

Licence to speculate

By Jan Dehn

In a special version of the weekly, we put last week's Fed and ECB announcements into context. Both institutions last week issued licences to speculate. Bubble Economics now appears to be official policy across developed economies. This poses serious challenges to asset allocators. Notwithstanding these challenges, Bubble Economics is neither unfamiliar nor difficult to understand. We were here, recently, during the Greenspan Fed. Ignorance is therefore not a credible defence.

Emerging Markets	Index level/ yield	Spread over UST	1 week change	Global backdrop	Index level/yield/ FX rate/price	5 business day change
MSCI EM	1,065	–	1.59%	S&P 500	1985	1.28%
MSCI EM Small Cap	1,100	–	1.37%	VIX Index	10.32	-8.35%
MSCI FM	697	–	0.67%	5 year UST	1.76%	13 bps
GBI EM GD	6.55%	–	-0.18%	10 year UST	2.64%	11 bps
ELMI+	3.13%	–	-0.09%	US HY	5.20%	0.09%
EMBI GD	5.14%	248 bps	-0.12%	European HY	4.35%	0.11%
EMBI GD IG	4.43%	172 bps	-0.32%	EURUSD	1.3598	-0.69%
EMBI GD HY	6.80%	437 bps	0.25%	USDJPY	101.95	0.61%
CEMBI BD	5.09%	274 bps	-0.05%	Brent	109.67	-2.16%
CEMBI BD HG	4.32%	196 bps	-0.15%	Copper	330.93	2.03%
CEMBI BD HY	6.70%	439 bps	0.16%	Gold	1312.84	-1.10%

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

Bubble Economics

The very modest reaction in the US treasury market last week to what was, after all, one of the strongest sets of employment numbers for some time is more revealing than appears at first sight. US treasury yields ended the week at 2.65%, around 14 bps higher than a week ago, but more or less unchanged from a month ago.

The less important reason for the modest reaction is that even material advances in US high frequency data, including labor market data, is unlikely to push the US growth rate much higher than 2% this year. Barring a major revision to past data, even a 3% print for Q2 real GDP will only return the economy to the size it was at the end of 2013.

We believe the far more important reason for the orderly behaviour of the US treasury market was the set of extraordinary signals coming from both the ECB and Fed last week. Collectively, these amounted to a licence to speculate, the official return of Bubble Economics.

Fed Chairwoman, Janet Yellen, kicked off proceedings by stating that interest rate policy would not be used to stamp out bubbles. This has resolved decisively, it seems, the debate within FOMC about the relative merits of using macro prudential regulation or interest rates to stamp out bubbles.

Shortly afterwards, at the ECB, President Mario Draghi and his officials explained at their press conference that banks will be able to use the recently announced Long-term Refinancing Operations (LTROs) to buy periphery government debt. Given the backdrop of a sick European banking system, LTROs are certainly a useful device pending a political solution to the problem of undercapitalised European banks (unlikely to materialise, in our view). But the Eurozone debt crisis showed that any threat to Europe is likely to play out via the sovereign bond market. Thus, by allowing banks to use LTRO money to buy European periphery sovereign debt, even at the expense of lending to the real economy, the ECB has in effect bought insurance against a bigger set of risks. But with Spain and Portugal already trading at bubble levels, the ECB has also given its green light for Bubble Economics. Former 'conquerors' Spain and Portugal today trade well inside their former colonies of Mexico and Brazil, despite the fact that the latter have far, far lower debt burdens, hugely greater policy flexibility, higher trend growth rates, stronger external stock balances and a multiple of other advantages.

Note that the Bank of England (which is slightly ahead of the Fed) is also on the same page: they too will use macro prudential measures rather than rate hikes to stamp out bubbles. In other words, this is a coordinated developed market-wide policy declaration.

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We don't believe that addressing bubbles with macro prudential measures will work due to the 'waterbed effect'. Bubbles arise because of excessively abundant and excessively cheap funding. Against a backdrop of super-easy monetary policy, stamping out a bubble in one area only causes it to re-appear elsewhere. What makes matters worse, of course, is that the frothy markets of Bubble Economics draw attention away from the deeper structural problems in the real economy, which are left unaddressed as a result.

Bubble Economics is both pretty basic economics and not entirely unfamiliar. The policy adopted by the Fed and ECB last week was staple fare during the Greenspan Fed. No asset allocator worth his or her salt will therefore be able to claim, ex-post, that they did not see the problems coming. Ignorance is simply not a credible defense so soon after the collapse of the last bubble. US stocks set new highs almost every day. US bond yields are close to all-time lows. Moreover, only last week the Bank of International Settlements issued a strongly worded and widely reported assessment that asset prices are getting dangerously out of line with fundamentals.¹

The Fed and the ECB's preference for bubbles present asset allocators with a genuine – even classic – challenge. Do they trade the developed market bubble in the vain hope that they can get out before everyone else? Or do they get out early at the risk of underperforming for a period of time? Has the world learnt from Greenspan bubble and the crash of 2008/2009? Asset allocators have almost certainly learned but, in the meantime, financial markets have been so thoroughly rigged in favor of developed markets – financial repression – that asset allocators, in practice, have little choice but to participate.

