Ashmore

EM traffic light: Red, Amber, Green

By Jan Dehn

We believe that the last few years have seen unusually protracted valuation mismatches, between Emerging Markets and developed markets assets which have been caused by an enormous technical 'bid' for developed markets assets from central banks across the globe. By contrast, fundamentals have largely been ignored so far. There are now signs that valuations in developed economies have reached levels where they are beginning to clash with weak underlying fundamentals. This is likely to usher in a more balanced outlook for Emerging Markets versus developed markets assets, in spite of ongoing central bank support for developed countries.

The 'traffic light' for Emerging Markets (EM) assets has now turned to Amber from Red, but a full reversal to Green is still some way off. Even so, we believe that investors should think ahead and act early. One reason is that positioning is now so heavily skewed in favour of developed markets that the eventual unwinding of central bank sponsored long positions will be disorderly, especially in currency markets.

Enter history's largest asymmetric central bank bid…

The unprecedented policy responses by central banks to the 2008/2009 crisis have disrupted conventional market dynamics, but also twisted them in an unhealthy direction.

The QE programs of the UK, Japan, Europe and the US are the largest ever programs of officially sanctioned bond purchases. Purchases have been targeted exclusively at assets in developed economies, where bond yields have been pushed to unprecedented lows and stock prices elevated far beyond pre-crisis highs.

The overwhelming consensus within developed economies has been that the US will recover more quickly and the Fed will hike rates sooner than Europe, so US stocks and the USD have been the popular ways to play QE in the US, while the bond market has been the favoured destination for QE flows in Europe which is viewed as growth-challenged. The regulatory system has of course pushed heavily in the same direction.

…and the herd…

Global asset allocators have jumped on this central bank band wagon in a big way. Many pension funds, insurance companies, sovereign wealth funds and other pools of capital have increased their allocations to developed markets since 2008/2009. Even EM central banks have pitched in by employing their vast FX reserves to help developed governments finance their fiscal deficits.

By contrast, there has not been a single orchestrated official QE program to purchase EM assets and no sign of global asset allocators climbing aboard any EM band wagon. Most investors have ignored fundamentals and shunned value arguments in favour of chasing the central bank generated momentum in developed markets – buying the very markets whose vulnerabilities were so explicitly on display in 2008/2009.

…and the 'momentum jockeys'

Commentators and many investment banks also love a good momentum trade. Between them they have helped to generate a narrative that portrays developed economies as powerful recovery stories and EM countries as fragile and crisis prone entities. Normal business cycles in EM are routinely portrayed as structural weaknesses, while issues in individual EM countries are commonly extrapolated widely, to the detriment of the entire asset class.

This narrative of developed market strength and EM weakness has in the main survived despite overwhelming evidence to the contrary. For example:

- The first bold forecasts of US 'exit velocity' (and even Fed hikes) appeared as early as 2011. Four years later, exit velocity and US Fed hikes remain elusive.
- How many 'hard landings' have been predicted for China in the past few years?
- Why was India ever labelled a Fragile Five?
- Why did Turkey not blow up during the Gezi Park protests?
- Why did the market fret so much about education strikes in Chile?
- Why did Russian sovereign bonds trade 700bps over Treasuries as recently as December 2014 when Russia's debt to GDP ratio is still below 20% and reserves exceed USD 350bn?
- Why did default rates in EM corporate high yield markets fall to less than half their historical average by the end of 2014 when the consensus predicted that FX mismatches would destroy them in a year of a very strong USD?

What has happened to all the crises predicted for EM? Looking back, each was an over-reaction.

Investors should think ahead and act early. We believe that positioning is so heavily skewed in favour of developed markets that the eventual unwinding of central bank sponsored long positions will be disorderly

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Meanwhile, in the real world…

Even as central bankers, herd investors and countless commentators between them prompted an unprecedented buying spree, the real economy has been less spectacular. Developed economies have grown far, far more slowly than in any previous business cycles despite the abundance of easy money. The US has seen 2% real GDP growth each year for the past half a decade. With a few exceptions in the European periphery, most developed economies have neither deleveraged nor reformed.

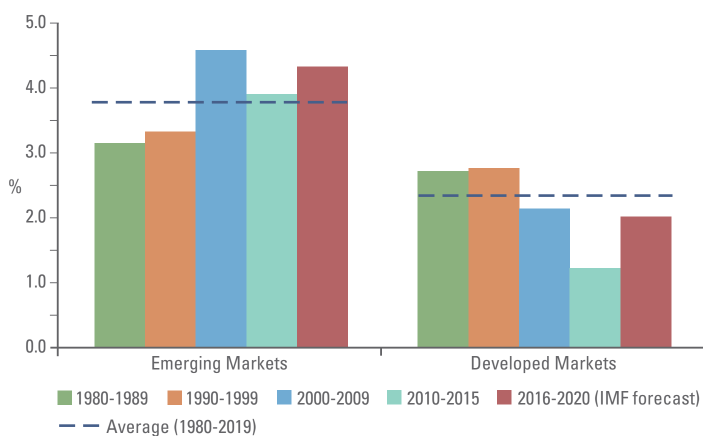
Productivity levels continue to fall. During this period of hyper-easy monetary policy, policy makers in developed economies have singularly failed to exploit the opportunity to fix their tough underlying economic problems. Instead, whenever weakness has re-surfaced they have just resorted to yet more stimuli.

