

The View from Kilimanjaro: EM FX in a QE world

By Jan Dehn

Enormous, majestic and almost perfectly symmetrical, Kilimanjaro is Africa's highest mountain and it never fails to impress. The mountain has three distinct sections – a gradually rising western face that gives way to a wide, almost flat snow-capped roof and an eastern slope that tumbles towards the Tanzanian plains interrupted only by a few wobbles before merging into the surrounding savannah.

Kilimanjaro's iconic shape also happens, quite by accident, to describe the likely evolution of global currencies under quantitative easing (QE). Since the onset of QE, the USD in particular has evolved more or less along this path with strong sustained appreciation for several years followed by a flatter trajectory and eventually a descent in line with the destiny of all QE currencies.

This brief note explains why the driving force behind currencies under QE suggests this pattern, particularly for the USD and what this means for Emerging Markets (EM) currencies now and in the future. The conclusion offers suggestions on how to position portfolios accordingly.



Up the Western Face

The US embarked upon its first QE program in 2011. It has since gone on to launch two additional QE programs and a so-called Twist operation, while all the other major Western economies have also launched their own versions of QE. Through these programs, Western central banks have, between them, printed literally trillions of Dollar-equivalent freshly minted bills that have been used exclusively to buy developed markets assets.

Printing money initially led to fears that it would weaken the currencies in question, but it has had the opposite effect. Why? Because: money printing has not, so far, resulted in inflation. This means that every single unit of currency printed has been real value. The purchasing power of each bill still equates to its face value.

There have, of course, been nuances. Each QE program has been accompanied by its own narrative, which in turn has helped to shape the performance of financial asset prices. In the US, for example, the QE programs have been accompanied by views that the US economy is (perennially) on the cusp of achieving exit velocity and that the Fed is just about to hike rates. QE in

Technicals dominate the Western Face, a goldilocks period for developed markets and particularly the USD. EM fundamentals have remained stable since QE began

the US has therefore primarily manifested itself as a stock market rally and a USD rally. US stocks are much higher than before the 2008/2009 crisis and the USD is nearly 40% higher against almost all currencies in the world.

Of course, the US economic reality has somehow been less impressive than the market performance. Roughly 2% of real GDP growth per year for the past five years is shockingly poor, given the tailwinds from QE and zero interest-rate policy (ZIRP). But for most of the last four years, reality has not managed to get in the way of a beautiful market rally!

EM currencies have behaved dismally versus the USD over the same period. Why? The answer is more technical than fundamental. Not a single EM central bank has engaged in QE practices and not a single one of the central banks in the developed

world has bought EM assets as part of their QE programs. EM assets – and with them, their currencies – have in effect languished in a state of benign neglect. Global asset allocators have been quick to jump on the central bank bandwagon by adding to their already large core allocations to stocks and bonds in the now central bank-sponsored developed economies, sometimes funding their purchases by reducing exposure to EM.

Sentiment continues to mirror the destination of QE flows. This means that EM countries have experienced a slowdown in their share of financial flows – even outflows in some cases. The result has been that financial conditions have tightened in EM – which explains why there is not a single financial asset in EM that is not significantly cheaper today than before 2008/2009, as compared to developed markets assets. The strong USD has also pushed down commodity prices, which has benefitted the majority of EM countries. However, in a market that rarely distinguishes between EM countries and tends to focus on the negative stories, even the lower commodity prices have reinforced the EM scepticism.

It is therefore ironic that EM fundamentals have remained very stable since QE began. EM countries have settled on a 4-5% real GDP growth path after their initial V-shaped bounce-back from 2008/2009. There have been no major balance of payments crises and no major defaults. A small number of EM countries have fallen into disfavour each year, usually for reasons that are entirely self-inflicted, but this is entirely normal and the affected countries tend to take quick remedial action, so the panics typically do not last very long.

In short, the trek up the western face of Kilimanjaro between 2011 and 2015 has been far more of a technical than a fundamental story. It has been a goldilocks period for developed markets and particularly the USD. Until recently there were no signs at all that the good times would come to an end.

Hitting the roof

The illusion that QE – money printing – can support indefinite rallies was brutally shattered towards the end of Q1 2015. In the US, growth seriously undershot expectations in the first quarter (0.6% qoq annualised versus 3.5% qoq annualised expected). Of course, this was not the first time that first quarter growth disappointed in the US, but this time was different. The US real effective exchange rate has gone vertical. Oil prices have tanked, taking down the US shale sector. Productivity has begun to really struggle. Earnings have missed. And the US trade deficit is now a serious concern.

The difference from previous growth disappointments is that the US economy is now suffering from American-style ‘Dutch Disease’, that is, the damaging effects of the enormous USD rally of the past few years.

It may not yet feel that way, but this is an important turning point. Recall that the USD rally was always predicated on a view that the US economy would grow faster and that the Fed would hike sooner than other developed countries. But the USD has now become so strong that, at the margin, it is impeding growth and influencing Fed policy in a dovish direction. Thus, when the

At the summit of Kilimanjaro, there is a more balanced view for EM FX versus the USD as well as a value opportunity in EM local bonds

Fed failed to hike in September, citing trade and global factors, the Fed was really saying that the USD is too strong. The USD has become a victim of its own success.

