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Ashmore

From trade war to currency thaw?

By Jan Dehn

It is high time for new and constructive ideas in global finance. The Trump Trade War has failed. There may not yet be any concrete signs that the US government is engaging in direct currency intervention to weaken the Dollar, but it is no longer outside the realm of possibility. The late stage of the economic cycle, the increasing scarcity of easing options in the US and the stated policy preferences of the Trump Administration all point to the possibility that the Dollar could be weakened by official means. This would help the US economy in ways the trade war never could. Indeed, from a global growth perspective the world is far better served if the marginal Dollar flowed out of the US and into the Emerging Markets (EM) rather than flowing into already over-financed and over-bought developed markets. Fed Chairman Jerome Powell noted last week, correctly in our view, that no one should assume that the Dollar's status as the global reserve currency will be permanent. The key question is who should partner the US government in an effort to weaken the Dollar. China is the obvious answer, but a broader programme involving other Emerging Markets would be hugely beneficial for global growth, and certainly far superior to a currency accord revolving only around developed market currencies. So the challenge is clear: a push into EM FX would require policy-makers to think outside of the conventional boundaries. Maybe this is the right time. After all, so many other preconceived notions have been discarded in recent years.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.5	–	3.84%
MSCI EM Small Cap	10.3	–	2.18%
MSCI Frontier	9.3	–	0.86%
MSCI Asia	12.2	–	4.06%
Shanghai Composite	10.4	–	4.49%
Hong Kong Hang Seng	8.0	–	4.98%
MSCI EMEA	9.5	–	3.16%
MSCI Latam	11.9	–	4.55%
GBI-EM-GD	5.69%	–	2.19%
ELMI+	5.20%	–	1.22%
EM FX spot	–	–	1.38%
EMBI GD	5.56%	347 bps	1.55%
EMBI GD IG	3.89%	176 bps	1.20%
EMBI GD HY	7.52%	547 bps	1.90%
CEMBI BD	5.30%	333 bps	0.73%
CEMBI BD IG	4.00%	204 bps	0.68%
CEMBI BD Non-IG	7.16%	518 bps	0.81%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.0	–	2.22%
1-3yr UST	1.75%	–	0.16%
3-5yr UST	1.77%	–	0.21%
7-10yr UST	2.04%	–	0.23%
10yr+ UST	2.57%	–	0.09%
10yr+ Germany	-0.30%	–	0.40%
10yr+ Japan	-0.16%	–	0.88%
US HY	5.75%	361 bps	1.01%
European HY	3.89%	418 bps	1.23%
Barclays Ag	1.51%	-53 bps	0.87%
VIX Index*	15.40	–	0.12%
DXY Index*	96.12	–	-1.44%
EURUSD	1.1387	–	1.51%
USDJPY	107.39	–	-1.06%
CRY Index*	178.52	–	3.71%
Brent	65.4	–	7.35%
Gold spot	1406	–	4.93%

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

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When the decade-long recovery of the US economy began to run into diminishing returns towards the end of 2017, Congress was quick to respond by passing a massive tax cut, which helped to keep the party going for a while longer. Unfortunately, the stimulus was poorly designed. It ensured a payday for wealthy individuals and big business, i.e. the primary constituency of Congress Republicans, but it was soon found lacking in terms of its capacity to ignite a sustained pick-up in economic growth. Most of the gains went into stock buybacks and increasing the wealth of already rich people with very low marginal propensities to spend, so growth has steadily slowed since the post-tax cut peak quarter of growth (4.2% qoq saar) in Q2 2018.

Perhaps aware of the need to come up with new ways to Make America Great Again, President Donald Trump decided that starting a trade war with China, one of America's largest trading partners, was just what the doctor ordered. In May 2018, he stunned the world by announcing 25% tariffs on USD 50bn of Chinese goods. More tariffs followed. A year later, however, it is becoming clear that the trade war is not going to ignite a sustained increase in US growth rates either. If anything, the trade war has had the opposite effect. As Figure 1 shows, the American economy has deteriorated sharply since the trade war started. GDP growth has slowed, the trade deficit has widened, the Dollar has appreciated in nominal and real terms, inflation has declined and manufacturing has tanked. To add insult to injury, the trade war has improved the trade balance for China.

