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Ashmore

Update on US and EM business cycle dynamics

By Jan Dehn

Markets are worried about business cycle dynamics as the era of easy money ends. *A priori*, such concerns ought to apply most to developed markets, which benefitted from enormous stimulus in the past decade, but ultimately it is an empirical question. To that end, we present updated estimates of real effective exchange rate misalignment and policy accommodation in nineteen EM countries as well as the US. We find that EM countries are very close to equilibrium, while the US stands out with an overvalued real effective exchange rate and a monetary policy stance, which is still fanning the flames of demand. Based on these numbers, EM investors are justified in being optimistic about the future, while US investors need to re-examine the bullish thesis of the past decade.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.4	–	-2.58%
MSCI EM Small Cap	10.2	–	-1.42%
MSCI Frontier	9.2	–	-3.35%
MSCI Asia	11.0	–	-2.78%
Shanghai Composite	9.2	–	-3.71%
Hong Kong Hang Seng	7.4	–	-4.42%
MSCI EMEA	8.6	–	-1.54%
MSCI Latam	11.3	–	-1.50%
GBI-EM-GD	6.54%	–	0.99%
ELMI+	5.15%	–	0.39%
EM FX spot	–	–	0.12%
EMBI GD	6.81%	401 bps	0.03%
EMBI GD IG	5.00%	219 bps	0.19%
EMBI GD HY	8.93%	614 bps	-0.15%
CEMBI BD	6.32%	358 bps	0.11%
CEMBI BD IG	5.07%	233 bps	0.35%
CEMBI BD Non-IG	8.08%	535 bps	-0.20%

Data as at 21 December 2018.

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.0	–	-6.88%
1-3yr UST	2.67%	–	0.24%
3-5yr UST	2.66%	–	0.46%
7-10yr UST	2.78%	–	0.97%
10yr+ UST	3.01%	–	2.60%
10yr+ Germany	0.24%	–	0.76%
10yr+ Japan	0.05%	–	0.89%
US HY	7.92%	508 bps	-2.33%
European HY	4.88%	566 bps	-0.28%
Barclays Ag	2.07%	-71 bps	0.90%
VIX Index*	27.97	–	6.34%
DXY Index*	96.65	–	-0.79%
EURUSD	1.1412	–	0.96%
USDJPY	111.20	–	-1.92%
CRY Index*	171.73	–	-8.58%
Brent	53.2	–	-11.73%
Gold spot	1261	–	1.84%

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

Emerging Markets

Macroeconomic concerns are moving to the fore as 2019 beckons. Investors are rightly asking whether economies and markets can sustain forward momentum under their own steam as the era of cheap money ends. The question is particularly relevant in developed economies, which have benefitted far more from cheap money than Emerging Markets (EM) countries over the past decade. For example, Quantitative Easing (QE) policies exclusively targeted developed market bonds and global asset allocators withdrew funds outright from EM in order to chase capital gains in the QE-sponsored countries. Today, EM bonds still price in far tighter monetary policies than the Fed is likely to deliver (EM bonds currently price in a terminal fed funds rate between 520bps and 542bps).

Our view is that *all* countries have the capacity to grow when cheap money is withdrawn. However, developed countries may have to go through a period of rehab before they can return to strong growth, especially if they have become addicted to easy money during the last few years. Moreover, the speed at which they are able to grow after rehab depends on how much attention they have paid to their 'pre-existing conditions', that is, whether they have taken steps to improve productivity reduced their debt burdens and opened their economies to trade, immigration and cross-border capital and the quality of fiscal and monetary policies.

With respect to these structural factors, there are grounds for optimism in EM. EM countries are far less indebted than developed countries and EM credit growth has been in line with long-term trends.[1] Also, the growth outlook for EM countries over the next few years looks significantly stronger than that of developed markets.[2]

However, what about business cycle dynamics? To answer this question, we compare estimates of the state of the business cycle in the 19 EM countries (those included in the GBI EM GD index) with the United States.

[1] See *'A closer look at EM bank lending'*, Weekly investor research, 10 December 2018, and *'The 2019-2023 EM fixed income outlook'*, The Emerging View, 6 December 2018.
[2] See global backdrop section in *'No nonsense Nabiullina'*, Weekly investor research, 17 December 2018.

