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China kills two birds with one stone

By Jan Dehn

If inflation is slowing because a government is undertaking serious structural adjustment there are grounds for being optimistic. This is China today. If inflation is slowing because a government is unable to undertake much needed structural adjustment you have a problem. Add in a major debt overhang and you are in big trouble. This is Europe and Japan today. This week we discuss China's rate cut and interest rate liberalisation, subsidy cuts in Indonesia and Malaysia, the Russian economy plus the usual snippets. The discussion of the global backdrop focuses on ECB President Mario Draghi's dovish comments and Japanese Prime Minister Shinzo Abe's decision to call early elections. Finally, we put the latest US CPI print into context ahead of the 19 December FOMC meeting.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,014	–	2.84%
MSCI EM Small Cap	1,034	–	1.09%
MSCI FM	640	–	-1.04%
GBI EM GD	6.30%	–	1.48%
EM FX spot	–	–	0.81%
ELMI+	3.25%	–	0.28%
EMBI GD	5.29%	296 bps	0.60%
EMBI GD IG	4.30%	192 bps	0.46%
EMBI GD HY	7.38%	519 bps	0.84%
CEMBI BD	5.33%	322 bps	-0.08%
CEMBI BD HG	4.34%	222 bps	0.10%
CEMBI BD HY	7.49%	542 bps	-0.43%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2064	1.13%
VIX Index	12.90	-7.79%
5 year UST	1.63%	1 bps
7 year UST	2.04%	0 bps
10 year UST	2.33%	-1 bps
US HY	6.43%	-0.26%
European HY	5.13%	-0.13%
EURUSD	1.2404	-0.35%
USDJPY	118.25	1.49%
Brent	79.30	2.30%
Copper	310.02	-0.10%
Gold	1195.66	1.00%

Additional benchmark performance data is provided at the end of this document.

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- **China:** The declining pace of inflation in China last week enabled the central bank, PBOC, to cut interest rates. The PBOC lowered lending rates by 40bps to 5.6% and deposit rates by 25bps to 2.75%. At the same time, the PBOC announced a widening of the band within which banks must lend funds from 10% above the benchmark rate to 20%. PBOC guidance for 5-year savings rates was also removed. The timing of the move surprised the markets, but the central bank's actions are consistent with the general direction of travel in China. China's government is pro-actively re-engineering a transition of the economy towards consumption-led growth from export and investment led growth. This process is slowing the overall economy and putting downward pressure on inflation. The new growth model also requires brand new policy levers to manage the economy, particularly a greater reliance on interest rates. PBOC's latest policy moves achieve two things: First, they help the economy though its economic transition. Second, they advance the objective of interest rate liberalisation. The latter is ultimately far more important than the former, in our view. The Chinese bond market is destined to be the main transmission mechanism for PBOC rate changes and interest rate management is in turn going to be China's principal instrument of macroeconomic policy in the future (just as it is in most developed economies). That is why interest rate liberalisation and the development of the Chinese bond market, including opening of the market to foreign investors, is so key. For more information please see *"Probably the best bond market in the world",* Emerging View, August 2014.

  In other Chinese news, the pace of slowdown in the Chinese property market slowed in October and there are signs that a recovery may soon take root. House prices are declining at progressively low rates. In October, house prices declined by 0.83% versus -1.03% in September, based on the NBS 70 city survey. Another survey, the Soufun 100-city survey, shows similar dynamics. Land prices are also picking up strongly, while housing starts and property investments are showing signs of stabilising. We think the broad macroeconomic environment – interest rate liberalisation, curtailment of excess credit creation, and a slowing economy – have weighed on the housing sector for some time. However, housing cycles are shorter in China than elsewhere due to the smaller role of mortgage financing and both central and local governments have extended various measures to support the housing market during this transition period, including easier criteria for applying for mortgages. The latest PBOC rate cut will also support the sector.