The Fed/ECB licence to speculate is massively dovish, coming at a time when bubble risks pose a more immediate danger than wage inflation, even taking into account last week's strong US labor market data. There is little material risk of near-term rate hikes. And developed market central banks are ultimately likely to lean as heavily towards dismissing conventional inflation as they are now dismissing bubble risks.

Or to put it differently: the biggest risk to the consensus today is not rises in rates, which are widely expected to begin next year. Rather, it is the re-appearance of inflation and the sudden realisation that developed market central banks will not do very much about it. The resulting decline in real rates would fly in the face of consensus expectations of a stronger Dollar and require a complete re-pricing of the US treasury curve in a bear-steepening direction.

We believe this risk is far greater than the market thinks. The market has barely begun to contemplate the possibility of a return to inflation. Inflation has not been the subject of polite conversation since Volcker pushed 10-year US treasury yields to 16% in the early 1980s. Even so, markets are likely to come around to the new reality soon enough, because asset price inflation and conventional inflation are the best friends of the indebted, indeed part of the solution to their problems. Inflation erodes away the real value of outstanding debt, keeps real rates low and makes currencies cheaper to help exporters. The desirability of inflation, moreover, rises with real rates as long as debt stocks are large. And in the US, inflation would spare current voters from austerity at the expense of future generations and foreigners, so inflation works as a political choice too. This is why inflation will soon begin to be 'sold' by politicians as an attractive option in developed economies, while in Emerging Markets (EM) countries, inflation offers no benefits and only hurts voters, whose real incomes are close to subsistence.

True, inflation is far from costless, even in heavily indebted countries. The main cost of inflation has always been that it creates serious uncertainty about the future and thus impedes investment. But with investment rates running at very low levels to start with, the opportunity cost of inflation is presently low. This will gradually change over time, partly because the costs of inflation rise in a non-linear fashion, partly as deleveraging places developed economies in better positions to grow. But at this stage in the cycle, the trade-off strongly favors higher inflation. Only when inflation has done its important work of reducing the outstanding real debt stock can substantial rate hikes be put in place to crush inflation.

This relatively benign monetary policy backdrop, sadly, does not guarantee that the US treasury market is well behaved. A pickup in US cyclical data, even against the backdrop of soft trend growth, could quickly re-activate the bond vigilantes. It would not be the first time that markets overreact. Technicals are likely to have deteriorated after the dip in 10-year yields to 2.4% earlier this year. Bond vigilantes scored big last year when they forced the Fed to U-turn on tapering before the policy had even begun. They will be looking to repeat the success.

Another speculative attack on the Fed would create material but temporary volatility in the US bond markets. We think the Fed is aware of this risk and likely to step in to prevent any material rise in real yields, even, potentially, to limit excessive volatility. For example, we think the Fed would act if 10-year yields threatened to move rapidly towards the 3.5% level (forward markets are currently pricing 10-year US treasuries to reach about 3% in 12 months' time). The Fed knows that the US economy is still vastly indebted and cannot handle quick material increases in real rates. The fact that America's debt burden is close to 400% of GDP is still the unspoken 'headwind'.

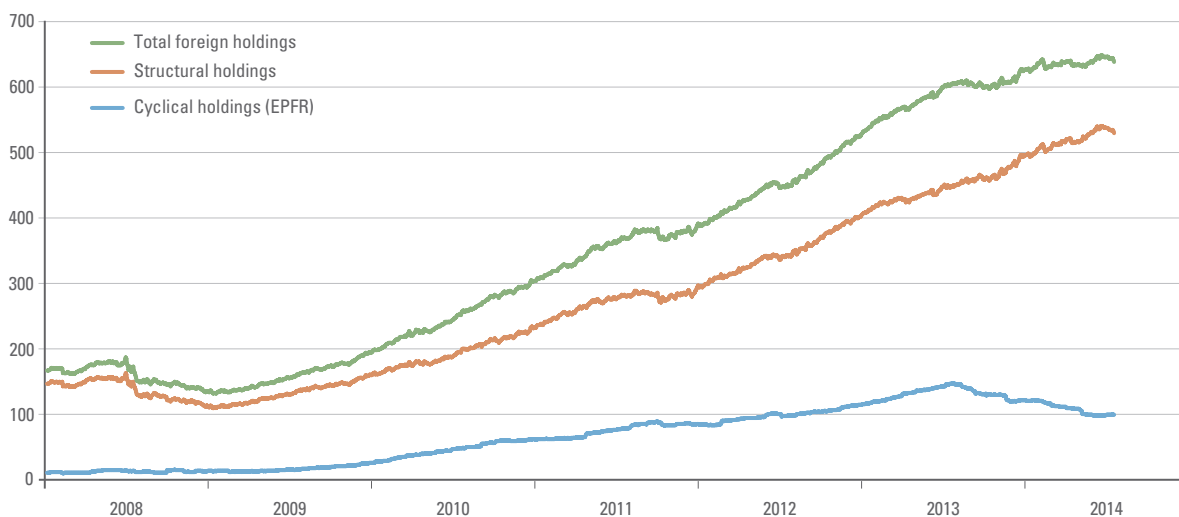
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¹ "Euphoric' capital markets are out of step with reality, warns BIS", Financial Times, 29 June 2014.

