Ashmore

2018 EM fixed income outlook

By Jan Dehn

2018 is likely to be the strongest year for inflows to Emerging Markets (EM) for many years due to a combination of strong performance in the last two years, supportive technicals, attractive absolute and relative valuations and healthy economic fundamentals. Domestic demand-led growth should gradually take over from exports as the main driver of growth as inflows into local markets increase and ease domestic financial conditions.

The business cycles in EM countries are of the conventional variety, so EM central banks should be expected to hike sooner, faster and by more than central banks in developed economies. The combination of stronger domestic demand-led growth and faster and greater rate hikes should be supportive for EM currencies. This suggests further downside for the US dollar, which has already underperformed EM currencies for two years, but remains richly valued.

The biggest risk to EM investors continues to come from developed markets due to a dangerous combination of asset price bubbles, inadequate room for policy easing in case of macroeconomic shocks and increasingly populist economic policies set against a backdrop of excessive debts and low productivity growth. We think global asset allocators are far too complacent about their exposures in developed markets.

Strong flows

We expect 2018 to be one the strongest years of inflows to EM for some time on the back of two years of strong absolute and relative performance. EM started to outperform developed markets as far back as Q1 2016. All EM markets – currencies, bonds and equity – are outperforming (Figure 1).

Fig 1: **EM returns versus other markets 2016-2017**

	% return (USD terms)		
Sub-asset class	**2016**	**2017 ytd**	**Combined 2016-2017**
Fixed income			
EM local currency bonds	9.94%	12.57%	22.52%
3-5yr UST	1.33%	1.04%	2.37%
EM external debt (USD)	10.15%	9.72%	19.87%
7-10yr UST	1.04%	2.68%	3.72%
Credit			
EM corporate debt (USD)	9.65%	7.79%	17.44%
EM HY (USD)	16.21%	10.46%	26.67%
US HY	16.96%	7.21%	24.17%
EU HY	5.91%	5.87%	11.78%
Currencies			
EM FX	0.54%	4.19%	4.73%
*DXY Index**	*0.53%*	*-8.08%*	-7.55%
EURUSD	*-0.55%*	*11.59%*	11.04%
USDJPY	*0.58%*	*-2.95%*	-2.37%
Stocks			
EM stocks	11.27%	30.49%	41.76%
EM Small cap	0.27%	25.45%	25.72%
Frontier Markets	-1.28%	28.70%	27.42%
US stocks	*11.95%*	*20.05%*	32.00%

Source: Ashmore, JP Morgan, Bloomberg, MSCI. Data as at 8 December 2017.

Yet, positioning remains extremely light, especially in local markets. The lag between major turning points in the market and changes in asset allocation is typically 18-24 months for large institutional investors.[1] Institutional flows to EM only started to pick up in earnest in Q3 2017 and we estimate that so far only one fifth of the institutional money, which left EM between 2010 and 2015, has returned. This gives us strong grounds to expect a very positive flow picture for EM in 2018.

In addition to the usual bureaucratic lags, flows to EM are also usually subject to a heavy tussle between fear and greed. Fear tends to dominate greed in the early stages of the recovery as memories of recent volatility juxtapose deep-seated prejudices about the asset class. However, over time, as EM performance picks up fear gives way to greed. There are only two ways to make money: capital gain and income. While developed markets increasingly offer neither, EM now offers both, because EM was the only asset class in the world to sell off outright during the years of Quantitative Easing (QE). We expect EM's continuing outperformance versus the erstwhile

[1] These lags arise because many institutional investors first wait for a consultant to advise them to allocate and then have to undertake time consuming and sometimes cumbersome processes before they can allocate cash, including board approvals, RFPs, manager selection, preparing and signing of IMAs, etc.

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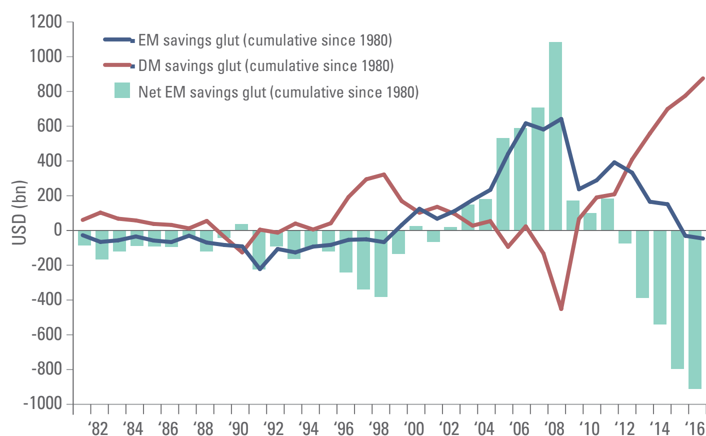
QE-sponsored markets in developed countries to be brutal in the coming years. Investors will therefore likely want to build over-weights in EM assets in the coming years. It seems reasonable to us to expect, at a minimum, that all the money, which left EM during the QE years will eventually return. And then some, because as EM markets grow, a USD 1bn allocation to EM today represents only half of what it represented in 2010 in terms of market share.