EM fundamentals have been remarkably stable – continuing to clock up about around 4-5% real GDP growth

Incidentally, EM fundamentals have also been remarkably stable over this period. EM continues to clock up around 4-5% real GDP growth and serious forecasters continue to predict a clear and sustained growth outperformance versus developed economies. Some 5-10% of EM countries run into problems in any given year, which has always been the case. Most of these countries quickly fix their problems and regain market confidence.

In its recent update of the World Economic Outlook, the IMF's two largest downwards 2015 growth revisions were the USA and Canada with -0.6% and -0.7%, respectively. In aggregate, developed economies were revised down 0.3%, while EM were revised down just 0.1%.

Fig 1: **EM versus DM growth** (IMF projections as at April 2015)

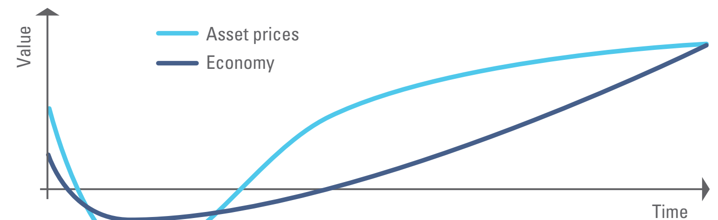


Source: Ashmore, IMF World Economic Outlook April 2015.

The result: Major mispricing and misallocation

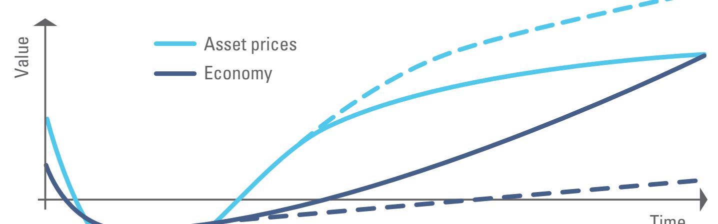
The sluggish economic performance in developed economies following the 2008/2009 crisis sits uncomfortably alongside the powerful appreciation of developed market asset prices. QE has pushed asset prices far higher than intended, while the lack of attention to fundamentals has meant that the underlying economies have performed worse than anticipated. We believe that this translates into a dangerous asset price distortion, which will ultimately have to be corrected. Figures 2 and 3 illustrate in stylised form. The big question is when and how these price distortions correct.

Fig 2: **Theory of QE in developed economies**



The theory behind unconventional monetary policy is that boosting asset prices using monetary stimulus prompts a recovery which temporarily pushes prices ahead of economic fundamentals. The faster economic growth that follows the stimulus then gradually catches up with asset prices and equilibrium is eventually restored. However, the reality has been that asset prices have continued to push higher as more and more stimulus has been needed, and economic growth has stubbornly disappointed. As a result, the gap between asset prices and underlying economic fundamentals has become unsustainably wide.

Fig 3: **Reality of QE in developed economies**

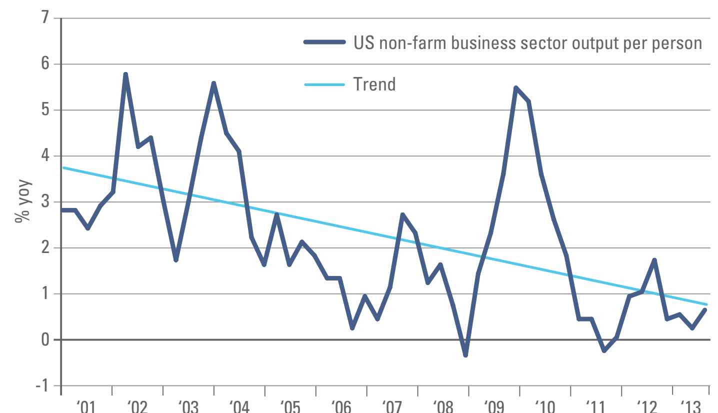


The light turns from Red to Amber

Does this growing gap between the valuations and fundamentals matter? Is there a limit? The answer is yes. The price action this year suggests that developed markets may, after all, be running out of upside.

