Issued: October 2019

MARKET COMMENTARY

Ashmore

Low EM inflation: the gift that keeps on giving

By Jan Dehn and Gustavo Medeiros

Emerging Markets (EM) inflation set a new cycle low in September. Due to falling inflation, bond yields in real terms have barely budged in the past decade, while developed market bonds trade with negative real yields across the board. This paper represents an update on EM inflation and local currency bond yields and what their implications are in terms of returns going forward.

The paper then takes a very close look at the outlook for EM currencies over the coming years. Based on current valuations, EM local bonds should return close to 30% compounded over the next five years, but in US Dollar terms returns could be as much as 20% higher if, as we expect, a slowdown in the US and continuing weakness in productivity growth begin to weigh on the Dollar.

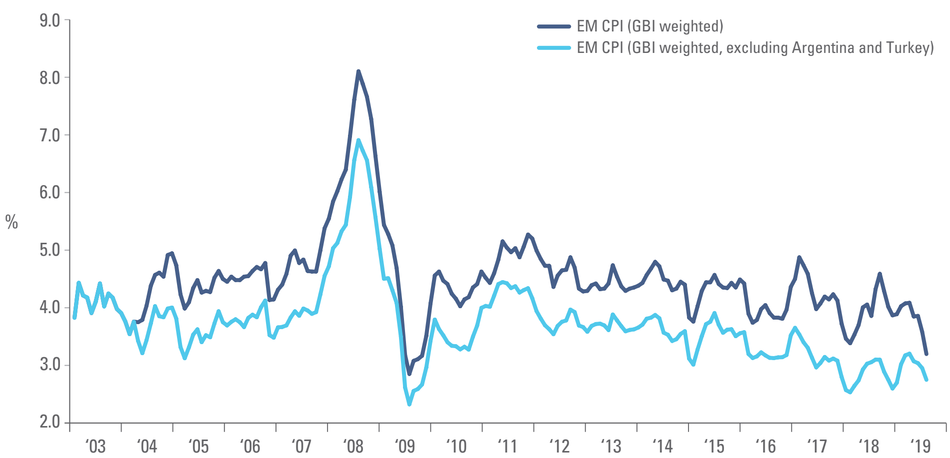
The paper also discusses the main risk to a bearish view of the Dollar over the medium term.

EM inflation at 10-year low

At the end of September, year-on-year CPI inflation as weighted by the JP Morgan GBI EM GD fell to 3.2%. This is the lowest inflation rate in the history of the index except for a brief spell during 2008/09. The inflation rate is even lower at 2.7% yoy after excluding the 'inflation sinners' Argentina and Turkey from the index (Figure 1).

Inflation is declining sharply in EM

Fig 1: **CPI inflation weighted by GBI EM GD (% change yoy)**

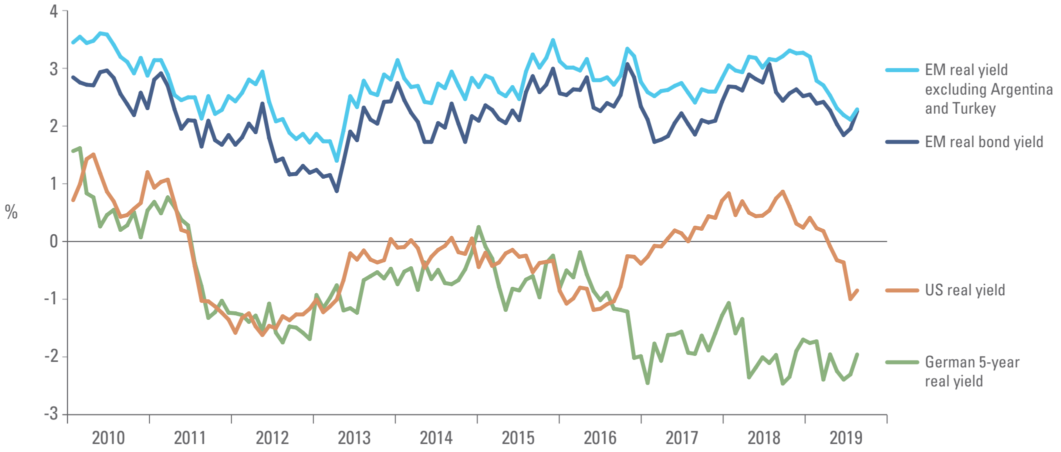


Source: Ashmore, JP Morgan, Bloomberg. Data as at 30 September 2019.

