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Ashmore

The Fed ditches one of its crutches

By Jan Dehn

Ukraine plays the crisis card and scores big. The Indian central bank's growing assertiveness is refreshing and welcome. Rising political noise in Turkey could have positive unintended consequences for economic policy. And the Fed deems the US economy capable of walking with one less crutch – the commencement of tapering is good news, because it reduces one of the largest sources of uncertainty in global markets today.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	993		0.32%
MSCI FM	589		0.84%
GBI-GD	6.77%		-1.10%
ELMI+	4.28%		-0.70%
EMBI GD	5.84%	293 bps	0.19%
EMBI GD IG	4.96%	206 bps	-0.03%
EMBI GD HY	9.26%	657 bps	0.65%
CEMBI BD	5.63%	315 bps	0.16%
CEMBI BD HG	4.80%	231 bps	0.06%
CEMBI BD HY	7.51%	507 bps	0.36%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,818	1.81%
VIX Index	13.79	-13.97%
5 year UST	1.67%	14 bps
10 year UST	2.90%	2 bps
10 year Bund	1.88%	5 bps
EURUSD	1.3702	-0.32%
USDJPY	103.93	0.90%
Brent	$112	3.49%
Copper	$336	-1.00%
Gold	$1202	-3.71%

Emerging Markets

Ukraine: Ukraine's strategy of playing the 'crisis card' – in effect threatening to blow itself up unless either EU or Russia steps in to provide assistance – paid off handsomely this week. Russia committed to lending Ukraine up to USD 15bn and slashing the price of Ukraine's gas imports by one third from USD 406 per thousand cubic metres to USD 269.

What did Russia gain in return? Firstly, Russia prevented Ukraine from slipping out of its sphere of influence and into the EU's orbit. Secondly, Ukraine will now be even more beholden to Russian support, because the money allows Ukraine to avoid the necessary structural adjustment otherwise required by both the IMF and the EU. Without these reforms, Ukraine's macroeconomic problems will return and the required adjustment will be even larger. Russia knows this and plays the long game.

In contrast, Ukraine is playing a shorter game. The immediate objective is to maintain economic and financial stability going into the Q1 2015 election. The election precludes deep reforms. The government will continue to play the Russians against the EU, while at the same time seeking third party financing sources. This keeps Ukraine firmly in the realm of high beta credits for the foreseeable future, albeit now with lower upfront risks.

India: Recently appointed Reserve Bank of India (RBI) Governor Raghuram Rajan expressed a bolder view than we usually see from EM central bankers, when he last week steered the central bank away from hiking policy rates in spite of a recent spike in food prices.

Indeed, only days before the RBI's decision to leave the repo rate unchanged at 7.75% the November wholesale prices index had spiked to 7.5% yoy from 7.0% yoy in October, mainly due to food prices inflation.

The RBI took the view that the spike in food prices is temporary, that core inflation is well-behaved, that the economy has a comfortable output gap, and that the effect of its previous hikes will begin to impact prices in the coming months. This position is not without risk, so, as a hedge, the RBI also stated clearly that if these assumptions turn out to be wrong it stands ready to tighten policy, even intra-meeting. Hence the downside risks are limited.

The upside for Rajan and the RBI is more substantial, albeit also subtle. Recall that the RBI lost considerable credibility prior to Rajan's appointment earlier this year. By displaying leadership and the courage to act on its convictions the RBI is helping to restore its own credibility and in turn helping to repair business confidence in India as well as confidence in India abroad. In short, this was the right decision.

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Emerging Markets

Turkey: The starting gun for the Turkish local election race in March 2014 went off with an almighty 'bang' last week. A number of prominent business people with close links to the governing AK party and Prime Minister Erdogan's administration were arrested on charges of corruption. Allegations that these arrests were orchestrated by supporters of Fethullah Gulen's Hizmet movement may never be confirmed, but it is well-known that tensions have been increasing for some time between Gulen and Erdogan.

The Hizmet movement – a modernist Islamic movement – has been a strong ally of Erdogan in his first term and influential in securing major victories over the military and anti-AK elements within the judiciary.

The split between Gulen and Erdogan makes the situation in Turkey a bit different from many other EM elections in that the race is de facto between factions within the support base for the government of Prime Minister Erdogan, while the traditional opposition remains divided and weak.

Things have been turning sour between Gulen and Prime Minister Erdogan for some time. There have been tensions over policy towards the Kurds. Divisions also emerged between the erstwhile allies over Erdogan's handling of this summer's Gezi square protests, and Turkey's support for ousted Egyptian president Mohamed Morsi, which, de facto, ended Turkey's privileged position as neutral arbiter in the Middle East conflict.

Most recently Gulen has strongly opposed the government's plans to reform the school system, a move seen by Gulen as a direct challenge to the Hizmet movement. Hizmet runs a large number of private preparatory schools in Turkey, which are highly popular, because they offer quality education in a country with a weak government education system. Popularity is power, and hence political.

The outbreak of discord among the traditional backers of the Erdogan administration is therefore neither completely new nor hugely surprising. After all, Erdogan has been in power for more than a decade and long-serving governments ultimately break apart. We are not overly concerned about the resulting political noise; noise is normal ahead of elections and tends to leave no lasting trace.

Instead, the significance of the outbreak of discord is mainly how it may affect the government's economic policy. The backdrop for the current spat is that Turkey is heading into three important political contests between March 2014 and the middle of 2015, namely local, presidential, and parliamentary elections. The latter is scheduled for 2015 and is particularly important for economic as well as political reasons. Politically, Erdogan's grip on power after he becomes president in 2014 (largely a ceremonial role) hinges on retaining strong influence over the AK party. And that in turn depends on 'delivering' a strong performance for party members in the parliamentary elections. Economically, the parliamentary elections have to be out of the way before Turkey's usually pragmatic leaders would consider a change in direction of macroeconomic policy.