We expect particularly pronounced inflows to EM's local currency markets, both bonds and equities, for two reasons. First, local markets are not just the best performing, but also the least owned

Technicals

We think few investors are positioned for a continuing rally in EM local markets. Most institutional investors are still heavily overweight in developed markets, particularly in US stocks and high yield bonds as well as in European bonds and in the Dollar. While these trades all delivered extra-ordinary capital gains in recent years – 300% in US stocks, 80% in German bonds and 40% for the US dollar – the prospect for further capital gains going forward is distinctly less convincing and there is not very much yield either. This state of affairs is a consequence of too much money pouring into developed markets relative to the availability of attractive investment opportunities in the real economy. The most obvious reflection of the changes in technicals in favour of EM and against developed markets is that the so-called global savings glut, which was first made famous by former Fed Chairman Ben Bernanke in 2005, has now 'migrated' from EM to developed markets (Figure 2). A savings glut reflects a dearth of investment opportunities, the lack of one an abundance of opportunity. In other words, a positive technical backdrop now exists for EM investors and a negative one for those exposed to developed markets.

Fig 2: **The shift in the global savings glut**



Source: Ashmore, IMF.

Local markets

Against this positive performance and technical backdrop where will EM inflows go? We expect particularly pronounced inflows to EM's local currency markets, both bonds and equities, for two reasons. First, local markets are not just the best performing, but also the least owned. In 2016/2017, EM local government bond returns were nearly ten times as much as US bonds of the same duration. EM local bonds also delivered larger returns than in EM US dollar denominated bond markets. Second, EM currencies are steadily outperforming the US dollar and we think there is more to come. The technical backdrop is particularly good in local markets, because, as Figure 3 shows, global asset allocators have been selling EM FX versus the US dollar since 2010. EM currencies only neutralised in the course of 2016 and only began to outperform modestly in 2017. FX is where the action is at.

Fig 3: **EM FX versus USD**

Source: Ashmore, Bloomberg, JP Morgan.

Healthy return expectations in local markets

Between currency and yield we expect EM local markets to deliver around 50% in return in US dollar terms over the five year period from 2017 through 2021. We are not aware of any other government bond market with 4.5 years of duration, which, barring recession, will match these returns.

It is appropriate to look at returns over a five year time horizon, because the EM trade over this period will be driven by the unwinding of massive positions in developed markets accumulated during QE years. It will likely take at least the same time for people to unwind these trades as it took them to put them on. We look upon 2018 as the second year in this five year 'normalisation' period, which began in 2017 after the 2016 transition year.

Our 50% return expectation for the period 2017-2021 breaks down into roughly 30% return from bonds and about a 20% return from currency. As Figure 4 shows EM local bonds currently pay a yield of about 6.16%. We expect this yield to decline steadily towards 5.75% up to 2021 for an average yield of 6% over the five years. A terminal yield of 5.75% is unproblematic, because EM index weighted inflation is still a very comfortable 4.0% and we do not see inflation exceeding 5%, even by 2021. Hence, EM bond yields should remain comfortably within positive real yield territory for the entire forecast period.

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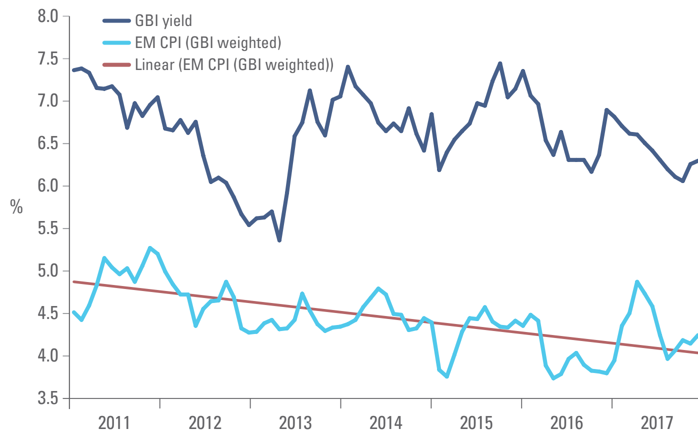
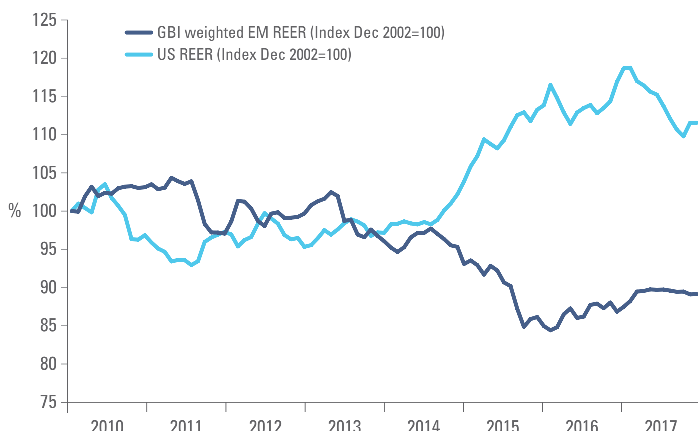
Fig 4: **Nominal yields and inflation in EM local currency markets**



Source: Ashmore, Bloomberg, JP Morgan.

