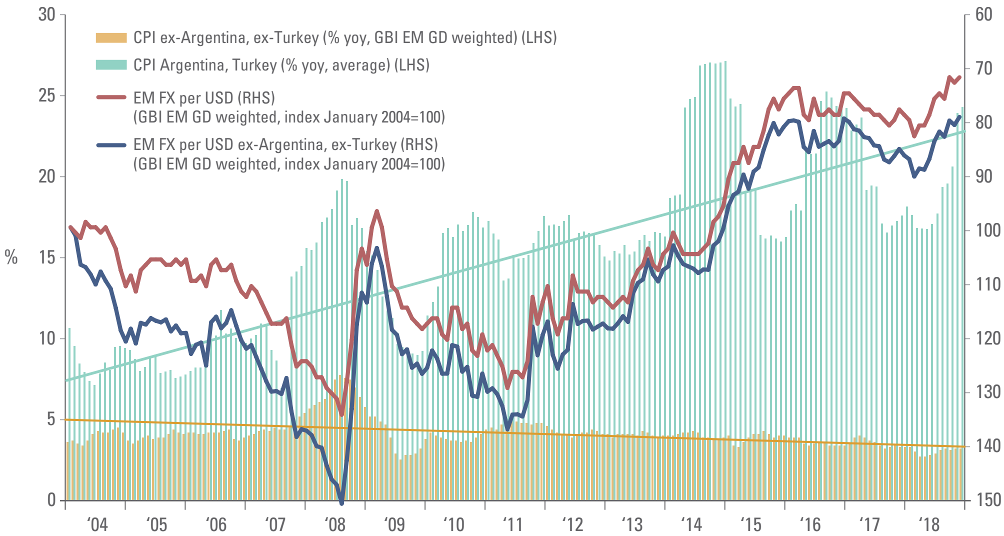
How has the weakness in EM currencies so far this year affected inflation rates? At first sight, the data in 2018 appears to confirm the standard hypothesis of pass-through. After all, the index-weighted CPI inflation went sharply from a low of 3.3% yoy in March of this year to 4.4% yoy last month (blue line in Figure 1).[1]

However, upon closer inspection most of the rise in inflation can be attributed to Turkey and Argentina, which have inflation rates two standard deviations higher than the rest of EM. Turkish President Erdogan has bullied his central bank into keeping rates too low for the past eight years, while Argentina's central bank has not managed to get inflation under control since the Kirchner era. When Turkey and Argentina are omitted, the index-weighted EM inflation rate is only 3.2% yoy (red line). While inflation in EM ex-Turkey and ex-Argentina also increased, this happened from a multi-year low of 2.7% yoy in March and inflation remains well within the normal range around a broad trend of EM disinflation starting around the time of the onset of Quantitative Easing policies (QE) in 2010. In fact, EM inflation ex-Turkey and ex-Argentina is nearly two percentage points lower than in 2011 even after the increase this year.

In short, the FX pass-through hypothesis makes no sense without taking explicit account of the quality of monetary policy. As the single most important determinant of inflation, monetary policy needs greater prominence in the discussion of FX pass-through in EM countries. To make this point even clearer, consider Figure 2, where the columns show EM inflation rates for Argentina and Turkey and as well as the rest of EM and the lines depict index-weighted EM exchange rates, with and without Argentina and Turkey.

Fig 2: **EM FX and inflation (Turkey and Argentina versus the rest of EM)**



Source: Ashmore, Bloomberg, JP Morgan.

Four conclusions emerge from Figure 2. First, EM currencies have weakened across the board versus the Dollar in recent years with almost no distinction across countries. Second, EM inflation rates have exhibited large differences across EM countries (high inflation in Argentina and Turkey and outright disinflation in the rest of EM). Third, FX pass-through as measured by the correlation between inflation and currencies, appears to be strong only in countries with high inflation rates, while it appears to be entirely absent in the rest of the countries. In short, the simple notion that "EM currencies are weaker, therefore inflation must go up" is simply not supported by the data.

