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Ashmore

The market begins to distinguish between EM countries

The market has begun to re-focus on fundamentals. This is healthy because Emerging Markets are highly diverse. For example, the BRICs have little in common apart from their size. The removal of IOF taxes in Brazil and value in the government' oversold bond market triggered net portfolio inflows into Brazil in the month of June. Meanwhile, in Russia the Central Bank put in place contingencies in the event of a Fed-induced global credit crunch. India did exactly the opposite as the Reserve Bank of India (RBI) tightened liquidity in the domestic market. It is the slow pace of reform in India which is making the RBI dish out tough love. In contrast, the Chinese government is pushing ahead with reform at a furious pace which is only constrained by the need to avoid too sharp a slowdown in economic growth during the transition. We will write more about the other 61 countries in future issues.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	956		0.26%
MSCI FM	551		-0.92%
GBI-GD	6.50%		-1.57%
ELMI+	4.24%		-0.32%
EMBI GD	5.60%	299 bps	-0.92%
EMBI GD IG	4.67%	206 bps	-1.05%
EMBI GD HY	8.94%	654 bps	-0.63%
CEMBI BD	5.53%	339 bps	-0.56%
CEMBI BD HG	4.67%	250 bps	-0.47%
CEMBI BD HY	7.46%	537 bps	-0.35%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,692	-0.22%
VIX Index	12.72	3.50%
5 year UST	1.35%	5 bps
10 year UST	2.55%	7 bps
10 year Bund	1.65%	14 bps
EURUSD	1.3277	0.69%
USDJPY	97.85	-1.86%
Brent	$109	0.00%
Copper	$321	-1.04%
Gold	$1329	-0.55%

Emerging Markets

As the initial panic from the Fed's tapering announcement begins to fade and Emerging Markets asset prices have stabilised and, in some cases, retraced a significant amount of the losses from June, the focus is slowly beginning to shift from technicals and positioning towards fundamentals. This is a healthy sign. It shows that many of the leveraged longs are out of the market and that the market is regaining rationality. The focus can then turn to what is happening to the actual risk in the various countries in Emerging Markets. The past week's events in Brazil, Russia, India, and China illustrated just how different the situations are in individual Emerging Market countries. Consider the four so-called BRIC countries, often lumped together as if they were similar (in ways other than their sheer size). In Brazil the protests of last month have died down and given way to euphoria over the Pope's visit. Fresh data on the current account for the month of June showed a significant improvement relative to May and consensus expectations. The trade surplus improved sharply and FDI flows were up significantly. Portfolio flows were also positive as inflows into fixed income exceeded outflows from equity markets by a factor of two. This was probably due to the lifting of the IOF tax and the value offered as a result of the oversold state of Brazilian local fixed income at the height of the June sell-off.

Russia is an entirely different type of economy. Heavily reliant on oil production, running an overall current account surplus, and having zero net government debt, Russia this week launched a new measure to increase liquidity to Russian banks. We think this a pre-emptive measure by the Russian Central Bank to insure against a possible sudden tightening in global liquidity conditions following the US Fed's tapering talk. (This is in the same vein that the ECB opted for forward guidance to try to prevent rising rates in the US causing rates to rise in Europe.) Named Russia's LTRO, the Rub 500bn measure allows Russian banks to tap 12 month financing against placement of non-marketable collateral (mainly corporate loans). This is extremely powerful insurance against a global credit crunch which underlines the considerable capacity Emerging Markets have due to their generally sound macroeconomic conditions.

Meanwhile this week India found itself in the entirely opposite situation to Russia. The RBI tightened liquidity by capping liquidity facilities, raising reserve requirements, and auctioning cash management bills. The tough love from RBI, which is happening at a time of relatively slow growth, followed similar measures in the recent past. Why is RBI being so tough? The RBI is concerned about the weakness in the INR and its potential impact on inflation. The RBI sees the inflation problem, India's currency weakness, and the slowdown in growth as originating from the same problem: excessive fiscal stimulus in the past and a failure to undertake sufficient supply-side reforms. RBI's view – with which we entirely agree – is that control of prices should not be sacrificed on the altar of short-term demand stimulus. The only solution to India's problem is sustained fiscal discipline (now underway) plus an acceleration of reforms (partially done, but more reforms will probably occur mainly after next year's general election).