EM currencies have cheapened dramatically in nominal terms in recent years, but they have also cheapened significantly in real terms (Figure 5). This means that EM currencies have material upside even after taking account of likely higher inflation in EM over the next few years. Our base case expectation is that EM inflation will be 2% higher than US inflation per annum out to 2021 due to EM's more normal business cycle dynamics. Assuming that past ranges for real effective exchange rates (REERs) will continue to hold – a prudent assumption – higher inflation in EM will, all else being equal, leave less room for nominal exchange rate appreciation. Still, given the cheapness of EM real exchange rates, we still see room for EM nominal exchange rates to recover some 20% following their 45% decline against the US dollar between 2010 and 2015. So far EM currencies have only recovered 5%, so in our view, there is at least 15% upside from here. Of course, it is not inconceivable that some EM countries can grow materially faster than in previous years due to recent productivity-enhancing reforms. If that is the case, then in our view, there is also more currency upside than 15%.

Fig 5: **EM and US REERs**



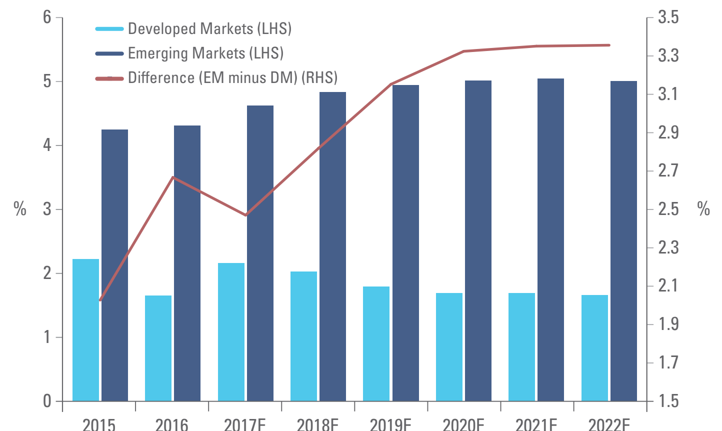
Source: Ashmore, Bloomberg, JP Morgan.

The true significance of flows returning to EM's local markets is in the easing of financial conditions and pickup in domestic demand

Thawing domestic demand

The true significance of flows returning to EM's local markets is in the easing of financial conditions and pickup in domestic demand. EM economies are generally severely finance constrained. Inflows therefore have a powerful effect on domestic demand.[2] Domestic demand led growth has been frozen for several years, but now looks set to emerge as the mainstay of EM's next growth phase. This is important, because domestic demand is three times larger than exports as a share of GDP.[3] We expect the domestic demand-led phase of EM's cyclical recovery to deliver material positive growth surprises relative to expectations. For example, IMF's growth forecasts, shown in Figure 6, do not take account of capital inflows and their positive impact on domestic financial conditions.

Fig 6: **IMF growth forecasts**



Source: Ashmore, IMF.

Improving credit conditions support Dollar-denominated bonds

Stronger EM growth will not just be positive for local markets; it will also improve credit quality with positive implications for US dollar-denominated bonds. Stronger growth means that governments collect more taxes, while the demand for counter-cyclical spending declines as more and more people obtain gainful employment in the private sector. As fiscal deficits narrow, issuance will decline. Corporates will likewise benefit from stronger growth as earnings rise, while easier financial conditions improve access credit and refinancing, so default rates drop. In this improving fundamental environment how much can investors reasonably expect to make in US dollar-denominated sovereign and corporate bonds over the five year period (2017-2021), given current valuations as shown in Figure 7?

[2] Flows into external debt markets will also ease financial conditions provided that the bonds are newly issued. Flows into secondary markets will not result in any inflows to EM, because the bonds trade off-shore. However, there will be a domestic impact from flows into external debt markets to the extent that sovereign and corporate spreads narrow, which lowers the overall cost of capital for EM issuers.

[3] On average domestic demand makes up 72% of GDP in EM countries compared to 28% from exports.

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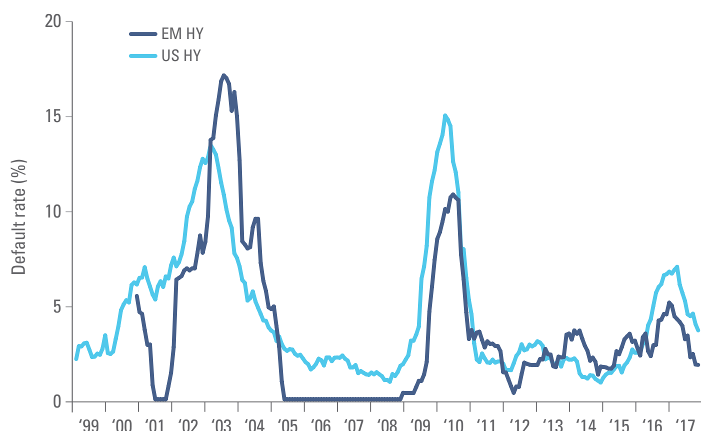
Fig 7: **EM fixed income valuations as at 8 December 2017**

