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WEEKLY INVESTOR RESEARCH

Ashmore

Time to take the chill pill

This week we explain why some investors have recently pulled money from Emerging Markets. We explain why the current volatility does not change the outlook for currencies and why there is no new Asian crisis. We describe the Emerging Markets' formidable defences and why they have barely yet been used. We explain what happens if developed market investors leave Emerging Markets. And, more importantly, vice versa. Finally, we explain what tapering does for rates in the US and developed and Emerging Markets economies.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	923		-0.97%
MSCI FM	555		-1.22%
GBI-GD	6.85%		-1.03%
ELMI+	4.65%		-0.30%
EMBI GD	6.09%	325 bps	-0.23%
EMBI GD IG	5.19%	235 bps	-0.14%
EMBI GD HY	9.33%	670 bps	-0.41%
CEMBI BD	5.89%	351 bps	-0.01%
CEMBI BD HG	5.01%	262 bps	-0.09%
CEMBI BD HY	7.82%	546 bps	-0.12%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,657	0.29%
VIX Index	14.99	0.54%
5 year UST	1.59%	5 bps
10 year UST	2.79%	-2 bps
10 year Bund	1.89%	5 bps
EURUSD	1.3368	-0.37%
USDJPY	98.12	0.87%
Brent	$109	0.00%
Copper	$339	0.47%
Gold	$1402	2.18%

Emerging Markets

Q: Why are funds flowing out of Emerging Markets now?

A: The main reason funds are flowing out of Emerging Markets is an increase in uncertainty about the outlook for US monetary policy. Global uncertainty always causes some segments of the investor base to sell, notably hedge funds, banks, and temporary visitors, such as cross-over investors. The same thing happened when sub-prime erupted, US treasuries were downgraded, Greece blew up, and when Spanish banks were in trouble. In each of these cases, Emerging Markets asset prices moved a long way out of line with fundamental risks, ultimately creating buying opportunities.

Q: Does the recent currency volatility mark a major shift in the outlook for global currency dynamics?

A: No. Emerging Markets currencies have been singled out for special treatment in this particular bout of uncertainty, because large technical imbalances built up in EM currency markets during H1 2013, which are now being unwound. We've also seen cyclical weaknesses in a small number of high-profile Emerging Markets countries (Brazil, Indonesia, and India in particular). The other reason is JPY has already weakened a lot, while EUR is supported by ECB's OMT (Outright Monetary Transactions) programme.

Consistent with our view that currencies are locked into a zero-sum 'phoney currency war' pending the arrival of inflation in developed countries, it seems to be the turn for Emerging Markets currencies to give up some ground.[1] The logic of the phoney currency wars is that currencies can move considerably in response to 'good stories' despite very little change in underlying fundamentals. Moves are usually driven by changes in positioning. A well-known recent expression of the phoney currency war was the speculative attack on the EUR. The 'good story' in this scenario was that Europe had to break up. In fact, the Eurozone expanded rather than breaking apart. Similarly, we think the current pessimism about Emerging Markets is excessive.

Our long-term view that Emerging Markets currencies have to appreciate versus developed market currencies is unchanged. Inflation will happen where countries print the most money, and the countries with the most inflation will have the weaker currencies.

Q: Asia has been singled out for special treatment in the past week. Is there really a threat of an Asian crisis?

A: No, there is no such threat, in our view. A small handful of EM countries are facing conventional cyclical adjustments. The slow journey towards higher global interest rates requires that all economies adjust to various degrees depending how heavily they have stimulated their economies in the past. Regular cyclical adjustments are achieved through a combination of currency and domestic demand management. These measures are already underway. Only a small number of countries are affected. Closer inspection shows that even the most affected countries today have vastly stronger fundamentals than in 1997 as well as formidable defences, which they have barely begun to utilise.

[1] *"The Phoney Currency Wars"*, Ashmore Emerging View, February 2013.

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Emerging Markets

Q: What are those defences?

A: The capacity of Emerging Markets central banks to intervene is considerable. These central banks control USD 8.7trn in FX reserves (80% of the world's total). In Asia, the 10 largest Asian central banks alone control more than USD 2trn of reserves, excluding China's USD 3.5trn of FX reserves. India's central bank has USD 252bn of FX reserves, while Indonesia and Philippines have USD 93bn and USD 83bn, respectively as at August 2013.

At this level of reserves, central banks on average hold 4.6 times more reserves than the total outstanding short-term external debt obligations of their economies. In Asia, the ratio of reserves to short-term Dollar FX obligations is 3.7. In India and Indonesia, the ratios are 2 times and 2.6 times, respectively. In Philippines, reserves are a whopping 8.7 times larger than short-term external debt. By contrast, in 1997 short-term external obligations were 2.1 times larger than reserves.[2]

But Emerging Markets central banks do not operate in isolation of one another. Asian central banks have in the past pooled their resources and supported one another with swap lines. We suspect plans are already afoot to renew, enlarge, and widen the network of swap lines between Asian central banks, not least because Asian financial markets are far more integrated today than they were in the 1990s.

Q: If their defences are so strong, why have Emerging Markets currencies weakened so much?

A: It is indeed notable that Asian central banks have barely intervened at all. Our sources suggest that central banks in Asia have only intervened to the tune of USD 15bn since early June. This shows that Emerging Markets central banks have been happy to let speculative investors and leveraged investors reduce positions. They welcome the relief of lower currencies, partly because it is a necessary cyclical adjustment in countries like Indonesia and India, and partly because it helps exporters and growth. The adjustment in currencies will be accompanied by fiscal measures, as we have seen in both India and Indonesia.