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Emerging Markets

Finally, in China the focus is still firmly on growth dynamics as it continues to forge ahead with deep fundamental reform. Chinese manufacturing weakened again last month. While the scope for better manufacturing data in China is increasing as European and US manufacturing now show signs of improvement we think growth will remain subdued as the government continues to push ahead with restructuring the economy away from export to domestic led growth. After 20 years of de facto export-led growth the wholesale rotation of the economy in a different direction inevitably brings in its wake a slowdown in growth. This has already taken growth from a 12% to a 7% handle. Premier Li Keqiang this week declared that the government is not going to allow growth to fall below 7%. There is clearly a limit to how fast China can or wants to reform. But what we like about China is precisely that reform is the central priority, stimulus the fall-back position as and when the short-term costs of reform get too high. As such, China is almost diametrically opposite to India. Our view is that China's transition process is unlikely to be over in a flash. Still, China's deliberate restructuring away from a heavy dependence on exports is very positive. It prevents over-investment in the export sector, it sustains the overall return to capital in the economy, and it prepares the country for an eventual adjustment in global currencies (see below).

Global backdrop

The debate about who will take over from Federal Reserve Chairman Ben Bernanke when he steps down early next year is heating up. The two front-runners are Lawrence Summers, former US treasury secretary, and Janet Yellen, Fed Vice Chair. Both are also renowned academic scholars. The appointment will likely be made within the next three months, followed by confirmation and swearing in by early 2014, politics in Washington permitting. We have no privileged information about who will be selected, but we believe the next Fed Chair will be a dove. We hold this view because growth is weak (US Q2 real GDP growth is tracking around 0.5%) and inflation is running at half the Fed's target rate of 2%.

But there is a more important reason why the next Chair is likely to be a dove. The US economy is extremely heavily indebted – US government debt now exceeds 100% of GDP – but total debt in the economy is far greater, in excess of 350% of GDP. A sharp rise in real rates with conditions of so much debt would create massive negative wealth effects, pressure the public finances, and erode real disposable income in households. The housing recovery would also be derailed. It is simply not possible to raise real rates significantly without killing the economy until the debt burden has been reduced in size.

So how will the US bring down its debt burden? A material reduction in debt can be achieved in three ways. First, the real GDP growth rate can be raised dramatically, for example through a significant increase in productivity. But this seems unlikely because Congress is too divided to deal with any of the longer-term structural problems in the US economy. For example, President Obama's infrastructure investment programme – a very sensible way to spend public money – is almost certainly not going to be approved by Republicans in Congress. Second, the US administration can inflict massive fiscal austerity on voters, but this also looks unlikely, this time because of the Democrats in Congress. Moreover, a possible future Republican administration would likely opt for voter-friendly policies in its first term in a bid to ensure a second term in office.

With structural and fiscal reforms unlikely, the task of bringing down the debt burden will pass to those who set FX and monetary policies in the US. Our view is that the next Fed Chair will oversee a period of higher inflation without being able to raise nominal interest rates very far or very quickly due to the massive debt stock. The resulting decline in real rates – consistent with how the US escaped large debt burdens following World War II and the Vietnam War – will usher in inflation and put downward pressure on the Dollar. These policies will work very well politically in the US. Inflation pushes the cost of reducing the US debt burden onto future generations. Dollar deprecation pushes part of the cost to foreigners. The other domestic casualty is the Fed, which will lose credibility. The next Chairperson will therefore not be remembered fondly by posterity, in exactly that same way that Arthur F. Burns and G. William Miller are rarely talked about, while Paul A. Volcker, who succeeded them, is still regarded as a hero. Of course, Volcker was only able to play the part of hero, because his predecessors had deflated debt down to a size that enabled Volcker to jack up rates sharply in the early 1980s to crush inflation without killing the economy. Thus, regardless of who ends up occupying the Chairpersonship at the Fed next year, he or she is destined to play a very important patriotic role, albeit one that is likely to go unrecognised.

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