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China today imports USD 28bn less from the US (-18%, or USD 130bn versus USD158bn), exports USD 16bn more to the US (+4% or USD 461bn versus USD 389bn) and the Chinese trade surplus with the US has therefore increased by USD 44bn (+15% or USD 331bn versus USD 254bn) (Source: Bloomberg and the Customs Administration of the People's Republic of China, May 2019).

Trump's Trade War has been an unambiguous failure. That is probably why Trump blinked at the recent G20 meeting.

Fig 1: **Selected US economic indicators since the start of the Trump Trade War**

Selected indicators	May-18	Latest	% change	Latest data based on:
US GDP growth (%)	4.2	1.4	-67%	Atlanta Fed GDP Now as of 10 July
US trade deficit (USD bn)	44.4	55.5	25%	May-19
DXY	94.0	97.0	3%	12-Jul-19
US REER	113.1	117.7	4%	May-19
CPI inflation	2.8	1.6	-43%	Jun-19
Core CPI inflation	2.3	2.1	-9%	Jun-19
Markit manufacturing PMI	55.4	50.6	-9%	Jun-19
ISM manufacturing PMI	60.0	51.7	-14%	Jun-19

Source: Ashmore, Bloomberg.

Now, anyone with rudimentary training in international economics could have told the US Administration in May last year that protectionism would be counter-productive for growth, but sometimes the only way to make kids learn is to allow them to make mistakes. Protectionism – taxing American consumers and businesses to provide de facto state-support for uncompetitive American companies – is indisputably bad for the US economy and it is easy to see why. US competitiveness is measured using real effective exchange rates (REERs). The US REER is a function of the nominal exchange rate (USD versus currencies in rest of the world) and the relative cost of doing business in the US relative to other countries as shown here:

$$\text{US REER} = \text{USDROW} * \frac{\textit{(Costs in America)}}{\textit{(Costs in rest of world)}}$$ [1]

When the US imposes taxes on imports (tariffs), costs go up in the US. This undermines directly real incomes of US consumers and the competitiveness of US companies. Tariffs do not even fix the balance of trade, because the higher cost of imports pushes up the nominal Dollar too, which hurts exports. This happens because US consumers and businesses can afford fewer foreign goods when tariffs are applied. As US imports fall, fewer Dollars flow overseas and the resulting shortage of Dollars overseas pushes the Dollar up until US exports have retreated in equal measure to the fall in imports, leaving the trade balance entirely unchanged. However, protectionism also sows broader uncertainty about the reliability of the US as a trading partner, so the trade balance can worsen further, which has, in fact, happened. Hence, the only 'beneficiaries' of tariffs are the few companies who are protected behind tariff barriers. Sadly, tariffs perversely encourage protected companies to rent-seek rather than to improve their competitiveness and fitness, so they inevitably end up getting weaker rather than stronger.

So, now that the Trump Trade War has failed, what is next? The question is pertinent, because the present situation does not amount to stable equilibrium, neither economically nor politically. After all, the original problem, which led to the ill-conceived idea of protectionism in the first place, has not gone away. The US economy is still slowing and a slowdown is not politically sustainable as the US heads into a pivotal election year. What then will US policy makers pull out of the hat next? Unfortunately, the available set of policy options is not impressive:

1) Fiscal policy is more difficult now because the government's debt burden has increased from 64% of GDP in 2007 to 107% of GDP as of 2018 and the House of Representatives is now controlled by Democrats
2) The Fed can only cut 250bps, whereas 500bps of rate cuts has historically been required to extract the US economy from recession
3) Quantitative Easing (QE) will be far less effective at this late stage of the business cycle. QE was so effective in 2010, because it was launched at a time when the US economy had plenty of cyclical upside and stocks were cheap. These conditions no longer apply. The economy is near full employment and stocks are trading at highly elevated prices (27x long-term price earnings ratio for the S&P 500 versus 14x in 2010). Will people really buy stocks with the same gusto at current prices in the context of declining earnings and a slowing economy?

[1] See *'Trump blinks first at the G20'*, Weekly investor research, 1 July 2019.