But there is a limit to how far central banks will let currencies fall. They cannot sacrifice price stability, or risk materially higher long-term government bond yields. We see signs that currencies are now reaching the point where central banks become more decisive. Brazil has already responded with the launch of a USD 60bn swap facility. Central banks also keep an eye on technical conditions in the market to ensure that when they go in they achieve the biggest 'bang for their buck'.

Q: What is the risk if foreign investors leave Asian markets?

A: Asian markets can handle an exit of Western investors. Emerging Markets are far better positioned to weather tighter financial conditions than the developed economies. The vast majority of QE money has gone to developed countries, where sensitivity to higher interest rates is much greater, because debt levels are so much larger. Tepid recoveries in the Western economies can quickly be derailed if real yields rise much further. Indeed, US mortgage applications have fallen by more than 50% since 30 year mortgage rates began to rise in May. The US alone has a total debt load of 405% of GDP, according to the Federal Reserve. Such indebted economies simply cannot handle higher real rates. By contrast, in Emerging Markets, bond yields are currently at their average rate since 2003 of 6.9%, so the marginal impact of the recent 130bps move higher in global interest rates is therefore much smaller. The far greater risk today is how developed economies would cope if Asian investors lost faith in the US government and sold their holdings of US treasuries.

Q: How does Fed tapering affect the outlook for US rates?

A: The latest FOMC minutes suggest that the Fed is on track to taper down QE to zero over the next 12 months or so. We think tapering goes ahead almost regardless – because QE no longer works as intended. When better than expected data produces sell-offs in stock markets, because the market is more focused on its impact on the sugar high of QE than on the effect on company earnings then clearly the stock market has become unhealthily addicted to QE. Hence, it is good that the Fed is going back to a world where it mainly uses rates, rather than printing money. It's a not a world where the risk of bubbles is eliminated, but certainly it is one where bubble risk is reduced.

In the near-term, the path to tapering may fuel the current momentum of higher US treasury yields until the Fed signals a change in direction, technicals become too stretched, or some key fundamental variable starts to give. But tapering is not a natural precursor for higher rates: The Fed does not want to see material increases in real interest rates. The market is already pricing in early and substantial hikes in 2015. We think the market is wrong. There will be fewer hikes, later. The market is ignoring the debt, but the debt makes itself felt as soon as real rates rise.

In our view, the main question going forward is how the Fed will manage longer rates without the means to impact long rates with direct purchases. This is an important question for the housing market in particular. Maybe we will see more twist operations from the Fed, but we note that 84% of Fed holdings are already five years or longer and more than half have over 10 years to maturity.

[2] *"The Role of Short-term Debt in Recent Crises"*, Uri Dadush, Dipak Dasgupta, and Dilip Ratha, Finance and Development, IMF, December 2000, Volume 37, Number 4.

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Emerging Markets

Q: What are the economic implications of tapering?

A: Tapering is much more important for the developed countries than for Emerging Markets. Developed markets are super vulnerable to higher real rates. For example, the IMF's latest Article IV report shows that the US has an unsustainable level of debt, even at current negative real rates and the market's relatively bullish expectations for growth in the next couple of years (2.4% real GDP growth).

Our own analysis shows that the US needs about 6% higher real GDP growth rates, or 6% lower real interest rates, or 6% fiscal tightening, sustained for the next 20 years, to stabilise debt levels at current levels. Neither of these outcomes appears to be imminent or even likely. The implication is that sustainability is ultimately restored with inflation and currency realignment. This in turn implies a steeper US yield curve, even if the Fed enhances its forward guidance at the 18 September FOMC meeting.

Emerging Markets are not materially impacted by tapering. The vast bulk of QE money has gone into developed markets, where it has caused government bond prices and equity prices to soar relative to Emerging Markets. This is why debt ratios have remained stable in Emerging Markets throughout the QE years, while debt levels have increased from 80% to 110% of GDP in the developed world over the same period.

Besides, Emerging Markets now comprises 65 countries with enormous variation. The differences between the largest and the smallest, the richest and the poorest, the least and the most indebted, the range of macroeconomic policies, the variety of structural characteristics and political realities are far, far greater than, say, the differences between Greece and Switzerland, or the US and Japan.

There are clearly genuine trouble spots with Emerging Markets, such as Argentina and Venezuela, but the really vulnerable credits are very few in number. As mentioned above, there are also a smaller number of higher profile countries undergoing perfectly normal business cycle adjustments, such as India and Brazil. And then there are countries, which are aggressively adjusting and reforming, such as China, Mexico, and others. Active management and credit selection rather than wholesale reduction in Emerging Markets exposure is the right approach. Our view is that Emerging Markets are going to be just fine.

And this is a blessing, in our view: If Emerging Markets were to seriously falter – which is extremely unlikely – the consequences for the developed world would be serious, both because they would off-load US treasuries in size and because their growth remains the key to sustaining global demand in a de-leveraging world.

Q: What should investors do?

A: Markets lose sight of fundamentals and prices get way out of line with risks during episodes of global uncertainty. It is important that investors do not. The US treasury curve is now close to the steepest it has been in decades. We are also drawing closer to the point where Emerging Markets central banks may engage in more substantial intervention and their capacity to act should not be in doubt. The technical position in the market is becoming more stretched, which means central banks can be far more effective when they do intervene.
And we note that the economic data is improving in a number of Emerging Markets countries including China. After a very deep trough in the manufacturing cycle in the first half of 2013 we think the outlook is now improving, aided by better data in Europe.

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