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Emerging Markets

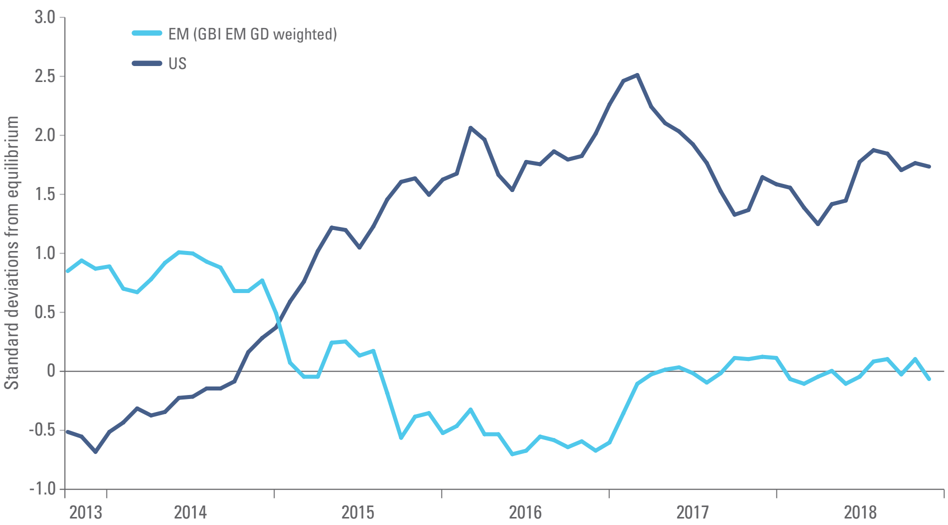
The inclusion of the US in any EM macroeconomic analysis is important for three reasons. First, the US Dollar is the main counterpart currency in most EM currency crosses, so the macroeconomic fortunes of the US matter more for EM investors than, say, the economic fortunes of Japan, UK or the Eurozone. Second, the US economy benefitted far more from QE and low rate policies than any other country, so policy normalisation in the US has greater potential to impact global capital flows. Finally, we believe that the quality of macroeconomic policy has deteriorated faster in the US than in other developed countries, including recent erosion in the quality of fiscal policy and the descent into protectionism.

What is the best way to assess the state of the business cycle? In the old days, it was common practice to look at unemployment and inflation, but with the onset of globalisation, these variables have become less insightful. For example, labour markets have become far more flexible and labour has lost its pricing power as companies in developed countries have turned to outsourcing. In light of this problem, the real effective exchange rate (REER) is a far better indicator of business cycle dynamics, because it explicitly takes account of exchange rates, which are so important for any type of cross-border economic activity. REER overvaluation is typically associated with nominal exchange rate overvaluation, excessive current account deficits, rising inflation and asset price bubbles, while REER undervaluation is typically associated with low or falling inflation, cheap currencies, recession and asset price deflation.

At the margin, government policy is the single most important contributor to the business cycle. As such, in order to obtain a more complete picture of the state of the business cycle, including its potential momentum, it is also useful to take into account whether monetary policy is leaning against or underpinning the business cycle. It is easy to measure the monetary policy stance: simply determine whether the current policy rate is higher or lower than the policy rate implied by the Taylor Rule. Policy-makers fan the flames of demand when they keep the policy rate lower than the rate implied by the Taylor Rule and they restrict demand when they keep policy rates higher than the Taylor Rule-implied rate. The Taylor Rule gap is now regaining relevance as Western central banks move away from outright QE.[3]

For each country, we divide each 'misalignment indicator' – one for the business cycle and one for policy accommodation – by the standard deviation to express disequilibrium in standard deviation terms. We then add the two measures together to create a single equal-weighted measure of macroeconomic misalignment, also expressed in standard deviation terms. We call this indicator the Icarus Index.[4] A positive Icarus Index score denotes overheating, either due to the REER or due to policy, while a negative Icarus Index score denotes that the economy is operating below capacity, or the central bank has restrictive monetary policies, or some combination of the two. In general, one would expect countries with large positive Icarus Index scores to be overheating and heading towards a downturn and countries with low Icarus Index scores to be operating below capacity with prospects of improving over time. Countries with Icarus Index scores around zero should be close to balance.