- **Indonesia:** The government formally announced fuel subsidy cuts of 30%. This will reduce the fiscal burden of subsidies from a peak of 3% of GDP to 1% of GDP next year. The freed-up resources will be allocated to

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infrastructure spending. In this way, the Jokowi administration will be able to effectively address the single largest constraint on growth in Indonesia despite Jokowi's weak position in parliament. The price rises resulting from the subsidy cut will have a one-off effect on inflation. Bank Indonesia has already responded to this risk with an immediate 25bps rate hike; this measure is largely to manage expectations because the binding fasbi rate was left unchanged. Fuel subsidies remain protected by Indonesian law. A change in the law is required to move Indonesia structurally towards a more efficient system.

- Malaysia: Following similar moves in Indonesia and India, the Malaysian government has announced that it is scrapping diesel and gasoline subsidies from 1 December onwards. Going forward, prices will be a function of global prices. Fuel subsidies in Malaysia accounted for 2.4% of GDP in 2013. The government is cleverly taking advantage of the dip in global energy prices to make this change. The resulting decline in the subsidy bill for the government will offset declines in oil-related revenues which accounts for 30% of the Malaysian government's total fiscal intake. This will keep the government on track to meet its fiscal target both this year and next. In addition, the removal of subsidies has broader benefits in terms of increasing economic efficiency in the country. The rate of inflation in Malaysia in October was 2.8% yoy versus 3.0% expected.

- Russia: The Russian economy continues to show considerably more robustness than the behaviour of Russian asset prices would seem to imply. Russian bonds, stocks and the currency have taken a beating this year on the back of lower oil prices, Western sanctions and continuing unrest in Eastern Ukraine. However, recent growth numbers beat expectations significantly and fresh data on retail sales released last week further underlined Russia's economic resilience, at least relative to expectations in the market. Retail sales for September rose 1.7% versus 1.2% expected, while real wages rose at a rate of 0.3% yoy versus an expectation of a 0.9% yoy decline. Fixed asset investment declined 2.9% yoy versus -3.5% yoy expected. Industrial production rose 2.9% yoy versus -1.5% yoy expected. Unsurprisingly, given the decline in the RUB, weekly inflation picked up 0.1% to 0.3% on the week, which suggests that the Russian central bank could yet again raise rates. The resilience of the Russian economy compared to investor confidence and the insistence of the Russian central bank to do what it takes to keep inflation under control suggests that there may be considerable value in Russian assets. After all, investing is not about allocating resources to only good or popular countries. Rather, it is about allocating to countries, where asset prices and the true underlying risks have moved out of line with one another.

- Ukraine: A ruling coalition government has been formed following the recent election. The coalition, which controls 300 of the 450 seats will consist of President Petro Poroshenko's supporters (132 seats), Prime Minister Yatsenyuk's People's Front with 82 seats, the Samopomich party with 33 seats plus former Prime Minister Tymoshenko's Fatherland party with 19 seats and the Radical Party of populist Oleh Lyashko, which controls 22 seats. Despite the formation of a coalition, a new government team is yet to be formed (we expect this to happen shortly) without which talks with the IMF are unlikely to progress beyond the technical stages.

Snippets:

- Mongolia has a new Prime Minister following a few weeks of political uncertainty after a no-confidence vote brought down previous Prime Minister Altankhuyag. The new Prime Minister is former cabinet secretary Chimed Saikanbileg. One of Saikanbileg's key assets is that he has been involved in discussion over phase 2 of the Oyu Tolgoi mega mining project, which is critical to the long-term outlook for Mongolia both in terms of economic growth and the public finances. As such, the odds of reaching agreement with Rio Tinto, a British-Australian mining giant, have increased.

- Korean exports continue to be strong despite considerable currency manipulation by Japan (many Korean companies compete directly with Japenese companies in several industries). In the first 20 days of November Korean exports were up 3.6% yoy following strong yoy growth rates in the previous two months.

- Sentiment towards Venezuela improved last week as the government increased transparency about the sections of the public finances. The government announced that USD 4bn of foreign currency denominated assets would be moved from various off-budget slush funds to the central bank reserves. Reserves stand at just over USD 20bn, but as much as USD 15bn may be held in various government accounts outside of the central bank.