Sub-asset class	Description	Yield/spread	Historical tights
GBI-EM-GD	Local currency government bonds	6.16%	5.23%
ELMI+	Local currency FX fwds	3.44%	1.74%
EMBI GD	External sovereign bonds	5.28% 291bps	4.38% 162bps
EMBI GD IG	External sovereign bonds (HY)	4.03% 163bps	3.45% 81.8bps
EMBI GD HY	External corporate bonds	6.62% 427bps	5.82% 196bps
CEMBI BD	External corporate bonds (IG)	5.05% 273bps	4.43% 141bps
CEMBI BD IG	External corporate bonds (HY)	4.14% 183bps	3.72% 118bps
CEMBI BD NON-IG	External corporate bonds (HY)	6.27% 395bps	6.21% 254bps

Source: Ashmore, IMF.

Sovereign US dollar-denominated bonds currently pay a yield of 5.3% with a spread over Treasuries just below 300bps. If the asset class does not rally at all, the compounded yield will generate a total cumulative return of 29% in Dollar terms in the five year period to 2021. However, we think the increased diversification of the external debt asset class justifies a lower spread of 200bps.[4] If the mispricing of external debt is arbitraged away over the investment period, investors should expect a one-off capital gain of 7% for a total return between 30% and 36% depending on when spreads go to fair value. Corporate US dollar-denominated bonds pay 5% yield for a compounded return of 28% over the forecast period, assuming no rally. Note that corporate bonds have materially shorter duration than sovereign bonds.[5] EM corporate high yield bonds should deliver 36% compounded return. Again, this assumes no rally and no change in default rates. However, it seems reasonable to expect default rates to decline as fundamentals improve further (Figure 8). If so, the total return will be higher.

Fig 8: **Corporate default rates (EM HY and US HY)**

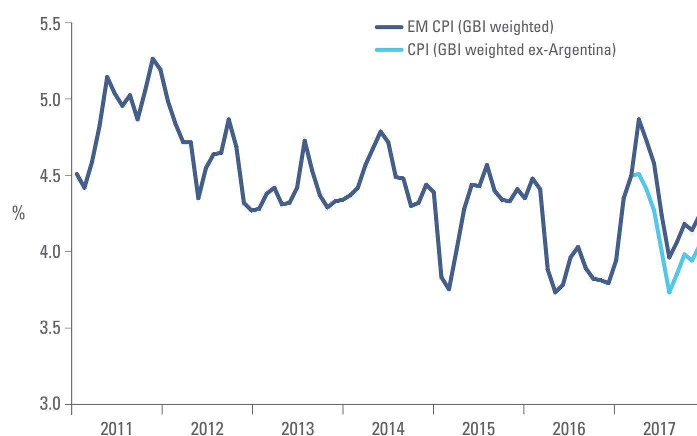


Source: Ashmore, BAML, data as at October 2017.

Modest increases in inflation

If domestic demand picks up so will inflation. Our base case is that EM inflation will increase modestly in 2018 from a low base. Capital inflows are positively correlated with inflation in EM due to their impact on economic activity.[6] While inflows also have short-term deflationary effects as stronger currencies reduce tradeable prices, these FX pass-through effects are soon thwarted by the positive effect of inflows on non-tradable prices via the broader pickup in economic activity. Inflows allow credit markets to expand, which in turn stimulates both consumption and investment. However, given the low starting point for EM inflation – average index weighted CPI inflation in EM declined by a fifth since 2011 (Figure 9) – we believe EM inflation will only return to 5% by 2021 or even later, based on the assumption that all the outflows from EM over the 2010-2015 period are reversed in full by that date.

Fig 9: **EM CPI inflation – a good starting point**



Source: Ashmore, Bloomberg, JP Morgan.

EM to lead global hiking cycle

Stronger growth and modest, but steadily rising inflation in turn implies higher rates. Contrary to popular perceptions, we believe that EM, not the US, will lead the global hiking cycle. The reality is that EM countries face much stronger 'normal' business cycle dynamics, while developed economies are stuck in so-called 'new normal' business cycles, where trend growth rates are much lower than in the past despite hyper-easy monetary policies. EM central banks can be expected to hike without hesitation as domestic demand-led growth really kicks in; their only concern is to ensure that inflation expectations remain well anchored and they generally have strong political backing for hiking early, since EM populations have very low tolerance for inflation. Still, EM central banks will not have to hike at a draconian pace, because there is still spare capacity in many economies and inflation is below average, as mentioned above.

The notion that EM countries will lead the global hiking cycle is clearly not market consensus. Our view is that developed market central banks, including the Fed, are quite severely constrained in terms of their abilities to match the pace of rate hikes in EM over the next couple of years as EM growth picks up in earnest. Indeed, even if inflation picks up they may still opt to err on the side of higher inflation due to overvalued asset prices and still

[4] The JP Morgan EMBI GD index today has 67 countries compared to just 32 countries in 2006. This increase in the number of countries has helped to reduce the volatility of the EMBI significantly. For more details see: *"Free Money: Arbitrage opportunities in EM external debt"*, Market Commentary, 14 June 2016.