'Normal' real yields in EM

Record low inflation is intriguing in the context of the meaningful nominal yield available on EM local currency bonds of 5.4% as of end-September, which implies a real yield on bonds of 2.2%, i.e. mid-range for the past decade (Figure 2). The 'normal' real bond yield on EM bonds stands in sharp contrast with real yields in Europe and the US, which are and have been negative most of the time since the start of Quantitative Easing (QE). Put it differently, the current index-weighted yield is consistent with a Fed funds rate around 4.0%, which is excessive since the Fed funds rate is at 2.0% and widely expected to decline as the US economy slows.

Fig 2: **Real bond yields (5-year duration)**



Source: Ashmore, JP Morgan, Bloomberg. Data as at 30 September 2019.

Better return prospects

Return forecasts are buoyed by high real rates

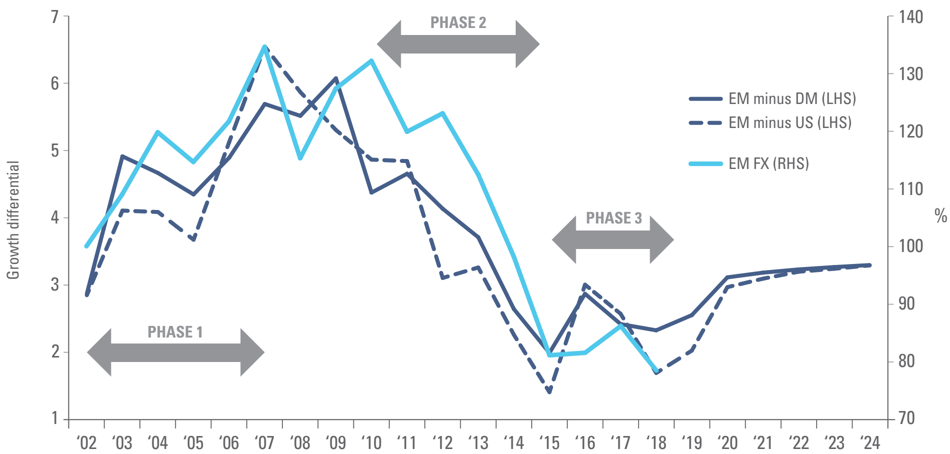
EM local bond markets dramatically outperformed the US bond market in recent years. As at 8 October, EM local currency bonds were up 9.4% year to date, in Dollar terms, compared to 6.1% for US five-year Treasuries. Since the start of the Fed hiking cycle in December 2015, the annualised return on EM local currency bonds has been 7.5% compared to 2.6% for US five-year bonds.

In our opinion, the outperformance of local currency bonds is likely to continue going forward. Investors in EM local currency bonds can expect to be paid a compounded return of 29% over the next five years, assuming no yield compression. By contrast, investors in US bonds have to hope for capital gains from yield compression in order to offset losses arising from negative real yields. The situation is far worse in Europe. Of course, developed market bonds may well realise capital gains if their economies slip into recession. Even then, however, the large yield differential still makes it hard to see how developed market bonds can outperform on a sustained basis.

What about FX?

The performance of EM currencies versus the Dollar has a significant effect on total return for foreign investors in EM local markets. Since the inception of the GBI EM GD in December 2002, EM currencies have moved through three distinct phases. Phase one - between 2002 and 2009 – saw EM currencies appreciate 30% versus the Dollar. Phase two between 2011 and 2015 saw EM currencies decline by 50% versus the Dollar. Phase three, EM currencies have been broadly stable versus the Dollar (1.2% annualised depreciation) since the Fed started to hike rates. The light blue line in Figure 3 shows index-weighted EM FX versus the Dollar and the arrows denote the three phases.