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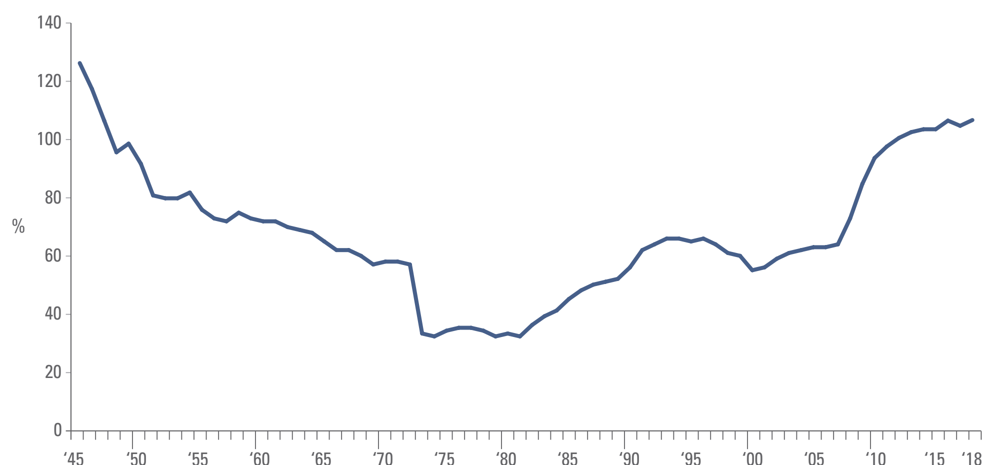
Fig 2: **US government debt to GDP (%)**



Source: Ashmore, Treasury.

It is these limitations on conventional easing, which has increased the odds that a trade war will give way to a thaw in currencies. Moreover, the odds of intervention to weaken the Dollar only increase when US growth slows more, or, perhaps, if Trump simply gets more impatient about the slow pace of implementation of his frequently voiced desire for a lower Dollar.

What do we mean by a thaw in currencies? We mean that the Dollar's strangle hold on global capital flows over the past decade may be about to ease, that is, the US government may soon begin to take steps to deliberately weaken the Dollar versus other currencies. This could be done either as a type of QE, where the US government buys foreign bonds instead of domestic bonds, or it could be pure currency intervention.

From the US perspective, unlike a trade war, currency intervention has the great advantage that it actually depreciates the REER, i.e. improves US competitiveness. This can be seen in equation [1], where a lower nominal Dollar clearly reduces the REER, provided that costs in the US, i.e. inflation, do not rise in lock-step with the lower Dollar. This condition is likely to be satisfied; because the US economy is slowing, the Fed is reasonably credible (i.e. inflation expectations are anchored by policy, not by the exchange rate) and the US economy has a large non-tradable economy, where prices are not overly influenced by the price of imports.

Still, weakening the Dollar is no trivial matter. For one thing, a lower Dollar could trigger wholesale liquidation of long positions in US equity and credit markets, which have been accumulated during the QE years. A correction in US equity and credit markets is probably preferable sooner rather than later to prevent the bubbles from growing even larger, but a careful coordination between US agencies and other countries could materially reduce the risk of a disorderly unwinding of longs. Another risk is that the Dollar's reserve status is called into question. The Dollar's reserve status has easily survived interventions in the past, but the actions of the Trump Administration, in sharp contrast with every previous US Administration since World War II, shows that this administration is comfortable with the idea of ending the Dollar's status as the world's pre-eminent global reserve currency. So perhaps it is time to consider this possibility.

There are two additional questions pertaining to a US-led intervention to weaken the Dollar. Firstly, should it wish to do so, how does the US government actually lower the Dollar? Second, what role, if any, should other countries play?

In terms of the operational aspects, there is absolutely no obstacle to the US unilaterally weakening the Dollar. The Fed and the Treasury are both mandated to act in unison or independently to weaken the Dollar provided the President wishes them to do so. Congressional approval is not required. The Treasury could, in fact, at this very moment, intervene to the tune of about USD 88bn via the Exchange Stabilization Fund (ESF), while the Fed could, in principle, intervene in infinite size via the System of Open Market Operations (SOMA). In terms of making a mark, however, history shows that unsterilised, well-signalled interventions, which form part of a larger programme of interventions, coordinated between the Treasury and the Fed, as well as with foreign central banks, are by far the most effective.