- Industrial production in Poland rose 1.6% yoy in October versus 1.4% yoy expected, but in seasonally adjusted terms output slowed to 1.4% yoy from 1.9% in October.

- Mexican retail sales rose again in September, this time 4.5% yoy (marginally slower than in August on a seasonally adjusted basis).

- India's trade deficit narrowed to USD 13.4bn in October from USD 14.2bn in September mainly due to falling crude oil prices.

- Ghana announced that it will put in place new fiscal measures to reduce the current fiscal deficit from 9% to 3.5% by 2017 with the aid of a USD 1bn program from the IMF. The main challenge is that 2016 is an election year. Ghana has perhaps the most severe political business cycle of all countries in the world. Ghana's debt to GDP ratio has nearly doubled from 36% of GDP in 2009 to more than 60% in 2014, largely due to massive increases in spending on civil service salaries and other elements of public spending around elections.

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- A new poll by OPSM, a Buenos Aires based pollster, showed that the three candidates for **Argentina's** president in 2015 are neck and neck. Daniel Scioli, Sergio Massa and Mauricio Macri each polled between 22-26% of votes. Incumbent president Cristina Kirchner is not running. Macri, Massa and Scioli are significantly more market friendly than Kirchner, in roughly that order.
- **Zambia** will hold a presidential election on 20 January following the recent death of President Sata. We expect the election to proceed in line with the requirements of the constitution. Candidates for the two main parties have not yet been announced.

Global backdrop

Like the Bank of Japan, the ECB is increasingly desperate for inflation. There are good reasons for concern. Saddled with unsustainable levels of debt and entirely unable to raise trend growth rates through reforms due to short-sightedness of their politicians the central bankers in both Japan and Europe know that their economies are extremely vulnerable to higher US interest rates.

If they can increase rates of inflation at least they can keep real yields low when nominal rates rise. Higher real bond yields are a total nightmare in both Japan and Europe, because they would reduce domestic demand further, raise the spectre of debt crises, and ultimately push currencies higher. Both Europe and Japan need exactly the opposite in order to grow. The Japanese government is now forcing its USD 1.4trn pension fund (GPIF) to make massive changes in asset allocation in an attempt, we believe, to help weaken the JPY, and speculation in currency markets about sovereign QE from the ECB in the near future has reached fever levels.

With respect to the latter, ECB President Mario Draghi only encouraged speculation last week by saying that he will do what he must to raise inflation and inflation expectations as fast as possible. Weakening albeit not terribly weak European PMI numbers added to the speculative frenzy (in reality, the Eurozone composite PMI declined 0.7 points to 51.4 in November, which is still well above 50, which marks the threshold between expansion and contraction).

In Japan, Prime Minister Shinzo Abe also did his best by calling fresh lower house elections for 14 December. Abe is trying to renew his mandate before his short-term policies lose their effectiveness. Labelled 'Abenomics', his hyper-easy fiscal and monetary policies are distinguishable from the policies of previous administrations only in terms of magnitude; in terms of failing to address Japan's underlying structural problems 'Abenomics' is so far no different from previous versions.

Not that that matters much to the markets. The news from Europe and Japan pushed EURUSD further towards 1.20 and the JPY set fresh lows against the USD. These moves are clearly driven more by momentum and speculation than fundamentals. After all, the US experience with QE over the past 6 years and Japan's experience with QE over the past couple of decades have shown that printing money itself does not generate inflation. The impact on prices depends on the willingness of consumers and businesses to take out new credit and go shopping/invest. The propensities to shop and invest are not just a function of the cost and availability of cheap money, but also of consumers' and businesses' feelings about their own and their government's balance sheets along with a myriad of other macroeconomic and microeconomic factors. If inflation does not come and if major structural constraints are not addressed it is likely that present currency relief arising from QE policies (and GPIF portfolio management in the case of Japan) will be temporary.