While currency weakness makes sense in Turkey and Argentina, increasingly it looks nonsensical in the rest of EM. Low inflation combined with a period of currency weakness means more competitive real effective exchange rates and stronger external balances. In short, it looks like an opportunity, not a cause for concern. In fact, this opportunity delivered strong returns in 2016 and 2017, but received a strong set back in 2018. Why? The Dollar rallied in 2018 due to election-driven pro-cyclical fiscal stimulus and protectionism in the US. These policy interventions are not the stuff of sustained Dollar rallies, however. The most important take-away from the mid-term election is that the Trump Administration is now a lame duck. This means lower odds of major new fiscal stimulus, which has always been a key driver of the Dollar. The likelihood of outflows from the Dollar zone towards EM have increased following the election. These flows will stimulate domestic demand and push up non-tradeable inflation. In short, stronger currencies should be associated with higher inflation in EM countries, which is also consistent with the longer-term data – this has been illustrated in Figure 3.[2]

[1] CPI is weighted by the JP Morgan GBI EM GD, the most used local currency benchmark index in EM.
[2] See https://www.ft.com/content/a52e621e-3407-11e7-99bd-13beb0903fa3

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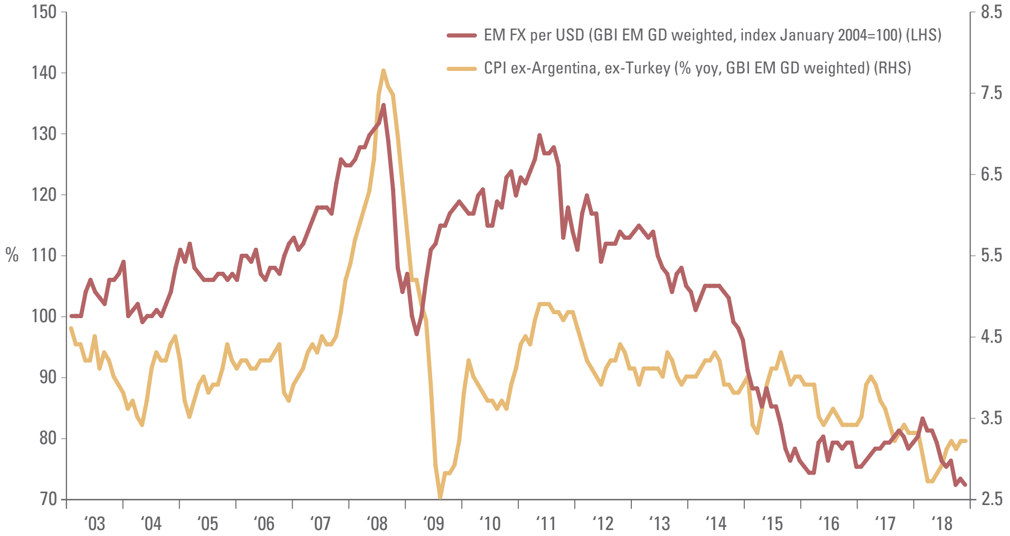
Fig 3: **The long-term relationship between inflation and currencies in EM**



Source: Ashmore, Bloomberg, JP Morgan.

Where might FX pass-through risks be under-estimated? Apart from high inflation economies, investors should perhaps concern themselves more with FX pass-through risk in developed economies. The Dollar is seriously overvalued and could fall precipitously in the coming years, especially if the economy slows. A weaker Dollar would mechanically push up US inflation via higher import prices, but unlike in EM countries, where outflows are deflationary due to the resulting tightening of financial conditions, in the US this deflationary effect would not happen.

In conclusion, the usual knee-jerk position that EM countries will always suffer higher inflation when their currencies weaken is not supported by the data. FX pass-through is largely a myth in EM, because most EM countries have credible central banks, but countries with weak central banks can experience major pass-through from weaker FX to higher inflation. The long-term relationship between FX and inflation is positive, because currency inflows both push up currencies and stimulate inflation by increasing domestic demand. As such, going forward, we expect inflation rates to rise gradually in EM. FX pass-through risks are probably underestimated in developed countries, especially in the US, where the currency has room to fall and where, unlike in EM countries, domestic financial conditions will not necessarily tighten to offset rising import prices during bouts of currency weakness.