EM countries would not be unaffected by temporary bouts of US treasury volatility. But there are good reasons to believe that a repeat of the severe market reaction of 2013 can be avoided:

- The technical position in EM local markets is vastly better than last year. Huge amounts of US mutual fund money in EM local markets left over the past 12 months and while some has returned of late, the market is still far less imbalanced than last year.

Fig 1: **Behaviour of EM investors in 2013 (USD bn): Cyclical versus structural investors**



Source: Standard Chartered Bank, Ashmore.

- Valuations are more attractive. Local bond yields temporarily dipped to 5.25% last year before the sell-off as speculators placed bad bets on imminent and large inflows from Japanese pension funds. Today, yields are 6.55%.
- Thirdly, for all the reasons discussed above, we think the Fed is more dovish. And we think the Fed has learned from its U-turn last year.
- Finally, those that cried "Wolf!" about EM last year have lost a lot of credibility. This includes large sections of the mainstream financial media and many prominent investment banks. In hindsight, they panicked and gave into fears rooted in their own outdated prejudices rather than looking at facts. To err is human. When the dust settled, EM grew about 4.5% in real terms last year. China did not have a hard landing. The 'Fragile Five' turned into the 'Frugal Five'. There was not a single banking crisis in EM. No EM country ran out of reserves. There were just a handful of corporate defaults in the whole of EM (despite it representing 50.4% of global GDP) and several of them were due to a regulatory change in Mexico. None were due to anything the Fed did. Instead, as we went into 2014 it was the US economy that really failed to deliver.

The last point should not lull anyone into complacency about EM. There is no such thing as a risk-free investment. Anywhere. Period. In EM, at least 10% of countries experience some kind of economic or political problem at any given time. And the tightening of global conditions, albeit slow, will inevitably create more differentiation between EM countries. Careful attention to risk should however not be confused with bearishness. We believe EM is much safer than developed economies. As central banks in developed economies lead their countries slowly into a world of inflation, devaluation and financial repression in order to buy growth and to rid themselves of their debt problems, the prudent way forward for asset allocators is to think about protecting the purchasing power of their pools of capital. The best way to do this is to allocate to EM, but to do so actively.²

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² For more details on why active management is becoming more important than it has ever been see our latest 'Emerging View' titled "The difference between Paraguay and Uruguay and the need for active management", July 2014.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.6%	7.6%	18.4%	-0.3%	9.7%
MSCI EM Small Cap	1.4%	10.5%	17.2%	0.8%	11.8%
MSCI FM	0.7%	20.8%	35.4%	12.3%	10.1%
S&P 500	1.31%	8.54%	25.47%	16.47%	19.71%
GBI EM GD	-0.18%	5.81%	3.86%	0.80%	7.28%
ELMI+	-0.09%	2.22%	3.07%	-1.12%	2.57%
EMBI GD	-0.12%	8.53%	10.71%	7.33%	10.27%
EMBI GD IG	-0.32%	7.71%	8.38%	5.86%	8.38%
EMBI GD HY	0.25%	10.15%	15.63%	10.05%	13.15%
5 year UST	-0.51%	1.65%	1.41%	2.25%	3.52%
7 year UST	-0.66%	3.49%	2.10%	3.76%	4.94%
10 year UST	-0.99%	6.01%	2.89%	5.89%	5.61%
CEMBI BD	-0.05%	6.29%	9.25%	6.38%	9.64%
CEMBI BD HG	-0.15%	6.11%	8.56%	6.41%	8.64%
CEMBI BD HY	0.16%	6.62%	10.73%	6.64%	12.77%
US HY	0.09%	5.83%	12.26%	10.18%	14.58%
European HY	0.11%	6.14%	15.67%	13.45%	17.17%
Barclays Ag	-0.64%	4.26%	6.92%	2.34%	4.41%

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