Fig 3: **EM FX and the EM-DM growth differential**



Source: Ashmore, IMF, Bloomberg, JP Morgan.

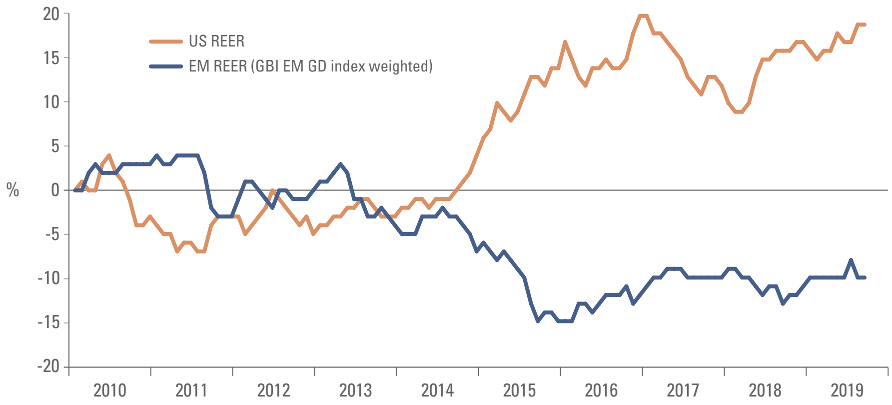
Continued overleaf

The big question facing investors is where EM currencies go next. Based on growth fundamentals, EM currencies will appreciate about 20% versus the Dollar over the next five years. The dark lines in Figure 3 show the forecasts from the International Monetary Fund (IMF) for the growth differential EM versus US and EM versus developed economies more broadly for the next five years. The IMF expects this growth differential to grow in favour of EM mainly due to slower growth in developed economies. Faster EM absolute and relative growth should be currency supportive as capital tends to flow towards high growth economies, which also tend to have higher interest rates.

Currency valuations also lend support to expectations of a recovery in EM currencies. As Figure 4 shows, the real effective exchange rate for the US has appreciated by about 20-25% versus EM real effective exchanges rates (on a GBI EM GD weighted basis) since 2010. Investors pushed up the nominal Dollar over this period as they partook in the 420% rally in US stocks since QE began.[1] Meanwhile, EM nominal exchange rates fell 50%. US inflation has also been broadly stable over the period, while EM inflation has declined outright albeit from a higher starting point. The net effect has been to significantly depreciate EM currencies in real terms relative to the real Dollar.

EM FX is undervalued and likely to rebound

Fig 4: **The real price of the Dollar and EM currencies (GBI EM GD weighted)**



Source: Ashmore, Bloomberg, JP Morgan. Data as at January 2019.

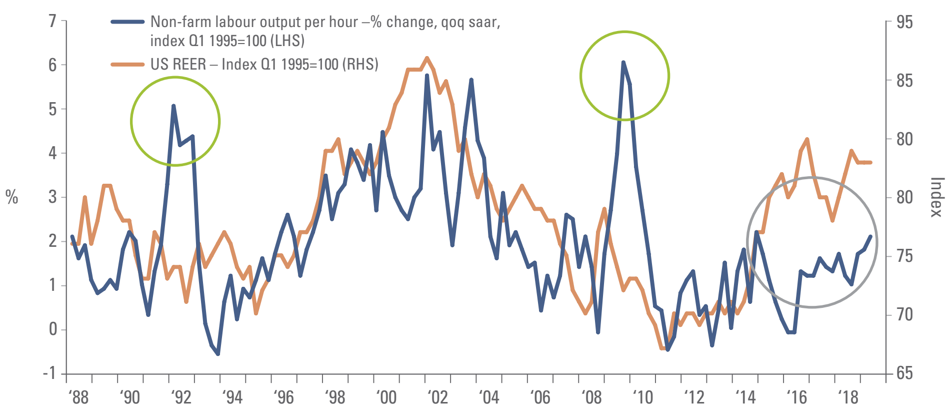
EM does not drive the Dollar – what does?