Fig 1: **Icarus scores for EM and US**



Source: Ashmore, JP Morgan, Bloomberg.

Figure 1 shows Icarus Index scores for 19 EM countries (weighted by the GBI EM GD) as well as the United States over the past five years. The US economy is currently 1.74 standard deviations from equilibrium, while EM countries are almost exactly in equilibrium (-0.07 standard deviations away from balance).

[3] The ECB announced the end of net bond purchases starting later this month.
[4] See *'The Icarus Index'*, Weekly investor research, 13 March 2017.

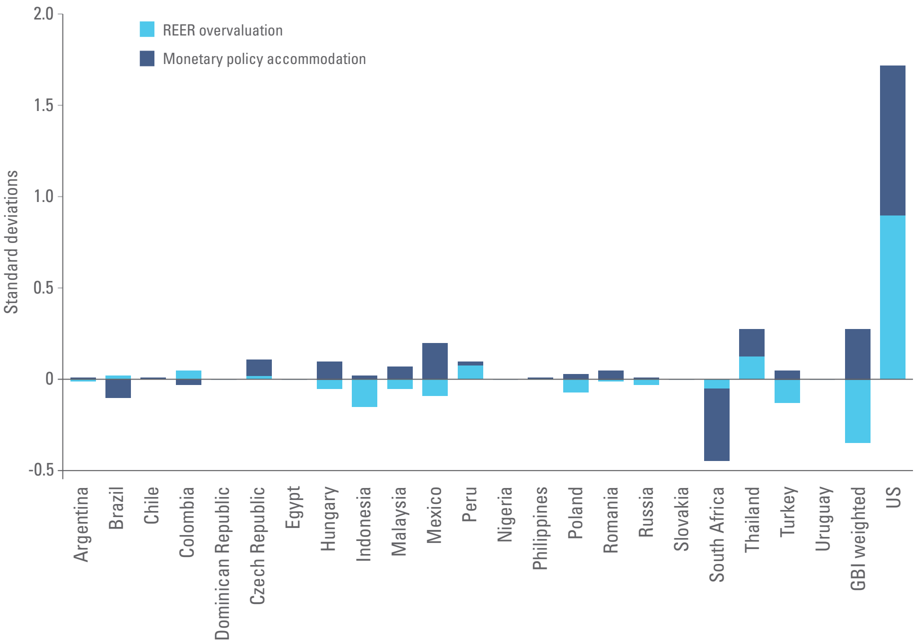
Emerging Markets

Unpacking the index-weighted EM Icarus Index score, we find that EM REERs currently contribute -0.35 standard deviations to the macroeconomic balance, while domestic policy contributes +0.28 standard deviations. In other words, EM central banks are attempting, to a modest degree, to offset the bias against EM currencies in global capital markets by keeping rates a bit lower than long-term equilibrium rates.

It would also appear that EM central banks are generally doing a good job of calibrating monetary policies to the needs of the economy, that is, policy accommodation is not too far out of line with the degrees of macroeconomic misalignment.

By contrast, Fed policy in the US is still providing a serious positive cyclical tailwind (0.83 standard deviations) even as the US economy itself appears to be overheating (the US REER contributes +0.91 standard deviations to the overall imbalance).

Fig 2: **Contributions to imbalance, by country**



Source: Ashmore, JP Morgan, Bloomberg.

In Figure 2, we disaggregate the GBI EM GD weighted Icarus Index score into its individual EM country scores, which are shown by their individual REER and policy misalignment components. What is immediately clear from Figure 2 is that the variation across EM countries is very small and that most countries are close to equilibrium in both policy and REER terms. It is also clear from Figure 2 that the US is a serious outlier. This leads to two important conclusions: EM countries have largely adjusted to the plethora of external shocks they experienced over the past few years, including lower commodity prices, a stronger Dollar, capital flight and pricing in Fed hikes.