Hence the importance of the March local elections: A poor showing could prompt Erdogan to move the parliamentary elections – and hence economic reform – forward by a year to coincide with the presidential election this coming summer. Since he has no serious challenger he should win the presidency handsomely and holding the parliamentary elections at the same time would allow AK parliamentarians to ride to victory on his coat tails. Ironically, the weaker the AK party's performance in March, the better the prospects for economic policy change in Turkey.

Still, our base case is the AK party emerges with a clear victory in the March local elections, despite the current shenanigans. This means that the parliamentary elections take place in 2015 as per the original schedule and there will be no material reform and no change in monetary policy before then.

Global backdrop

The whole point of QE is that it supports asset prices, confidence, and the broader recovery during the protracted recovery of a deleveraging economy. It is therefore in the nature of things 'QE' that a large gap opens up between asset prices and the real economy, but the gap does not stay constant.

The stylised chart (overleaf) illustrates how the relationship between asset prices and the real economy changes over time. Initially the gap between asset prices and the real economy is large as asset prices respond to money printing, while the economy struggles with the drags from deleveraging. But gradually over time the economy recovers and the pace of QE can be scaled back. In effect, what happens is that the gap between the underlying real economy and asset prices which was previously filled almost exclusively by QE related flows is slowly replaced by a rising economy. Eventually, in the very long run, the gap between asset prices and the real economy converges to zero as we reach some happy long-term equilibrium.

The Fed's decision this week to pre-announce the commencement of tapering starting in January 2014 signals that the Fed now feels that the underlying economy has now recovered to the point that the pace of QE can be scaled back. In effect, the Fed believes that the economy can now do with one less crutch, shifting some of the burden of recovery onto the economy's players. In announcing the start of tapering the Fed has also removed the single most important source of uncertainty hanging over the market for the past eight months.

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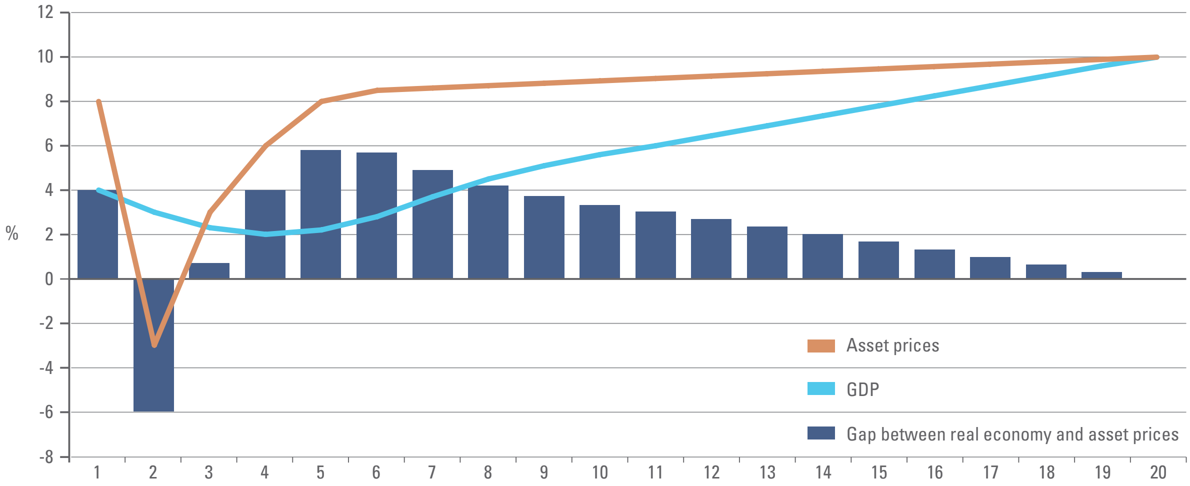
Global backdrop

Fig 1: **Stylised depiction of QE and the economic recovery**



Source: Ashmore.

The dangers of not tapering would have been that asset prices would become too elevated relative to the underlying economy. This would have created a dangerous bubble that, if it burst, would have undermined confidence in policy makers and, particularly, in the integrity of the recovery, which remains far more fragile than the behaviour of stock markets would suggest.

On the other hand, QE and easy monetary policy remain imperative supports for an economy that remains saddled with spare capacity, high levels of debt, and low inflation. This is why the Fed coupled its announcement of tapering with enhanced (albeit qualitative) forward guidance couched in inflation and unemployment terms. The intention is clearly to scale back QE going forward, but the process will be very gradual and it may well be delayed, slowed down, or even temporarily reversed. The main risks to a smooth taper are:

- The economy loses steam for some exogenous reason – this reverses or slows tapering in order to maintain the gap between asset prices and the real economy
- Bond vigilantes take on the Fed again and win – this results in a sharp bear steepening of the US treasury curve, which quickly threatens due to high levels of debt
- Stock markets get into clear bubble territory, where the Fed must tighten liquidity but without raising rates due to lingering weaknesses in the rest of the economy

Thus, it follows that asset prices, interest rates, and the economic cycle will have to remain very well behaved for QE to be scaled back in a smooth way. We think this is unlikely. Investors should be prepared for policy reversals and associated rate volatility, particularly in the long end. In our view, the main shocks to the global economy will continue to come from developed countries.

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