- Mexico: President Andres Manuel Lopez Obrador (AMLO) on Friday denied that he intends to change banking laws in Mexico. This follows a negative market reaction to a proposal from a Senator from MORENA, a party with affiliation with AMLO, that banks should be compelled to lower fees. Meanwhile, approval of US President Donald Trump's re-designed NAFTA trade deal with Mexico and Canada is in doubt after Democrats took control of the US House of Representatives. The original NAFTA arrangements remain effective pending approval of the new one, although President Donald Trump could opt to pull out altogether, though this would be economically damaging for all three countries. In economic news, the Mexican yoy rate of CPI inflation declined to 4.90% in October from 5.02% in September and industrial production increased at a solid rate of 2.5% yoy (sa) in September.

- Philippines: Real GDP growth in Q3 2018 was 6.1% yoy. The market had expected growth of 6.2% in Q3 2018. Q2 2018 growth was revised marginally higher to 6.2% yoy. The gentle slowdown in growth is good news. Philippines has been growing at a furious pace for several years, which has raised concerns about overheating and the growing trade deficit (the trade deficit increased to USD 3.9bn in September from USD 3.5bn in August). The jury is out on whether Philippines actually has an overheating problem. For example, capital goods imports make up a large segment of the widening trade deficit, so as long as this capital is employed effectively it may increase productivity and therefore not be problematic. The central bank is hiking rates, which should help to contain domestic demand. Inflation was stable in October compared with September (6.7% yoy).

- Turkey: The rate of CPI inflation was 2.7% in the month of October versus 2.5% mom expected. This translates into a yoy rate of inflation of 25.2%. Core inflation was 24.3% yoy. The combination of a big devaluation of TRY plus lack of credible monetary policy has conspired to high pass-through from the exchange rate to inflation. However, adjustment is underway. Credit growth nose-dived last week (yoy rate of -11.5%) and Turkey's current account has moved into surplus (USD 1.83bn in September). The government has hired banks to issue a 10-year EUR-denominated sovereign bond.

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- **Brazil:** President-elect Jair Bolsonaro said last week that he will not shirk from pension reform. Bolsonaro said he would like Central Bank President Ilan Goldfajn to stay in office. Goldfajn wants guarantees that Bolsonaro will respect the independence of monetary policy. Goldfajn is a solid central banker, but Brazil has many strong economists who could run the central bank well. Meanwhile, IPCA inflation was 0.45% mom in October. This was well below consensus (0.56% mom).

- **China:** Chinese exports defied very gloomy expectations by rising at a yoy rate of 15.6% in October. The market had only expected export growth of 11.7% yoy. Imports also beat expectations. While exports to the US are impaired by protectionism from the Trump Administration, the world does not revolve around the US. China's October trade data shows that China's exports are finding new buyers elsewhere in the world, including in EM countries, such as South Korea, Russia, Brazil, India and Taiwan. By imposing tariffs on Chinese imports, the US is cutting itself of from access to competitively priced Chinese final goods and intermediate inputs. Other countries will happily continue to trade with China. In other news, Chinese FX reserves dropped by USD 34bn in October to reach a level of USD 3.05trn. Most of the change in reserves was due to currency changes rather than flows. The rate of inflation was 2.5% yoy in October, unchanged from September. Core inflation was 1.8% yoy.

- **Argentina:** The government is reported to be close to expanding its currency swap line with China's PBOC by RMB 60bn (USD 8.7bn). The existing swap line is worth RBM 70bn. Industrial production contracted sharply on a yoy basis in September (-11.5%) due to the ongoing macroeconomic adjustment, which is required in order to restore macroeconomic equilibrium followed by a return to sustainable growth. Fitch affirmed the long-term sovereign credit rating at 'B', but moved the outlook to negative in anticipation of the slower growth.

- **Sri Lanka:** President Maithripala Sirisena has called for dissolution of parliament and a snap election on 5 January 2019. However, former Prime Minister Ranil Wickremensinghe has challenged the decision, so the issue will now go before the Supreme Court. The political impasse with jeopardise the timeline for the 2019 Budget and could put at risk Sri Lanka's commitments to the IMF. Sri Lanka has recurring fiscal problems. This is why the political crisis is important from an investment perspective.

