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The Fed's three mandates

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China wins a very important concession on RMB inclusion in the SDR from the US, Brazil's central bank signals impatience with recent FX volatility and Argentina changes regulations for local mutual funds' pricing of USD denominated bonds. In the global backdrop, the Fed is vacillating on the question of hiking rates because it has to give greater than ever weight to financial markets as a consequence of its own policies to inflate these markets to bubble levels. The de facto adoption of a third mandate – preserve valuations in US stock and bond markets – undermines its credibility in meeting its traditional objectives and promises to bring the Fed into serious trouble when inflation returns.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.1	–	-4.86%
MSCI EM Small Cap	11.0	–	-3.19%
MSCI Frontier	8.7	–	-0.99%
MSCI Asia	10.4	–	-4.52%
Shanghai Composite	11.7	–	-0.14%
Hong Kong Hang Seng	6.7	–	-5.15%
MSCI EMEA	9.1	–	-4.71%
MSCI Latam	12.4	–	-5.70%
GBI-EM-GD	7.18%	–	-2.77%
ELMI+	5.28%	–	-1.73%
EM FX spot	–	–	-2.39%
EMBI GD	6.19%	401 bps	-1.86%
EMBI GD IG	4.99%	273 bps	-1.99%
EMBI GD HY	8.18%	617 bps	-1.69%
CEMBI BD	6.16%	425 bps	-0.82%
CEMBI BD HG	4.78%	285 bps	-0.43%
CEMBI BD HY	8.80%	694 bps	-1.54%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	14.9	–	-1.35%
1-3 year UST	0.70%	–	0.02%
3-5 year UST	1.47%	–	0.00%
7-10 year UST	2.15%	–	-0.14%
10+ years UST	2.95%	–	-0.16%
US HY	8.06%	665 bps	-1.41%
European HY	5.48%	548 bps	-1.19%
Barclays Ag	–	225 bps	-0.41%
VIX Index*	23.62	–	1.34%
DXY Index*	96.26	–	0.37%
EURUSD	1.1189	–	-0.21%
USDJPY	120.22	–	-0.07%
CRY Index*	195.71	–	1.53%
Brent	48.2	–	-1.57%
Gold spot	1138	–	0.42%

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

Emerging Markets

- **China:** China won an important concession during President Xi Jinping's recent US visit, when the US administration shifted its policy on the RMB's inclusion in the SDR basket. The Obama administration indicated that RMB inclusion in the SDR basket is now only conditional upon China meeting the technical criteria set out by the IMF in a recent review. This puts the SDR firmly on track for formal adoption into the SDR next year, probably at the November 2016 G20 meeting to be held in China. This is good news as the world is likely soon to be in sore need of new, credible reserve currencies, because today some 97% of global foreign exchange reserves are denominated in four Quantitative Easing (QE) currencies (USD, EUR, JPY and GBP). Much has been made of recent volatility in the Chinese currency, which has even been labelled 'devaluation' in many circles.

  However, this characterisation of the recent volatility in the Chinese currency betrays a profound lack of understanding of the direction of policy in China and the global political context. China has absolutely no interest in engaging in policies that would undermine the credibility of its own currency or indeed undermine the global financial system, for example by wholesale dumping of US treasury assets. Indeed, Chinese policy makers are likely to do their best to achieve precisely the opposite, because China stands to gain vastly when the RMB becomes a global reserve currency. Constructive policies towards the US, especially right now, will maximise China's chances of success. Why? Because, it is absolutely the best possible time for China to extract concessions from the US. It is the second term of the US president, i.e. a time that is traditionally dedicated to foreign policy issues. The US is particularly keen not to experience excessive volatility in the Treasury market and in the USD right now. And a future US administration could easily turn out to be far more isolationist than the Obama administration, so now is the time to lock in gains. Economic activity in China continues to soften on the back of all the ongoing reforms. Caixin's PMI declined to 47 in August. The softening in economic activity, low inflation and prospects for RMB's inclusion in the SDR basket continue to make a strong case for exposure to government bonds in China.