What role will the rest of the world play then? In order to ensure an effective Dollar intervention, it is highly desirable to obtain buy-in from other central banks, which means that EM central banks will play a central role. Relative to, say, the ESF, or any realistic SOMA operation, the world's central bank banks have enormous fire power. As at the beginning of July 2019, the total stock of FX reserves in the whole world was USD 11.6trn,

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76% of which are controlled by EM central banks alone, or USD 8.8trn (with the balance mainly controlled by Switzerland and Japan with USD 2.0trn combined) (Source: Bloomberg, 12 July 2019). Moreover, 62% of known FX reserves are invested in Dollars with most of the remainder in Euros, a small amount in other developed market currencies, only 2% in Renminbi and almost nothing in other EM currencies. This composition makes no sense. While the timing of US currency intervention is still unknown, the risk is rising so it is only prudent for central banks to welcome and participate in a multi-year programme of diversification away from the Dollar, ideally starting as soon as possible.

China, as always, plays an absolutely pivotal role. Perhaps the most effective way to weaken the Dollar right now is for the US government to begin to buy Chinese government bonds in size. The timing is fortuitous. China's bond markets are currently being incorporated into global benchmark indices, so there will be an inflow to this market of as much as USD 500bn over the next few years. It would be smart and profitable for the US Fed and Treasury to get ahead of this flow. The effect will be to push down USDCNY, which will be welcomed by China, because it would facilitate orderly outflows as part of the general liberalisation of the Chinese capital account. Moreover, China has been expanding its domestic bond markets precisely in preparation for its greater integration in global bond markets and broader global ownership of its currency.

One of the reasons for focusing on China is that Europe, Switzerland and Japan would struggle if their currencies appreciated significantly versus the Dollar. Given their sluggish growth rates, all three regions would likely experience considerable economic stress if their currencies appreciated significantly. Besides, their markets are already flush with capital from their own QE programmes, as reflected in extremely low bond yields, so the marginal benefit of US purchases would be extremely low. The problem in Europe is not inadequate demand for financial securities, but insolvent banks, high levels of debt, structural rigidities and inadequate policy integration at European Union level. Certainly, Germany could issue more bonds to supply American official sector demand, but the stronger EUR would hurt other economies in the Eurozone.

Which begs the question whether the US can deploy enough capital to make a difference to the Dollar without looking beyond China, Europe, Switzerland and Japan. Probably not. There is one additional possibility, which is clearly outside the box, as far as conventional central bank thinking is concerned, namely, the possibility of allocating more to EM bond markets. Most Fed and Treasury officials, as well as officials in most central banks around the world, still cling to what we regard as outdated and rather unsophisticated preconceptions about EM currencies. EM markets are seen as illiquid and risky, while developed markets are seen as liquid and risk-free. These views have not changed in at least a quarter of a century.

Yet, it is clearly becoming more dangerous to wallow in the pleasant fiction of risk free markets in developed economies. For example, every major global-wide crisis to hit the world since 1998 has been caused by events in developed countries, be it Savings & Loans, the Dotcom Bubble, the Sub-prime and Banking Crisis of 2008/2009, the recent European Debt Crises and the Greek default. Developed markets are clearly not risk free.

Besides, the EM fixed income markets have grown ten-fold in less than twenty years. The total EM bond universe today measures USD 24trn, which is equivalent to 22% of global fixed income. Local currency bond markets make up USD 21trn, or 87% of this investment universe. The asset class has also broadened significantly. Today there are more than 150 individual markets (sovereign and corporate), formally represented within benchmark indices. This means that, by allocating broadly across the entire EM fixed income universe, it is possible to work around central banks' traditional concern about liquidity. Moreover, it is important that very large segments of the EM bond universe are now investment grade (IG), including the majority of corporate bonds, local currency government bonds and a sizeable segment of the Dollar-sovereign bond universe.