[5] The duration on EM corporate bonds is 4.9 years (4.2 years for high yield bonds). The duration on sovereign bonds is 6.8 years (7.7 years for investment grade sovereign bonds). These numbers are based on the main corporate and sovereign benchmark indices from JP Morgan.

[6] See *"The myth of EM FX pass-through"*, The Emerging View, March 2017.

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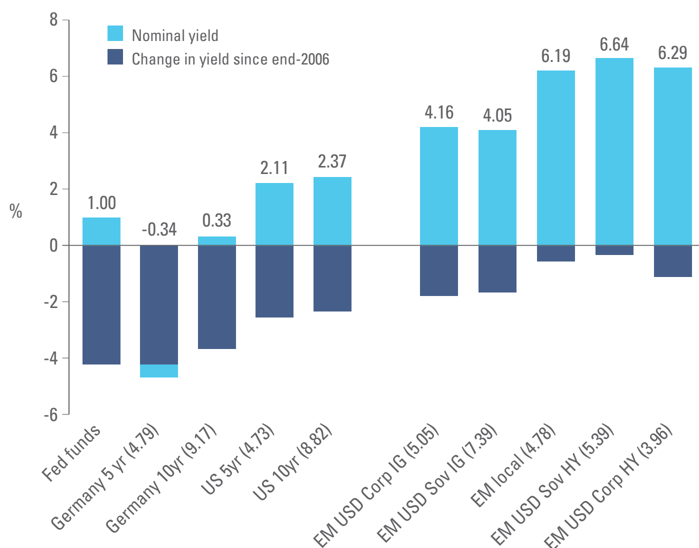
inadequate ammunition to cope with recessions. We return to the question of US monetary policy towards the end of this paper.

EM bond markets should be relatively insulated against volatility in developed market bond markets. Local EM bond yields in particular are not far from the levels, which prevailed under the normal monetary conditions preceding the developed market crisis, when the Fed funds rate was 5.25% (Figure 10). The same can obviously not be said for developed market bond yields, which have been severely depressed by QE. The high nominal and real yields in EM mean that although EM will hike more and sooner, there will not be a need for very draconian hikes.

Fig 10: **Relative nominal yields in EM and DM**



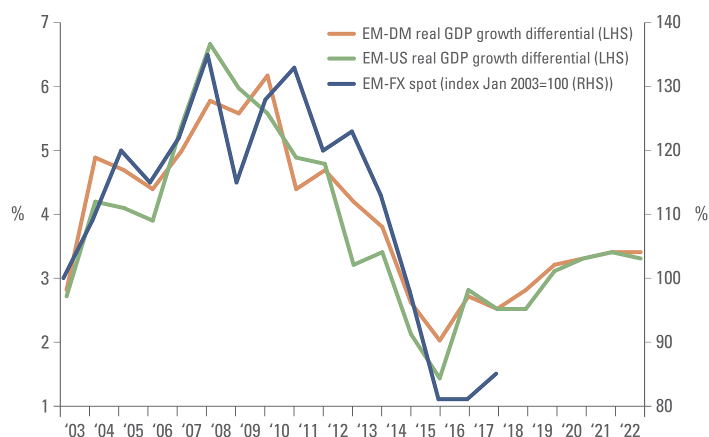
Source: Ashmore, JP Morgan, Bloomberg, data as at 8 December 2017.

Stronger EM currencies

Stronger growth and more rate hikes relative to developed markets will support EM currencies. We therefore expect EM currencies to continue their outperformance versus the Dollar throughout 2018 and beyond. Stronger currencies are important for fundamentals. A powerful feedback loop exists between EM currencies and EM growth (Figure 11). Stronger currencies induce inflows, which ease financial conditions and lead to stronger growth, which in turn justifies higher interest rates, which then further strengthens currencies and so on. Of course, interest rates do not always move currency markets on a contemporaneous basis, but if central banks raise rates in response to a healthy pick up in the business cycle rather than, say, in a delayed response to overheating, then higher rates can be a powerful positive driver of currencies.

We expect most EM central banks to hike early and hence support their currencies. In the longer-term stronger currencies will be required due to the so-called Balassa-Samuelson effect.[7] In countries where monetary policies are credible, we would expect higher rates to anchor the long end of bond curves, so the best place to be will be in the long end. Investors should therefore aim to extend duration in local markets in 2018 in the bulk of EM countries. Of course, not all EM countries have credible monetary policies. In countries with less credible monetary policies, inflation linkers may offer more value. In a few very badly managed EM countries or in countries with very expensive bonds, investors are best off not taking exposure at all. In short, each country is ultimately a unique play and active management will steadily become more important.

Fig 11: **EM FX and EM-DM growth differential**



Source: Ashmore, Bloomberg, JP Morgan, IMF.