- **Brazil:** The central bank stepped up its currency interventions last week in the face of increasingly violent currency moves. Central bank President Alexandre Tombini told reporters that the central bank can use all its tools to manage BRL volatility. Brazil has USD 371bn of FX reserves. The economy continues to show signs of

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Emerging Markets

contraction as 86,500 jobs were lost in August compared to 75,000 expected and the rate of unemployment rose from 7.5% in July to 7.6% in August. Inflation has yet to begin to fall decisively on the back of higher real interest rates and fiscal cuts. The mid-month IPCA-15 inflation rate in September declined only marginally to 0.39% mom from 0.43% mom in August. Brazil's economic troubles are self-inflicted and cyclical in nature, but made worse by a political crisis that has made it hard to do the necessary adjustment. In our view, Brazil will overcome this crisis and emerge 'on the other side' without defaulting or experiencing a major balance of payments crisis. The remaining downside risks are further economic deterioration until the economy has troughed, a possible loss of investment grade by one or both of the remaining ratings agencies that have not yet downgraded the credit and a possible impeachment of President Dilma Rousseff. An impeachment would be a major buying opportunity, because it would result in a PSDB/PMDB administration under which the current opposition to reforms would go away. This would speed up the recovery compared to the current scenario, where Dilma serves out her term. In a positive development, parliament opted not to reverse a number of key vetoes imposed by Dilma that would seriously erode the fiscal outlook. However, a number of vetoes still have to be reviewed by parliament, likely this week. Brazil's external accounts are now clearly improving. The current account deficit in August was USD 2.5bn versus USD 3.2bn expected. FDI inflows were stronger than expected.

- Argentina: Uncertainty about demand by local mutual funds for USD denominated bonds increased last week on the back of a resolution issued by the regulator requiring local investors to book bonds at the official instead of the parallel exchange rate. In local currency terms, this means that these securities are now worth less (USDARS is trading at 9.4 compared to the parallel exchange rate of 13.9). However, the outlook for the currency could improve next year depending on policies on the next administration. Bonds dropped sharply following the circulation of the draft announcement on Tuesday but then rallied strongly towards the end of the week after the publication of the resolution in the official gazette. In politics, recent polls show that Sergio Massa – former Cabinet chief in the Kirchner administration – has gained on the back of recent corruption-related defections from the Mauricio Macri campaign. Daniel Scioli continues to lead with about 40% of voting intentions. This means that he is around 10% clear of the nearest rival and could win in the first round of the election scheduled for 25 October. The economy expanded 2.3% yoy in real terms in Q2 2015.

Snippets:

- Colombia: Following a recent similar move in Peru, the Colombian central bank implemented a 'one and done' 25bps hike to 4.75% to ensure that any temporary spill-over from recent COP weakness into inflation does not impact inflation expectations. Headline CPI inflation is 4.74% yoy and core inflation is 4.2% yoy.
- Czech Republic: The central bank left rates unchanged at 0.05% in line with expectations.
- Honduras: January-July GDP was up 3.4% yoy compared to 2.7% yoy at the same time last year. Honduras imports oil.
- Hungary: The central bank narrowed the corridor around the policy rate by 25bps. The move is intended to induce banks and other parties to park excessive liquidity in government bonds instead of at the central bank.
- Kenya: The central bank left rates unchanged at 11.5%.
- Malaysia: Headline inflation declined to 3.1% yoy in August from 3.3% yoy in July.
- Mexico: The trade deficit widened in August on lower oil prices, while imports held up well due to stable domestic demand. Non-oil exports picked up. Headline and core inflation were both stable at 2.5% yoy and 2.3% yoy, respectively. Overall economic activity increased in July but at a more moderate pace than in June, but retail sales were stronger than expected (5.8% yoy versus 4.7% yoy expected).
- Nigeria: The central bank left rates unchanged at 13%. The key policy issue in Nigeria is not rates, it is the currency. Unlike Russia, Nigeria has not allowed the currency to adjust in line with oil prices.
- The Philippines: The central bank left monetary policy unchanged. The policy rate is 4%, the special deposit account rate is 2.5% and the reserve requirement for banks is 20%. The trade deficit widened 1.2% yoy in July compared to 3.3% yoy in 2014 and 5.7% yoy in 2013.
- Singapore: Industrial production declined 3.7% mom in August (-7% yoy), reflecting weak global demand, while strong labour markets at home are keeping MAS from weakening the SGD. August CPI inflation was -0.8% yoy versus -0.4% yoy in July.
- Slovenia: Fitch confirmed Slovenia's BBB+ sovereign debt rating, but changed the outlook to positive from stable.
- South Africa: The South African Reserve Bank left rates unchanged at 6.0%.
- Thailand: The trade surplus narrowed slightly in August to USD 0.7bn from USD 0.8bn in July.
- Ukraine: Gas supplies to Ukraine look secure this winter after the government agreed terms for Q4 supplies with Russia. Ukraine will get gas at roughly the same price as Western European gas clients of Russia.
- Zambia: Moody's downgraded Zambia's sovereign credit rating by one notch to B2 and changed the outlook from negative to stable.