What, then, is the outlook for QE and non-QE currencies at the roof of the Kilimanjaro? For QE currencies, the view is impressive, but it is a cold and lonely place. The USD is likely to linger at these valuations for some time. Having thus hit the roof, expected USD appreciation is likely to be far less pronounced than in recent years.

The valuation issues also extend to US stock markets, which are down for the year. The upside of the past few years is undeniable, but the fundamental issues continue to be ignored. If anything, the strong USD is now introducing new challenges. Further upside now hinges on a growth miracle or a major correction. The former seems unlikely; the latter is a distinct possibility.

This is why the discrepancy between financial market valuations and fundamentals is now the single largest source of nervousness in global markets. Sure, China is a convenient lightning rod for sentiment, but few foreigners are invested there. The real problems are closer to home.

Yet, the downside potential may be limited too. Having invested so much to get here, no one wants to see the USD and US stocks fall sharply. The illusion that a normal recovery can be achieved can still be sustained for a little bit longer, mainly because inflation has not yet shown up. In other words, the Fed can still delay hikes without too much cost to its reputation. But be warned: that window too is closing.

With the USD outlook now more balanced, what is the outlook for EM FX from here? Firstly, EM currencies are cheap after four years of unrelenting depreciation. EM currencies are down 37% since 2011, according to the JP Morgan EM spot FX index with the JP Morgan ELMF+ FX implied yields at 4.5% for just 57 days duration. Secondly, if the USD now flat-lines, the expected annual depreciation of EM currencies will also be less, probably closer to zero per year than -10% per year of the past few years.

But it is still premature to call a strong, directional and sustained rally in EM FX for two reasons. First, there are still no serious outright downside pressures on the USD, mainly because inflation is still absent. Secondly, the volatility of EM FX of the past four years has raised the threshold for investors to dip their toes.

The main implication is therefore for EM local bonds. Long-term investors with tolerance for FX volatility will look through a more balanced albeit volatile FX outlook to local bond yields, which, at 7.2% (550bps wider than US bonds with similar duration) are now very close to the widest level reached during the Taper Tantrum. Each time these levels have been reached in the past, the subsequent 12 months have delivered bond rallies of at least 100bps (2008, 2011/12 and 2014).

Down the Eastern Slope

Fed hikes, no matter when they arrive, are not likely to materially alter the 'Kilimanjaro path' for global currencies. The Fed will hike slowly. The uncertainty surrounding the timing of hikes is far more important than the hikes themselves. This means that the commencement of rate hikes should benefit credit, but only at the margin.

The next major turning point in the global currency story – and the start of the USD's descent from the current dizzy heights it has reached over the past four years – is likely to revolve around the return of inflation in the QE countries.

To see just why inflation is so important, consider what the Fed would do if prices began to rise in earnest. Inflation eliminates the Fed's freedom to relentlessly stimulate financial markets in the context of an unproductive economy. This impales the Fed on the horns of a dilemma – choosing between protecting markets and supporting the tepid economic recovery or crushing inflation.

In making its choice, the Fed will be acutely aware that none of the factors that deter the Fed from hiking today – financial asset price bubbles, an extremely unproductive economy, enormous debt burdens and an overvalued currency – will have gone away. The Fed will therefore ultimately have to give more weight to growth and the health of the QE-inflated financial markets. The result is that real yields decline and the USD's long-awaited U-turn begins.

When does inflation return? Provided that the US avoids recession and a major financial market melt-down due to, say, an acute loss of confidence in the Fed, the most likely start date for US inflation will be late 2016 when household debt levels, negative housing equity and labour markets return to normal.

Inflation is not widely expected to return, so when it does it will create some volatility. The Fed's dovishness will surprise the

The downward slope is likely to revolve around the return of inflation in QE countries. This will be marked by appreciation of larger EM currencies, bullish local bonds in these markets and the re-emergence of new global reserve currencies

markets. The yield curve will have to be re-priced to reflect inflation risks. Financial repression will stage a come-back and the Greenback will start to weaken precisely at the point when most investors are limit long USD. Expect considerable wobbles along the way.

The return of inflation in the QE countries also marks a critical turning point in the outlook for non-QE currencies. The world's central banks will suddenly find themselves desperately short of credible reserve currencies (roughly 97% of global reserves are invested in the four QE currencies: USD, EUR, GBP and JPY).

Central banks will strongly favour exposure to larger EM currencies over smaller ones due to their preferences for liquidity. The Chinese RMB will emerge as the strongest currency in the world. The appreciation of larger EM currencies will create strong disinflationary pressures and hurt EM exporters, so EM central banks will cut rates. Investors should therefore seek to receive rates in the bigger EM local bond markets.

The falling USD should help to push commodity prices higher. Smaller EM countries and frontier economies with heavy commodity dependence will benefit in this environment – they will be good destinations for equity investors. EM as a whole has to become more domestic demand-driven, so generally investors should favour small cap over large cap equities.

The 'Eastern Slope' stage of the global currency trade is likely to play out over a decade or more.

The Kilimanjaro trades

Western Face (2011 - 2015)

- Technicals dominate
- USD ↑ 40%
- EM FX ↓
- EM Bond yield elevated

Summit (2015 - 2016)

- Value opportunity in bonds
- More balanced view for EM FX vs USD

Eastern Slope (2017 onward)

- Fundamentals re-assert themselves
- USD ↓
- EM FX ↑
- Bullish Bonds in large EM markets
- Volatility in global currencies
- Re-emergence of new global reserve currencies

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