It is early days, but not a bad time to start to think the supply-side

Flows back into EM are likely to be sustained – with the odd wobble – for several years. While there is still plenty of room for EM countries to increase domestic demand in response to inflows without running into major inflation problems, EM output gaps should gradually close over the coming year or two, particularly in Asia and parts of Eastern Europe. Investors will therefore soon need to begin to differentiate more between credits; not just in terms of the quality of monetary policies, but also in terms of the quality of their supply-side policies.

As demand catches up with supply growth becomes constrained by the size of factor markets, i.e. investment rates and population growth, as well as the pace of productivity growth which, in EM countries, often turns on health care, education, openness to trade, infrastructure investment as well as conventional technical progress. Most of these factors are heavily influenced by government policies, including the proclivity to reform, rule of law, respect for property rights, etc.

There are enormous differences in the quality of supply-side policies within EM. The biggest advances in recent years have been achieved in Latin America, where reformers have been replacing populists at an unprecedented rate (Figure 12). So this region may be able to achieve faster growth before hitting the inflation barriers than before the downturn. Even if populists take power in, say, Brazil and Mexico next year, there may be many years of economic expansion on the cards before problems arise.[8] Asian economies have historically invested far more in infrastructure than other regions in EM. India, Indonesia and The Philippines have recently made important strides forward in easing critical supply-side constraints, including red tape, infrastructure and tax.

[7] The Balassa-Samuelson effect refers to the need for stronger currencies in countries with faster growth rates, since rising income pushes up consumer prices, whose impact on the general price level can only be offset by deflationary impulses coming from stronger currencies.

[8] This is exactly what happened in Brazil in the first term of former President Lula, where the economic continued to perform extremely well due the reforms undertaken under the Cardoso Administration.

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Fig 12: **Latin America's journey from dictatorship to reform to populism and back to reform**

Year: 65 66 67 68 69 70 71 72 73 74 75 76 77 78 79 80 81 82 83 84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17

Country	Regime	Leaders (chronological)
Brazil	Populism	Sarney, Lula, Rousseff
	Orthodox	Collor, Franco, Cardoso, Lula, Temer
	Authoritarian	Military (Various)
Argentina	Populism	Peron, Kirchner
	Orthodox	Alfonsin, Menen, De la Rua, Duhalde, Macri
	Authoritarian	Military (Various), Military (Various)
Venezuela	Populism	Chavez, Maduro
	Orthodox	Leoni, Caldera, Perez, Campins, Lusinchi, Perez, Velasquez, Caldera
	Authoritarian	
Chile	Populism	Montalva
	Orthodox	Azocar, Frei Ruiz, Escobar, Bachelet, Pinera, Bachelet
	Authoritarian	Allende, Pinochet

Source: Ashmore.

A small number of EM countries continue to neglect reforms, usually due to political dysfunctionality. Those countries will struggle to grow. Even within this class of countries, however, it is important to differentiate. The least dangerous type of laggard are countries, such as South Africa, which has been unable to reform for many years, but where orthodox fiscal and monetary policies are still being maintained. These countries merely grow at ever slower rates. A more dangerous class of countries go one step further by overstimulating demand in order to try to eke out some growth. This puts them on track to lose control of macroeconomic stability in addition to growing more slowly on a trend basis. Turkey perfectly illustrates this type of country. Finally, there are countries, which then regress to the point, where they seek to eliminate the symptoms of overheating and macroeconomic imbalances by imposing controls on capital flows and prices, etc. Venezuela is an example of such countries. Unless they change tack they may get into very serious problems.

Of course, that does not mean that investors should keep away from such countries. It all depends on what is priced in. The broader point, however, is that there is enormous diversity across the tradeable markets in the EM universe, which now measures some USD 20trn, i.e. 20% of global fixed income (Figure 13).[9] The need for – and reward from – active management can only be expected to increase. As global macroeconomic conditions gradually normalise it will become increasingly obvious which countries have done their reforms and which ones have not.

EM specific risks

We see two broad sets of risks to the base case outlined above, namely EM specific problems and non-EM risks. We do not think shocks in developed countries have the capacity to generate large permanent losses in EM, but they certainly have the potential to generate plenty of volatility. As far as actual EM risks are concerned they fall into three categories: (a) systemic risks; (b) country specific risks; and (c) China.

a) Systemic risks are events that could potentially derail the entire asset class, not just in terms of creating volatility, but actually precipitating serious fundamental impairment. Thankfully these risks are largely behind us. EM countries were exposed to major robustness tests in the past ten years. They survived a virtual collapse of Western economies including their banks in 2008/2009. Between 2013 and early 2016 they additionally weathered a 45% US dollar rally, a halving of commodity prices and having to price in a full normalisation of US monetary policy no less than three times in quick succession. To make matters worse, investors obviously did not have the stomach to stick around during these shocks, so EM also had to cope with unprecedented and sustained outflows. Yet, EM countries and corporates overcame these challenges with impressive resilience. There were remarkably few defaults in EM over this period, almost no balance of payments crises and only the poorest and least diversified countries had to turn to the IMF. In short, the last ten years have really shown that EM is far

Fig 13: **The EM fixed income universe (as of end 2016)**

	As at end 2016								
Asset class	**Index name**	**Index acronym**	**Index provider**	**Number of countries**	**Number of issuers**	**Number of issues**	**Index market cap (USD bn)**	**Asset class (USD bn)**	**Index as % of asset class**
External sovereign debt	EMBI Global Diversified	EMBI GD	JP Morgan	65	142	559	445	976	45.6%
External corporate debt	CEMBI Broad Diversified	CEMBI BD	JP Morgan	51	554	1,200	406	1,845	22.0%
Local currency government debt	GBI EM Global Diversified	GBI EM GD	JP Morgan	15	15	201	707	8,341	8.5%
Local currency corporate debt	Local EM non-sovereign	LOCL	BAML	13	185	336	104	8,909	1.2%
All EM fixed income							**1,662**	**20,071**	**8.3%**

Source: Ashmore, BIS, JP Morgan, BAML.