Snippets:

- **Chile:** The monthly GDP indicator was up at a yoy rate of 2.3% in September versus 2.0% yoy expected. CPI inflation was 0.4% mom in October, which was below expectations of 0.5% inflation.
- **Colombia:** Inflation was soft in October (0.12% mom versus 0.15% mom expected). On a yoy basis, inflation was 3.3%, up from 3.2% in September.
- **Czech Republic:** The rate of headline inflation declined to 2.2% yoy in October from 2.3% yoy in September. The consensus expected 2.3% yoy. Industrial production was up 2.5% yoy in September compared to 1.9% yoy in August on a working-day adjusted basis. The trade surplus was CZK 13.7bn in September.
- **Ecuador:** The 2019 Budget requires USD 1.75bn in new international bond financing. The government announced last week that it secured USD 1.2bn in fresh financing via four credit lines.
- **Gabon:** President Ali Bongo's health is improving after serious illness, according to government sources.
- **Hungary:** Core inflation drifted up to 3.8% yoy in October from 3.6% in September. Retail sales expanded at a yoy rate of 5.4% in September.
- **Indonesia:** At USD 4.4bn, the balance of payments deficit was broadly stable in Q3 2018 relative to Q2 2018. The current account deficit is running at 2.9% of GDP ytd.
- **Malaysia:** The Central Bank of Malaysia left the policy rate unchanged at 3.25% as expected. Industrial production expanded at a yoy rate of 2.3% in September, up from 2.2% yoy in August.
- **Mongolia:** S&P Ratings updated Mongolia's sovereign credit rating to 'B' from 'B-', with stable outlook.
- **Pakistan:** The government will seek USD 6-7bn from the IMF. The government is also sourcing financing from other sources, including China.
- **Peru:** The central bank left the policy rate unchanged at 2.75%.
- **Poland:** The central bank left the policy rate unchanged at 1.5%.
- **Romania:** The National Bank of Romania left the policy rate unchanged at 2.5%.
- **Russia:** The yoy rate of CPI inflation was 3.5% in October versus 3.6% yoy expected. The central bank's inflation target is 4.0%. Car sales were strong in October.
- **Serbia:** The National Bank of Serbia left the policy rate unchanged at 3.00%.
- **South Africa:** Mining production declined 1.8% on yoy basis in September versus a more bearish expectation of -3.4% yoy. However, manufacturing output was lower than expected.

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- **Taiwan:** Exports were 7.3% higher in October compared to last year and stronger compared to September (2.6% yoy). The inflation rate dropped to 1.2% yoy in October from 1.7% yoy in September.
- **Uruguay:** The yoy CPI inflation rate dropped to 8.01% in October versus an average of 8.33% in Q3 2018. Nevertheless, inflation remains materially above the inflation target of 5% +/- 2%.
- **Zambia:** Government bonds rallied on news that Zambia will seek a re-profiling of the country's debt with China. Re-profiling may free up resources to service the sovereign bonds. An Article IV mission from the IMF is scheduled for Q1 2019.

Global backdrop

The midterm election turned the Trump Administration into a lame duck. This immediately prompted US President Donald Trump to fire his Attorney General in a bid to derail an inquiry into his relations with certain individuals in Russia and Ukraine. More importantly, lame duck status means a lower probability of fiscal stimulus, which coincides with a continuing hawkish stance from the Fed. The Fed confirmed at the November FOMC that it will hike again in December and hike four more times in 2019, thus taking the expected terminal Fed funds rate to 3.5%. The fact that US policy is becoming less stimulatory on both the fiscal and monetary sides is positive for prospects for EM, which have traditionally outperformed the US over longer periods outside of major stimulus episodes.[3]

As noted, the US Treasury market is now pricing in a terminal Fed funds rate close to 3.5%. However, German bonds are only pricing in about 60bps, while EM bonds price in some 520bps. This lingering incongruence, which is due to the distortionary effects of QE, suggests that there is little reason for EM investors to worry about major shifts in the US yield curve barring major economic surprises, although US credit and equity markets may find the going tougher as financial conditions tighten. Meanwhile, company costs continue to rise for other reasons. US producer prices jumped 0.6% mom in October versus 0.2% mom expected. JOLTS job openings fell 3.8% in September.

Partly out of necessity, Europe is taking note of America's increasing use of tariffs and sanctions around the world. Europe may move closer to settling gas and oil contracts with Russian energy majors in Euros instead of Dollars. Europe is also setting up a special purpose vehicle to be able to continue to trade with Iran following the re-imposition of sanctions on Iran by the US government.