On the other hand, the US the economy looks overstimulated and seriously at risk of a downturn. The misalignment of the US economy should worry many, because the single largest consensus long position in currencies in still the Dollar and the single largest consensus long position in global stock markets is still the US equity market. Moreover, investors established these positions based on a bullish view of recovery of the US economy after 2008/2009. The fact that the US Icarus Index is flashing a warning means that the best of the US business cycle upswing is in the past. If so, investors need to move their money elsewhere. Given the far more balanced economies in EM, we believe that EM is a safer place to put the money as we head into 2019.[5]

Merry Christmas!

[5] For the outlook for EM bonds see *'The 2019-2023 EM fixed income outlook'*, The Emerging View, 6 December 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	-3.44%	-8.21%	-15.05%	-12.89%	9.65%	2.17%
MSCI EM Small Cap	-2.30%	-7.80%	-19.00%	-16.21%	4.41%	1.47%
MSCI Frontier	-3.55%	-4.94%	-16.95%	-16.51%	4.71%	0.67%
MSCI Asia	-3.40%	-9.30%	-14.84%	-12.91%	9.00%	4.53%
Shanghai Composite	-2.00%	-10.08%	-21.43%	-20.97%	-8.87%	6.38%
Hong Kong Hang Seng	-5.00%	-8.40%	-10.30%	-8.71%	5.74%	2.87%
MSCI EMEA	-1.87%	-4.34%	-15.84%	-12.60%	8.49%	-2.56%
MSCI Latam	-2.50%	-1.33%	-7.92%	-5.70%	13.89%	-1.52%
GBI EM GD	0.87%	1.67%	-6.61%	-5.80%	5.57%	-1.08%
ELMI+	0.38%	0.91%	-3.61%	-3.03%	3.56%	-0.85%
EM FX Spot	0.03%	-0.81%	-9.10%	-8.70%	-1.27%	-7.06%
EMBI GD	1.45%	-1.16%	-4.17%	-3.85%	5.25%	4.80%
EMBI GD IG	1.72%	-0.58%	-2.35%	-2.03%	4.48%	4.33%
EMBI GD HY	1.17%	-1.76%	-6.10%	-5.79%	6.09%	5.12%
CEMBI BD	0.65%	-0.11%	-1.71%	-1.44%	5.19%	4.34%
CEMBI BD IG	1.00%	0.24%	-0.75%	-0.47%	3.71%	3.89%
CEMBI BD Non-IG	0.18%	-0.58%	-2.88%	-2.62%	7.69%	4.87%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	-10.51%	-14.92%	-5.94%	-6.11%	9.34%	8.49%
1-3yr UST	0.43%	0.94%	1.19%	1.23%	0.81%	0.73%
3-5yr UST	0.89%	1.68%	0.76%	0.95%	0.95%	1.33%
7-10yr UST	1.85%	2.86%	0.04%	0.70%	1.01%	2.56%
10yr+ UST	5.38%	4.10%	-1.93%	0.46%	1.97%	5.45%
10yr+ Germany	1.96%	3.90%	6.79%	6.52%	3.69%	7.49%
10yr+ Japan	1.20%	2.37%	1.66%	1.75%	3.38%	4.25%
US HY	-2.21%	-4.60%	-2.16%	-1.91%	7.54%	3.86%
European HY	-0.63%	-3.85%	-3.81%	-3.60%	3.62%	3.89%
Barclays Ag	1.47%	0.65%	-1.74%	-0.95%	2.47%	0.96%
VIX Index*	54.79%	130.78%	153.35%	190.75%	49.57%	102.83%
DXY Index*	-0.64%	1.60%	4.91%	3.61%	-1.74%	19.95%
CRY Index*	-5.51%	-12.01%	-11.42%	-8.53%	-0.40%	-39.35%
EURUSD	0.81%	-1.65%	-4.94%	-3.89%	4.56%	-16.52%
USDJPY	-2.07%	-2.20%	-1.32%	-1.88%	-8.25%	6.82%
Brent	-9.37%	-35.67%	-20.43%	-18.01%	46.38%	-52.39%
Gold spot	3.17%	5.77%	-3.20%	-0.41%	16.97%	4.82%

*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.
Data as at 21 December 2018.

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