As such, the Dollar's rally against both EUR and JPY may eventually reverse itself, particularly when inflation returns. Inflation differentials are the most likely culprit. Inflation should resurface in the US long before it re-appears in Japan and Europe, because the US recapitalised its banks early and has achieved much more in terms of deleveraging household balance sheets. US inflation did indeed surprise to the upside last week, almost as if on cue. The headline number was unchanged at 1.7% yoy, but the market had expected a weaker print given recent declines in oil prices. Prices of services rose, albeit some of the move was due to changes in the methodology by which airline fares are measured. Owners' equivalent rent, an important element of the core CPI index related to housing, actually declined marginally. The upside to inflation is a head-fake; the start of serious sustained inflationary pressures in the US is more likely in late 2016, in our view. At that point, we expect those who are long Dollars to be particularly at risk, because we do not think the US economy is fit to handle the rate hikes required to quell inflation.

US data was mixed. The November release of the Philadelphia Federal Reserve Bank's index of manufacturing activity rose to the highest level in many years, but the much broader Markit PMI index declined to 54.7 in November from 55.9 in October. Industrial production fell 0.1% mom in October versus expectations of a gain of 0.2% mom. Initial claims for unemployment also disappointed slightly relative to expectations, though at 291K the number remained within low recent ranges suggesting continued improvement in the labour market. Importantly, however, job gains in new establishments – an indicator of business start-ups – was just 1.06% of total employment in Q1 2014, according to the Business Dynamics Survey. This is the lowest level of business

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Global backdrop

start-up employment since the early 1990s. Housing starts fell 2.8% in October, but mainly due to more multi-family dwellings (that tend to distort the overall figure). Indeed, the NAHB housing survey improved in November. Housing is one of the areas of the US economy that has benefitted the most from QE as financial asset price inflation has begun to percolate into real asset prices.

The market's attention is likely to increasingly focus on the 19 December FOMC meeting. In this meeting, the FOMC members will adjust their forecasts for the Fed funds rates (the so-called 'dots'). We think the FOMC wants to gain a foothold by getting the first hike done, but at the same time it is mindful of recent declines in inflation expectations (survey and market based measures alike). Moreover, the Fed is likely going to be mindful of the uncertainty created by the lack of clarity about its subsequent rate moves. Hence, as the first hike draws nearer the reference to "considerable period" in the FOMC statement – a code to guide markets about the timing for the first hike – will be dropped in favour of a new code intended to guide markets about the FOMC's expected trajectory for subsequent rate changes. We expect the pace of hikes to be extremely slow and not to pose threat to EM fundamentals for the foreseeable future.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-0.2%	2.6%	2.8%	6.3%	3.6%
MSCI EM Small Cap	-0.8%	4.5%	5.7%	8.4%	5.2%
MSCI FM	-4.3%	11.4%	15.0%	14.5%	8.1%
S&P 500	2.45%	13.70%	17.28%	22.63%	15.98%
GBI EM GD	-0.48%	1.07%	0.22%	2.25%	4.04%
ELMI+	-1.39%	-3.54%	-3.59%	0.20%	0.21%
EM spot FX	-1.37%	-7.31%	-8.44%	NA	NA
EMBI GD	-0.17%	9.69%	10.44%	7.29%	8.05%
EMBI GD IG	0.18%	10.35%	10.56%	5.84%	6.79%
EMBI GD HY	-0.77%	8.56%	10.43%	9.74%	9.95%
5 year UST	0.19%	3.25%	1.74%	1.08%	3.31%
7 year UST	0.30%	6.17%	4.26%	1.74%	4.84%
10 year UST	0.47%	10.40%	8.50%	2.67%	5.97%
CEMBI BD	-0.44%	6.74%	7.16%	6.90%	7.16%
CEMBI BD HG	-0.05%	7.83%	8.01%	6.38%	6.83%
CEMBI BD HY	-1.24%	4.45%	5.43%	8.37%	8.29%
US HY	-0.79%	3.95%	5.10%	10.13%	10.51%
European HY	0.37%	5.25%	6.70%	15.16%	12.60%
Barclays Agg	-0.82%	0.82%	0.61%	0.88%	2.20%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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