How would EM countries respond to US currency intervention? Interestingly, EM countries are probably among the best placed compared to anywhere else to cope with currency appreciation under a lower Dollar. To begin with, EM currencies are cheap versus the Dollar, because QE encouraged so many outflows from EM in favour of mainly US markets, a portfolio shift which pushed EM currencies 50% down versus the Dollar. Even today, we estimate that EM currencies are still about 20% cheaper versus the Dollar, based on real effective exchange rates and relative growth rates going forward. This means in turn that EM current account balances have improved considerably across the board, since the start of QE as shown in Figure 3, so most EM countries can handle considerably stronger currencies from an economic perspective. Indeed, the really important insight is that EM countries are severely financially constrained and actually need more inflows via the capital account in order to be able to grow faster. EM economies make up about 50% of the world GDP, but only about 20% of global finance. Inflows will ease these constraints and encourage growth. EM growth, in turn, increases imports, including imports of American goods, which helps the ailing US economy. Hence, everyone wins.

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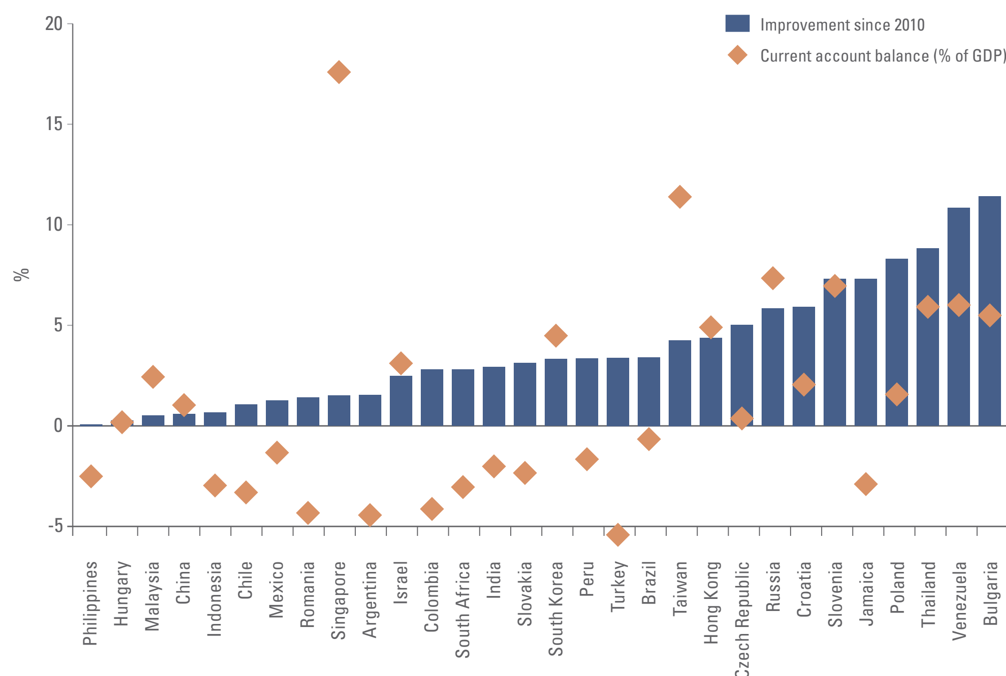
Fig 3: **Improvement in EM current account balances since QE began (% of GDP)**



Source: Ashmore, Bloomberg.

Granted, not all EM countries are equally well placed to handle currency appreciation. As inflows pick up, financial conditions ease and domestic demand picks up, they also push up prices and weaken current accounts, which can be challenging for some, particularly those EM countries, which have not been undertaking structural reforms in recent years. Such countries might lean against currency appreciation by buying Dollars, which is why it is important to work towards an international agreement, so that the sensitivity of individual countries can be taken into account. Fortunately, the number of genuine basket cases in EM is very low, while the big reserve holders in EM, such as Indonesia, Brazil, Mexico, India, China, even Russia, have reformed significantly in recent years. South Africa may do so too now, as President Cyril Ramaphosa has taken over the reins of power from his populist predecessor. The evidence that reform has taken place and monetary policy gained credibility is clearly manifested in EM inflation rates, which are running close to all-time lows, despite significantly weaker EM currencies in the recent decade.

What risks do policy makers face if they begin tentatively to diversify away from the Dollar into a broader selection of EM bonds and currencies? First, it is worth remembering that many of the largest risks to investors, which markets care about, when it comes to EM, such as Dollar appreciation, the Fed hiking cycle, lower commodity prices, the Taper Tantrum, are already behind us. Investors, it turned out, were far more fickle in the face of these risks than EM fundamentals, which have held up well.