The first indication was when US growth disappointed sharply in Q1. The outlandish downside surprise relative to expectations – -0.2% qoq annualised versus +3.0% expected – was almost entirely due to the stronger USD, which is now hurting exporters and investments in the shale sector alike. This is 'American-style' Dutch Disease, where exchange rate appreciation hurts exporters in conditions of declining domestic productivity.

Fig 4: **US productivity**



Source: Ashmore, Bloomberg.

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Fig 5: **US real effective exchange rate** (Index January 2011=100)

Source: Ashmore, Bloomberg.

In any other country this would hardly have been a surprise – after all, the USD has rallied nearly 40% in trade weighted terms since 2011. USD strength has now become a policy issue for the first time. Everyone from President Obama to Fed Chairwoman Janet Yellen now regularly refer to the problems created by the strong USD and the most recent US trade data points to unequivocal export weakness. If the economy is now beginning to hurt from the strong USD it seems unlikely that the Greenback can repeat the rally of the past few years. Indeed, since March the broad USD index is down 4%.

European bond markets have run into analogous problems. In April, German 30 year bond yields dropped well below zero in real terms. Around the same time an auction for 10 year bonds in Switzerland cleared with negative nominal yields. This too marks an important fundamental threshold of sorts – European countries have major structural and debt challenges, so in our view they simply should not issue long-term bonds with a negative real yield. The price action suggests that the upside may now be more limited for European fixed income. Since March, German 30 year bond yields have backed up 1% – and that implies a lot of pain when you take into account that the duration of the 30 year German benchmark bond is greater than 22 years.

Since the two most popular 'QE consensus trades' in developed markets – long USD and long European bonds – have now reached important fundamental thresholds, it seems likely that the journey from here will be choppier. At best there will be less upside and is likely to be accompanied by greater volatility and less liquidity. Regardless of what action central banks take.

Where does this leave EM?

None of this directly impacts EM. However, it does level the playing field somewhat. Despite considerable global risk aversion, EM FX volatility is now lower than G7 FX volatility.

Fig 6: **EM FX volatility minus G7 FX volatility**

Source: Bloomberg, Ashmore, JP Morgan.

How investors trade developed markets...

Financial markets occasionally go off on some truly breathtaking tangents. This is often because they trade on rules of thumb instead of rationally pricing risks. In particular, markets tend to respond to economic and political stresses in individual countries very differently depending on whether they are EM or developed economies. In developed countries, markets will typically respond to economic stress – such as a sudden cyclical downturn, a bubble collapsing or a political crisis – by rallying in anticipation of aggressive fiscal and monetary easing. A positive market response induces investors to focus on the fundamentals and the technicals, such as induced demand from deficit spending, better valuations as interest rates fall or simply the strong support from central bank asset purchases. In normal business cycles, the economy responds to the combination of official support and market enthusiasm by recovering and asset prices and fundamentals reconnect. Usually there is no reform effort at all, just stimulus.

In other words, one of the defining features of developed market dynamics is that asset prices tend to err on the side of optimism, while fundamentals (reforms, deleveraging, etc.) tend to underwhelm. Markets are often willing to overlook the neglect of the fundamentals, because regulators allow government securities to be classified as risk free. Over successive cycles, however, the repeated imbalance between excessive stimulus and insufficient reform can create a growing mismatch between asset prices and fundamentals, which ultimately gets resolved via a crisis.

...and how they trade EM

As every EM investor knows, EM markets behave rather differently. EM is never given the benefit of the doubt. Investors invariably act first and ask questions later. Sell-offs can be violent, even when fundamentals are sound and cyclical setbacks are modest. Indeed, EM markets can experience violent sell-offs even when the problems are entirely unrelated to EM itself, such as Greece in Q3 2011. In such a febrile environment, EM policy makers rarely have the luxury of resorting to deficit financing, hyper-easing and, in some cases are not even able to cut rates during periods of stress. Instead, they are forced to rectify the causes of their fundamental problems more or less immediately. The corrective measures often induce even more market stress, although they are typically instrumental in ensuring that the credits stay healthy.

Thus, in sharp contrast to the behaviour in developed markets, EM asset prices tend to undershoot during periods of fundamental stress, often significantly, even though fundamental remedies – such as reforms – are actually far more frequently applied. Over successive cycles, EM valuations tend to revert to fair value, while fundamentals are more stable, because problems are dealt with as they arise rather than being 'swept under the carpet' where they could fester into serious and potentially irreversible risks.

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The clever money has already recognised this shift, which is why EM high yield corporates are outperforming developed market high yield corporates by a factor of two year to date. Also, sovereign USD denominated bonds in EM have outperformed US treasuries of the same duration. There may be more to go. Figure 7 shows the relative performance of EM and developed markets since the third tranche of US QE (which was then followed by Japanese and European QE programmes). It shows how European Bond markets (here we show German government bonds), the Dollar and the US stock market have been particular beneficiaries of unconventional monetary policies.