[9] Needless to say with 92% of EM fixed income not represented in the main benchmarks there is a need to be active irrespective of the macroeconomic backdrop.

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more robust than its reputation would imply. In fact, the last time global market volatility was able dangerously to undermine EM fundamentals was twenty years ago in 1998. EM resilience to global shocks, which in the past posed potential systemic risks to the asset class, can be attributed to the fact that EM countries now get most of their financing from local sources. The reliance on local capital has decisively broken the erstwhile link between financial volatility and serious fundamental stress.

b) **EM country specific risks:** EM country specific risks come and go. A small number of EM countries get into trouble every year, usually entirely self-inflicted. In the vast majority of these cases their problems are resolved without major balance of payments crises or defaults. In fact, most such events turn out to be excellent buying opportunities in retrospect. Recent examples include Russia in 2014, Brazil in the last couple of years and Argentina since the interruption in payments in 2015. We generally expect EM fundamentals to improve in the coming years on the back of stronger growth and inflows, so country specific shocks should continue to be relative rare events, but even so investors should obviously keep a keen eye open for distressed situations, because they are typically a rich source of alpha.

c) **China:** China is special case for two reasons. First, the country is much larger and more powerful than most other EM countries (and indeed bigger and more powerful than most developed countries). Second, China is still not a very big part of most investors' portfolios, since the country's enormous markets have not yet become adequately represented in the main benchmark indices for bonds and equities. This discrepancy between China's indisputable economic and political clout and its minimal presence in investors' portfolios creates a fertile environment for speculation, innuendo and hyperbole. Thus, no other country veers so dramatically in the minds of investors between hard landings and overheating, with seemingly nothing in between. The reality is quite different. China has sustained stable and strong growth rates with moderate inflation, healthy external balances and a consistent commitment to reforms for many years. As far as 2018 is concerned the recently concluded Party Conference gave great new powers to President Xi Jinping, who will now be able to further his reforms of the financial system and accelerate China's transition from export to domestic demand-led growth. We think Xi Jinping has his eyes firmly on the bigger prize, namely realising China's destiny as the world's undisputed financial and economic hegemon. To achieve this, he will speed up the pace of reforms in China, such as the overhaul of state-owned enterprises, index inclusion, capital account liberations, reform of banks, etc. Rapid reforms create uncertainty in the short term, but they are also a guarantee that China's development will continue in a sustainable manner. We remain very bullish on the country and expect China's markets steadily to become more integrated with the global financial markets.

Non-EM risks to EM

The fact that investors are still so heavily positioned in the overvalued QE-stimulated markets in developed countries presents an obvious risk to global financial stability. Global asset allocators and policy makers are far too complacent about this risk, in our view. The lessons from every previous financial crisis are that the next crisis will not look like the last one and that investors will miss the warning signs because they are looking in the wrong place.

Today investors still look for bubbles in individual sectors of the economy, because all the major upheavals of the past 30 years have been sector specific. Yet, the biggest risks may be system-wide mispricing of assets. In other words, the mere fact that investors are not able to spot material mispricing in any one sector should not be grounds for comfort: the reason no single sector stands out is that all of them are mispriced.

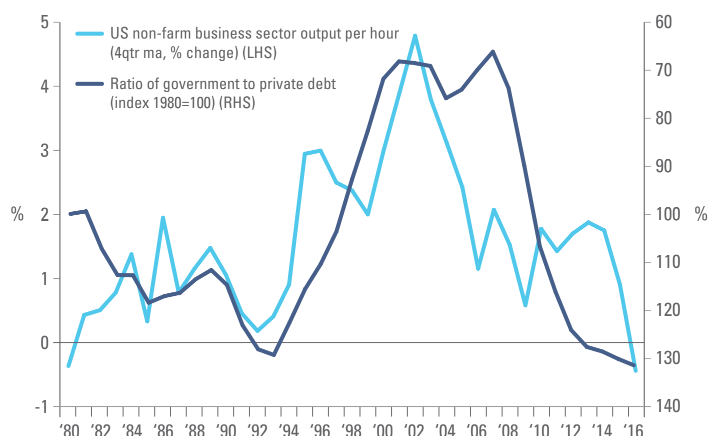
This is why the unwinding of QE is probably the most dangerous process currently underway in policy cycles. If QE is unwound successfully then the best strategy will probably be to simply reverse the QE trades, i.e. go long European equities versus US equities, go long EUR versus USD and shift money from German bonds to US Treasuries. These trades would make sense in a relative sense, but they offer little fundamental value and thus are not good value for money. The bigger trade would be to take profits on the entire complex of QE trades and allocate instead to the non-QE sponsored markets, which were the only markets in the world to cheapen outright during the QE era.