It is also unlikely that the painful volatility in EM asset prices of the last few years will be repeated going forward. The instability in EM asset prices can be traced directly back to a one-off shift in global asset allocation in response to central bank subsidies of yield curves in developed markets via QE. Such outflows will not be repeated, even if QE returns, because: (a) developed markets now offer far less upside and (b) investors own far less EM (only one third of the money, which left EM has returned so far).

The case for allocating to a broad basket of EM currencies also factors into account valuations. Whereas a frighteningly large part of the developed market bond universe today pays negative yields, EM yields are actually too high. Central banks – and the US government – would therefore obtain significant positive carry from holding EM bonds. To illustrate this, as of Friday last week, EM bond yields sat at levels, which have historically been consistent with a terminal Fed funds rate of about 4.4% (Figure 4). The high yields are not due to bad credit conditions, because EM corporate default rates – an excellent indicator of overall EM credit health – are currently seven times below their long-term average and less than half the default rates of US high yield bonds. In other words, investors are being genuinely well paid for the risks they are taking, which is something that even central banks ought to care about, if only at the margin.

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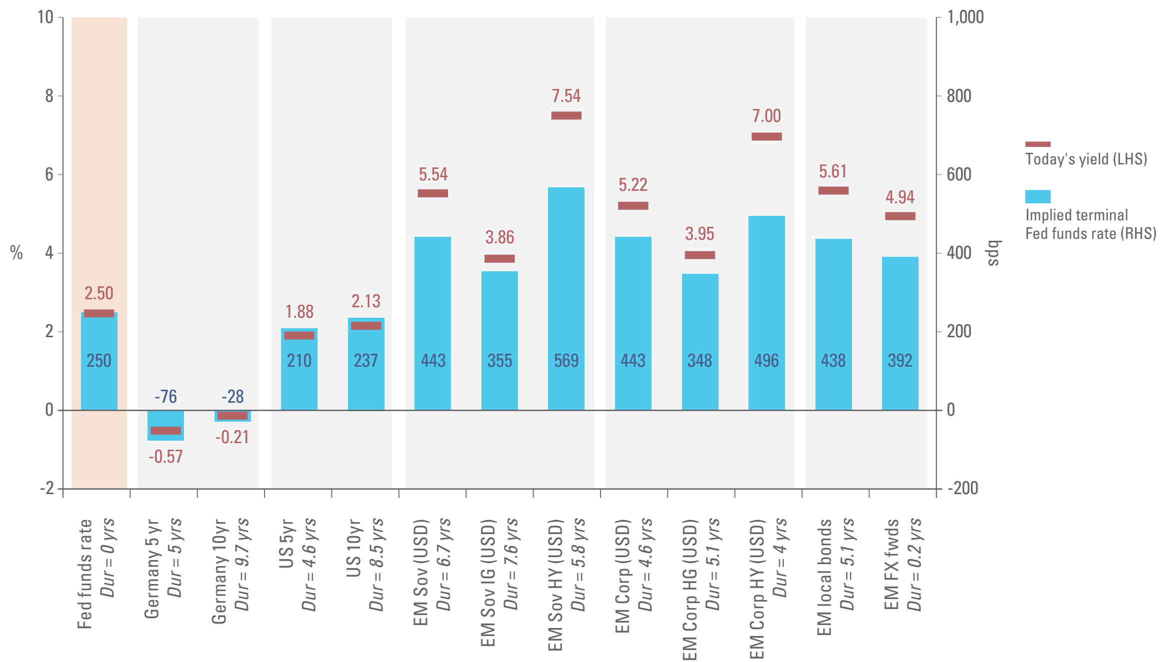
Fig 4: **EM bonds price in a far higher terminal fed funds rate than justified**



Source: Ashmore, Bloomberg, JP Morgan.