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Global backdrop

Two weeks ago the Fed failed to raise rates and Fed Chairwoman Janet Yellen sounded a dovish note in the post-meeting press conference. The market responded negatively. Last week, Yellen changed her mind on rate hikes, arguing that the Fed intends to hike this year and that she personally favours a hike. It is quite possible that Yellen will have to flip-flop again before year-end, for example if it becomes difficult to raise the debt ceiling towards year-end following the resignation of House of Representatives Speaker Boehner.

Actually, the point is not Boehner per se. The real issue facing the Fed is that it now has de facto three mandates instead of the two official mandates of full employment and stable inflation. The third mandate, to keep financial markets buoyant, has entered the Fed's reaction function as a direct consequence of its own policies of re-inflating asset prices without the accompanying reforms to restore fundamental health to the underlying economy. Indeed, asset prices are now so bloated relative to the state of the underlying economy that the Fed is forced to take account of all the issues that can potentially disrupt stock and bond markets, because such disruption can in turn directly impact both inflation and employment.

'Fed capture' at the hands QE-inflated stock and bond markets in developed economies means that all kinds of events that would not ordinarily influence Fed decisions now do so, including the fickle nature of investor sentiment itself. The dilution of the Fed's core mandates is bad enough for its credibility, but a Fed that is dragged around by its nose by a financial market that, frankly, could go anywhere is outright dangerous for global financial stability.

As if this state of affairs was not bad enough, think what happens when inflation returns. At least for now the Fed still has the option not to hike, that is, it can continue to support a tepid economy and keep the financial bubbles turgid without coming into direct conflict with its mandate to control inflation. The return of inflation removes this freedom. It forces the Fed to choose between (a) keeping inflation under control at a major cost to both the economy and the stock market (because the former is still unproductive and excessively leveraged and the latter is overvalued), or (b) living with higher inflation and sustain a further blow to its own credibility and the USD.

The Fed can therefore not have its cake and eat it forever. A genuinely sustainable exit from this self-inflicted dilemma is to re-engage with deep economic reforms in a bid to create a growth miracle. Supply-side reforms that pushed the trend growth rate to 5% or more via productivity gains could possibly do the trick, but such reforms looks extremely unlikely in the current political environment and without reforms the US economy has only been able to clock up 2% real GDP growth per year in the past five years under conditions of hyper-easy monetary policies.

The other option would be simply to recognise that inflation and currency weakness actually form part of the solution by eroding debt stocks and restoring external competitiveness. Clearly, they would be very self-serving policies that would inflict major costs on anyone saving in the USD, including US pension funds and EM central banks. The key to going down this road would be to stimulate inflation much more and to reverse the recent USD rally as quickly as possible, for example by formally adopting a weak USD policy. But the extent of denial about the real underlying macroeconomic challenges is still far too great, so neither investors nor the Fed are likely to go down this path until it is actually imposed upon them.

Clearly, we are now in the realm of the third or fourth or fifth best solutions. Doing nothing is itself becoming a problem – the uncertainty created by the Fed's vacillation over rates hikes is arguably causing more damage than hikes per se. So what else can the Fed do? Taking as given that the Fed will not be able to remove stock prices from its reaction function anytime soon, it may have to innovate. It should move, but in moving its main risk is that bloated stock and bond markets over-interpret a first hike like it over-interpreted tapering in 2013 (then forcing the Bernanke Fed to U-turn protect the housing market). To manage this particular risk the Fed will have to offer some kind of forward guidance specifically aimed at calming the financial markets. It should not offer verbal guidance, because its credibility is declining and it is already issuing conflicting messages due to the large number of FOMC members that comment on the direction of policy.