The problem, of course, arises if QE is not unwound in a successful manner. In this respect, we think investors in EM should focus especially on the US, because most EM currencies trade versus the US dollar and most externally issued EM bonds trade as a spread over US Treasuries. This makes the US far more important to most EM countries than, say, Europe or Japan, even when the latter have problems.

Special risks in the US

While President Donald Trump is in possession of an enviable ability to generate colourful headlines we think the real source of risk lies within the realms of US fiscal and monetary policies rather than in the White House. As far as fiscal policy is concerned our base case is that the Trump tax cuts will provide a short term boost to growth, but ultimately worsen America's trend growth rate, since the tax cuts will be funded by debt. More government debt relative to private sector debt is closely correlated with lower US productivity (Figure 14). Hence, the tax cut should ultimately lower r* (the FOMC members' expectation for where the fed funds rate will converge in the long run) and thus justify a lower rather than higher Fed funds rate, all else even. Investors should therefore use any short-term support for the Dollar arising from the tax cut to buy into positions in EM FX.

Fig 14: **US productivity and government debt**



Source: Ashmore, Bloomberg, US Treasury.

Continued overleaf

Our base case is that US monetary policies will continue to be dovish. Like the Yellen Fed, the Powell Fed is likely to be constrained in its efforts to hike rates by the presence of bubbles in the stock markets and the fact that the Fed still does not have enough hikes on its books to extricate the economy from a recession. The Fed wants to hike, of course, but for the foreseeable future only in order to build up some capacity to handle the recession, which will inevitably arrive one day. To achieve this, the Fed will only hike opportunistically, meaning when a hike is fully discounted by the market and thus risk free. In this mode, we think the Fed will end up hiking more slowly than many EM central banks, particularly as the Fed contemporaneously scales back QE in a bid to bring stock prices more into line with fundamentals. The objective is obviously not to push down stock prices outright, but to slow the pace of appreciation in order to let the economy catch up with valuations. The whole point is to deflate the stock market bubble, so that the Fed can hike freely without crashing the economy.

Against this base case we see three broad risks from the US, namely recession, inflation and a productivity miracle. Consider each in turn.

a) **Recession:** So much money has chased the Greenback in expectation of stronger growth and higher interest rates that a US recession would precipitate a very sharp decline in the US dollar. Recession would also trigger rapid Fed rate cuts and possibly further asset purchases. The problem is that the Fed does not have enough room to cut. The average rate cut in recessions since the early 1980s has exceeded 500bps and there is only 125bps on the books of the Fed today. A return to asset purchases would probably lead to associations with Japan. A lower Dollar and lower UST yields would be positive for EM local bond markets, but EM equities might struggle a bit on account of their short-term correlation with US equities.

b) **Inflation:** US inflation would pose major problems in developed bond markets. If rates were to normalise today it would take holders 10 years for carry to make up for the capital losses on US 10yr bonds. The corresponding numbers are 18 years for UK bonds, 86 years for German bonds and 498 years for Japanese bonds (by contrast, EM bond holders would be made whole in just three years due to the higher yield). Inflation would therefore generate volatility in all markets. The volatility would last until markets have discovered the Fed's true reaction function, which, in our view, would be to protect growth rather than fight inflation. Hence, the ultimate result would be higher inflation, financial repression and a lower Dollar much like in the 1970s. Inflation and the weaker Dollar are ultimately the way we expect the US to extract itself from its debt and productivity problems. EM central banks should already now begin to diversify away from the Dollar, because inflation seems inevitable at some point in the future.

c) **Productivity miracle:** US markets could entirely escape the recession and inflation scenarios outlined above if only the economy would suddenly achieve trend growth rate of 5%. Strong productivity growth would allow the Fed to hike without fear of pushing the economy irretrievably into a quagmire and the high valuations in US stock markets would suddenly look reasonable. EM countries would benefit from a strong US economy. For example, the minority of EM countries, which depend on commodity exports would benefit directly. Risk appetite would also increase, which should support the willingness to allocate to EM's higher yielders. However, the Dollar would likely surge, so flows into local markets would slow. This would translate into fewer inflows and hence slower growth as domestic demand would pick up less than in our base case. EM would be back to growing more from exports than domestic demand. However, we do not see how the US would suddenly pull off a productivity miracle without major reforms, which look very unlikely. In fact, the more likely scenario is that the US becomes more protectionist at the margin. Protectionism distorts domestic prices, which favours uncompetitive US producers, while at the same time raising prices for everyone else. Hence, America becomes less productive under protectionist policies. At the margin, EM would be negatively impacted by a protectionist US, but nearly half of all EM trade is now with other EM countries, so EM exposure to the US economy is lower today than it has ever been.[10]

[10] See *"Intra-EM trade"*, The Emerging View, September 2017.

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