Fig 7: **Performance of developed markets and EM since QE3 in late 2012**

	Developed Markets	Emerging Markets
Absolute change in 10yr yields	-0.75	1.2
FX	19%	-23%
Stocks	30%	-8%

Source: Ashmore, Bloomberg, 5 September 2012 to 9 July 2015.

German 10 year government bonds.
EMBI Global Diversified, DXY, EM spot FX, S&P 500 and MSCI EM in USD terms.

Still, we do not think investors are going to rush into EM just because their core allocations in developed markets are beginning to struggle. But smarter investors will begin to move ahead of the herd. Conditions are supportive for strategies that allow for managers to take tactical allocations across themes within EM fixed income given an outlook without major directionality in duration and a continuing bias among investors towards the USD but less actual USD upside.

Fed hike 'head fake'

We do not think the start of Fed hikes will be the next major turning point in global markets. Instead, we believe the start of the hiking cycle in the US will tilt markets further in favour of EM at the margin. The Fed is likely to hike modestly and very gradually over a long time. As such, the start of the rate hike cycle should be good for EM by removing much of the uncertainty that surrounds the timing of the first hike while signalling an improvement in the economic outlook. This tends to be good for credit spreads, while the early hikes will have virtually no impact on the cost of capital. By contrast, late cycle hikes can be very damaging as the impact on the US housing market of the Fed's last hikes in 2007 showed very clearly.

The return of inflation – the true Green light for EM

The event that signals the next genuine shift in global markets will be the return of inflation in developed economies, starting in the US. By late 2016, we think unemployment and negative housing equity will be back to frictional levels, while households will finally have shrugged off the debt overhang from the Greenspan Bubble. Consumers should then respond to cheap and abundant credit by spending more, but with the Fed severely constrained in its ability to hike materially in real terms due to low and falling productivity, a debt stock that is far too big and a stock market addicted to easy money leaves the odds in favour for a preference of inflation over lower growth.

We believe the start of the hiking cycle in the US will tilt markets further in favour of EM at the margin

Surprise inflation and a Fed reluctant to stamp it out means that the US yield curve has to bear steepen. This will, of course, immediately threaten newly re-inflated housing bubble. Another housing collapse is not likely to go down well in Washington, so we expect another wave of financial repression to head off a 'blow up' in the long end of the curve. Regulators are likely to 'remind' large holders of fixed income – pension funds for example – that they are meant to hold long term assets to match their long term liabilities. We envisage that new rules – such as minimum duration requirements and other devices – are likely to be employed to keep term yields low. The combination of low policy rates and depressed term yields amidst rising inflation combine to push down real yields, which can mean only one thing for the USD: it drops.

The return of fundamentals

Herein lies the central element in our medium term outlook for monetary policy normalisation in developed economies – this process is likely to involve far more inflation and currency debasement than real rate increases, austerity and reform. The writing is already on the wall – developed economies have squandered years of hyper-easy monetary policies without reforming or deleveraging. They are clearly trying everything they can to turn their debt problems into inflation problems and weaker currencies.

How does this constitute a Green light for EM? Certainly, EM economies will not welcome a weaker USD, because it erodes their capacity to export. Also, 97% of EM central bank reserves are invested in QE currencies, which makes them exposed to potentially large capital losses unless they diversify away from the QE currencies in time. Hence, the EM outlook is by no means unchallenging.

The event that signals the next genuine shift in global markets will be the return of inflation in developed economies, starting in the US

However, what is tough for EM countries can be good for EM fixed income investors. The falling growth rates and declining inflation caused by the return of EM currency appreciation means that local currency bonds once again become very attractive. Moreover, this will happen at the precise time that developed market fixed income starts to lose serious money.

An active approach to investing will remain important as the degree to which individual EM countries will experience currency appreciation will depend in large part on the size and accessibility of each country's bond market. Large EM countries with liquid bond markets that position themselves as the potential candidates for future global reserve currency status – such as China – are likely to be able to attract more financing than smaller EM countries. On the other hand, smaller EM countries benefit from a more bullish outlook for commodities as the USD weakens and growth gradually returns in developed economies. This constitutes a good case for looking at equities in smaller EM countries.

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Positioning and timing are key

We believe that investors' portfolios have become far too skewed towards developed markets in the past few years. Given the continued central bank induced momentum trade in developed markets and the incremental way in which institutional investors allocate, it seems likely that positioning will be even more stretched by the time inflation returns in the US.

When investors realise that the very central bank purchases that lured them into developed markets in the first place will now start to erode the real value of their holdings, the 'QE trades' will begin to reverse. By then the exit door will be narrow and most investors will turn sellers at the same time. It is wise to prepare early and be ahead of the herd.

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