One option would be to commit to a very slow pace of pre-announced rate hikes, say, increments of 5bps hikes implemented at regular intervals for several years into the future. This would go some way to calm the Treasury market and prevent over-interpretation of the early hikes, while at the same time achieving a sense that the Fed is on track to normalise policy albeit over an extended period.

The downside risks to such a policy would not be minor, however. It would be the interest rates policy equivalent of a crawling currency peg. Should inflation suddenly re-emerge in a non-linear fashion – which seems very likely – then markets would quickly discount the Fed's commitment to a pre-announced path for interest rates and the Fed's credibility would be directly challenged by the Treasury market. Similarly, if the economy descends into recession the Fed would have to abandon its pre-announced path.

The consequences of short-term policies piled upon short-term policies are now beginning to catch up with policy makers. There are no easy options. Yet there is still too much denial to accept the painful solution that actually would work. In this environment only one thing seems certain: the developed economies and their overvalued financial markets look set to continue to be the main sources of risk and volatility for the global economy for the foreseeable future.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-3.35%	-15.60%	-20.89%	-5.06%	-2.92%
MSCI EM Small Cap	0.37%	-9.33%	-16.10%	-0.54%	-1.66%
MSCI Frontier	-1.12%	-12.64%	-23.35%	6.55%	2.76%
MSCI Asia	-1.95%	-12.54%	-14.06%	0.44%	0.96%
Shanghai Composite	-3.46%	-2.92%	33.92%	18.13%	6.14%
Hong Kong Hang Seng	-2.14%	-18.20%	-7.83%	3.02%	-1.41%
MSCI EMEA	-4.88%	-12.41%	-22.25%	-9.47%	-4.65%
MSCI Latam	-7.73%	-29.05%	-40.26%	-17.48%	-12.17%
GBI EM GD	-2.92%	-14.87%	-20.97%	-8.77%	-3.31%
ELMI+	-0.88%	-7.72%	-13.46%	-5.30%	-2.82%
EM FX Spot	-2.51%	-16.23%	-23.41%	-12.67%	-9.02%
EMBI GD	-0.78%	0.45%	-0.96%	1.76%	5.03%
EMBI GD IG	-1.25%	-1.77%	-0.92%	0.61%	4.11%
EMBI GD HY	-0.14%	3.47%	-2.09%	3.46%	6.39%
CEMBI BD	-0.74%	1.29%	-0.33%	2.90%	4.55%
CEMBI BD HG	-0.30%	1.39%	1.38%	3.10%	4.85%
CEMBI BD HY	-1.54%	1.10%	-3.81%	2.70%	4.11%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-1.94%	-4.77%	0.28%	12.59%	13.30%
1-3 year UST	0.24%	0.77%	0.77%	0.51%	0.69%
3-5 year UST	0.53%	2.21%	3.19%	1.40%	1.79%
7-10 year UST	0.79%	2.54%	5.70%	1.63%	4.19%
10+ years UST	0.69%	-1.26%	7.69%	2.37%	6.78%
US HY	-1.13%	-1.10%	-2.90%	3.90%	6.99%
European HY	-1.33%	1.14%	1.15%	8.49%	9.79%
Barclays Ag	0.22%	-0.33%	1.25%	3.06%	4.30%
VIX Index*	-16.92%	23.02%	59.06%	50.16%	4.51%
DXY Index*	0.46%	6.64%	12.41%	20.43%	21.83%
CRY Index*	-3.16%	-14.89%	-30.17%	-36.72%	-31.17%
EURUSD	-0.13%	-7.53%	-11.88%	-12.99%	-17.59%
USDJPY	-0.85%	0.32%	9.95%	54.21%	43.56%
Brent	-11.08%	-16.01%	-50.36%	-57.16%	-38.83%
Gold spot	0.39%	-4.20%	-6.54%	-35.78%	-13.08%

*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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