In the UK, a key government minister, Jo Johnson, abandoned Prime Minister Theresa May in protest at the government's Brexit proposal, which leaves the UK with close to zero influence in order to preserve access to EU. Most Brexiteers voted in favour of Brexit in order to achieve the opposite outcome.

Finally, we note that the Brent oil price rose above USD 70 per barrel this morning after news that Saudi Arabia intends to curtail oil shipments as part of a broader OPEC initiative to stabilise prices. The Brent oil price has fallen from more than USD 86 per barrel in early October, but remains nearly USD 10 per barrel higher than at this time last year.

[3] For more discussion of this important point see *"US late cycle dynamics and EM bonds"*, The Emerging View, 8 November 2018.

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Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	2.14%	-6.74%	-13.70%	-11.50%	7.89%	2.37%
MSCI EM Small Cap	3.29%	-7.59%	-18.82%	-14.54%	3.32%	1.22%
MSCI Frontier	1.54%	-2.04%	-14.42%	-9.58%	3.37%	1.81%
MSCI Asia	2.41%	-8.70%	-14.28%	-12.90%	7.51%	4.63%
Shanghai Composite	-0.15%	-7.87%	-19.51%	-22.34%	-8.72%	6.68%
Hong Kong Hang Seng	2.89%	-5.30%	-7.27%	-7.55%	3.88%	4.02%
MSCI EMEA	4.22%	-2.80%	-14.49%	-6.42%	4.66%	-2.51%
MSCI Latam	-1.40%	2.01%	-4.80%	-2.73%	12.62%	-1.24%
GBI EM GD	1.42%	-0.57%	-8.67%	-5.13%	3.99%	-1.70%
ELMI+	0.80%	-0.35%	-4.81%	-2.41%	2.76%	-1.14%
EM FX Spot	0.79%	-1.12%	-9.39%	-7.28%	-2.05%	-7.28%
EMBI GD	0.30%	-1.86%	-4.85%	-3.25%	4.59%	4.77%
EMBI GD IG	-0.04%	-2.32%	-4.06%	-3.30%	3.56%	4.02%
EMBI GD HY	0.65%	-1.39%	-5.75%	-3.38%	5.66%	5.45%
CEMBI BD	0.35%	-0.25%	-1.85%	-1.30%	4.56%	4.39%
CEMBI BD IG	0.01%	-0.69%	-1.67%	-1.31%	3.17%	3.76%
CEMBI BD Non-IG	0.79%	0.33%	-2.00%	-1.20%	6.79%	5.19%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	2.65%	-4.37%	5.73%	9.72%	12.46%	11.70%
1-3yr UST	-0.03%	0.11%	0.36%	0.18%	0.52%	0.56%
3-5yr UST	-0.15%	-0.06%	-0.96%	-1.42%	0.49%	0.89%
7-10yr UST	-0.21%	-0.58%	-3.30%	-3.67%	0.24%	1.72%
10yr+ UST	0.22%	-2.83%	-8.46%	-7.38%	0.85%	4.14%
10yr+ Germany	-0.39%	0.71%	3.51%	3.48%	3.70%	6.73%
10yr+ Japan	-0.16%	0.06%	-0.63%	-0.51%	3.27%	3.69%
US HY	0.30%	-1.31%	1.23%	2.05%	6.95%	4.80%
European HY	0.51%	-0.66%	-0.61%	-0.85%	4.23%	4.83%
Barclays Ag	0.00%	-1.12%	-3.46%	-2.10%	2.22%	0.58%
VIX Index*	-18.23%	43.23%	57.25%	53.76%	-5.50%	35.41%
DXY Index*	0.27%	2.37%	5.71%	3.17%	-1.28%	19.95%
CRY Index*	-1.32%	-3.44%	-2.79%	-1.67%	1.09%	-31.08%
EURUSD	-0.32%	-2.83%	-6.07%	-3.35%	4.27%	-16.08%
USDJPY	1.08%	0.40%	1.30%	0.47%	-6.89%	14.57%
Brent	-5.15%	-13.47%	7.04%	12.69%	62.46%	-32.35%
Gold spot	-0.71%	1.14%	-7.44%	-5.65%	11.14%	-4.88%

*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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Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
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Tokyo
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