In conclusion, it is high time for new and constructive Ideas in global finance. The Trump Trade War has failed. There may not yet be any concrete signs that the US government is engaging in direct currency intervention to weaken the Dollar, but it is no longer outside the realm of possibility. The late stage of the economic cycle, the increasing scarcity of easing options in the US and the stated policy preferences of the Trump Administration all point to the possibility that the Dollar could be weakened by official means. This would help the US economy in ways the trade war never could. Indeed, from a global growth perspective the world is far better served if the marginal Dollar flowed out of the US and into EM than if it flowed into already over-financed and over-bought markets in developed countries. Fed Chairman Jerome Powell noted last week, correctly in our view, that no one should assume that the Dollar's status as global reserve currency is permanent.

The key question is: who should partner the US government in an effort to weaken the Dollar? China is the obvious answer, but a broader programme also involving other Emerging Markets would be hugely beneficial for global growth, and certainly far superior to a currency accord revolving only around developed market currencies. So, the challenge is clear; a push into EM FX would require policy-makers to think outside of the conventional boundaries. Maybe this is the right time. After all, so many other preconceived notions have been discarded in recent years.

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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	5.86%	0.29%	10.26%	0.44%	11.52%	2.95%
MSCI EM Small Cap	3.44%	-1.41%	6.25%	-7.00%	5.79%	0.85%
MSCI Frontier	2.05%	4.28%	11.48%	1.15%	7.54%	-0.62%
MSCI Asia	5.82%	-1.34%	9.94%	-2.70%	12.01%	5.30%
Shanghai Composite	4.29%	-1.88%	21.61%	7.05%	3.82%	10.62%
Hong Kong Hang Seng	5.90%	-2.37%	9.73%	0.40%	12.40%	4.86%
MSCI EMEA	6.10%	7.58%	13.60%	10.78%	8.94%	-0.89%
MSCI Latam	7.47%	5.81%	14.20%	23.93%	13.47%	-0.35%
GBI EM GD	4.80%	4.93%	7.99%	8.68%	4.73%	-0.37%
ELMI+	2.19%	1.59%	3.09%	3.24%	3.01%	-0.55%
EM FX Spot	2.37%	1.18%	1.44%	-1.26%	-2.03%	-6.74%
EMBI GD	3.29%	3.96%	11.19%	12.44%	6.03%	5.39%
EMBI GD IG	2.60%	4.54%	10.78%	12.70%	5.30%	5.01%
EMBI GD HY	3.98%	3.42%	11.70%	12.25%	6.88%	5.46%
CEMBI BD	1.82%	3.12%	8.43%	9.86%	5.66%	4.84%
CEMBI BD IG	1.58%	3.39%	8.32%	10.30%	4.73%	4.43%
CEMBI BD Non-IG	2.16%	2.75%	8.56%	9.29%	7.20%	5.32%

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	7.34%	4.59%	18.87%	9.48%	14.48%	10.73%
1-3yr UST	0.42%	1.37%	2.37%	4.02%	1.36%	1.22%
3-5yr UST	0.62%	2.20%	3.82%	6.39%	1.55%	2.05%
7-10yr UST	0.80%	3.37%	6.33%	9.92%	1.67%	3.30%
10yr+ UST	0.15%	4.79%	9.68%	12.15%	2.16%	5.75%
10yr+ Germany	2.16%	4.42%	10.08%	14.17%	3.17%	7.75%
10yr+ Japan	1.80%	2.65%	6.03%	6.60%	0.90%	5.18%
US HY	2.30%	2.52%	9.97%	6.94%	7.55%	4.70%
European HY	2.08%	1.74%	7.47%	3.87%	4.78%	3.92%
Barclays Ag	1.74%	2.81%	5.07%	5.59%	1.66%	1.30%
VIX Index*	-17.69%	12.33%	-39.42%	11.84%	-40.22%	26.96%
DXY Index*	-1.67%	-1.19%	-0.05%	1.69%	0.71%	19.66%
CRY Index*	1.80%	-2.85%	5.13%	-9.63%	-5.39%	-42.78%
EURUSD	1.94%	1.52%	-0.72%	-2.71%	2.44%	-16.31%
USDJPY	-0.82%	-3.12%	-2.11%	-2.17%	5.08%	5.32%
Brent	1.44%	-4.34%	21.60%	-13.41%	35.14%	-42.84%
Gold spot	7.68%	8.78%	9.61%	11.07%	6.86%	6.62%

*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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