While value arguments – such as fundamental currency cheapness and better growth prospects – ought to support EM currencies. In reality, such arguments often fail to move markets. So many investors take such a dim view of EM local markets that they need stronger arguments before they venture forth. Particularly US investors need compelling arguments for Dollar weakness to leave the comfort of the world's main reserve currency.

Low US productivity rates to drive the USD down

The single most important driver of the Dollar over longer periods of time is changes in US productivity growth, as can be seen in Figure 5. The Dollar has tended to strengthen when US productivity growth picks up and *vice-versa*. This relationship makes sense; higher productivity boosts US corporate earnings, which increases the attractiveness of US stocks relative to the rest of the world. As capital flows into the US, the Dollar rises.

Fig 5: **US Dollar (real) and productivity growth**



Source: Ashmore, Bloomberg. Data as at March 2019.

[1] S&P 500 total return from 9 March 2009 to 10 October 2019.

The important exception to this general rule is recessions (green circles in Figure 5), when US productivity growth increases, but the Dollar declines. Recessions tend to generate temporary spikes in productivity, because high levels of unemployment temporarily force members of the work force to work harder for less pay. However, recessions have no impact on long-term productivity growth.[2] Rather, in recessions the Dollar is driven by corporate earnings, which turn negative and prompt foreign investors to leave the US equity market, thereby pushing down the Dollar. Indeed, unless the world has changed profoundly it is likely that the next US recession will also see the Dollar decline and productivity spike for a time.

An odd and unprecedented discrepancy

Since the Dollar began its increasingly rapid ascent in 2011, an odd and unprecedented discrepancy has emerged between where the real Dollar was currently trading and the level of US productivity growth. As the black circle in Figure 5 indicates, the real Dollar now appears to be about 20% overvalued relative to current US productivity growth.

Needless to say, it is critical for the return prospects for investors in EM local bond markets how this gap is closed, i.e. whether the Dollar declines to the level of productivity, or vice-versa. Our view is that the most likely scenario is that the Dollar falls back towards the current level of productivity growth. If so, the five-year total return for EM local bonds is boosted from 29% (compounded yield) to 49% with 20% coming from currency appreciation versus the Dollar. US business cycle dynamics and the US fiscal stance are the two most important variables that are likely to lead the move lower in the Dollar. But how?

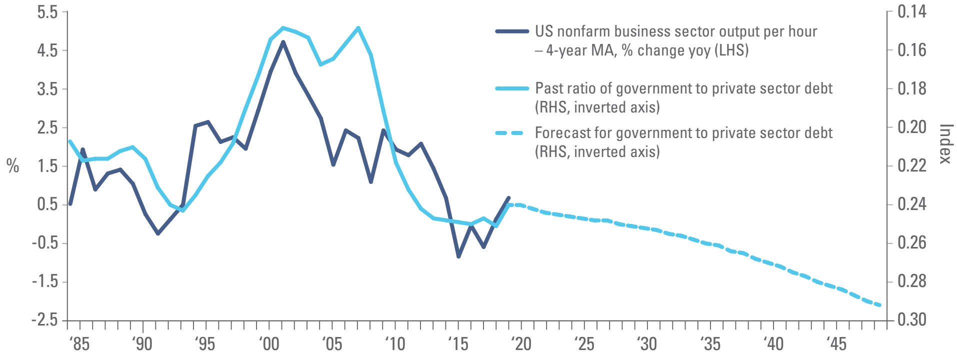
Productivity malaise: US government is crowding out the private sector

First, a downturn in the US business cycle is likely to impact the Dollar negatively by reducing foreign demand for US equities. Much of the overseas money currently invested in US equities arrived over the last decade predicated on a bullish view of the US economy and expectations of higher rates than in Europe. As growth slows and the Fed cuts rates, corporate earnings fall and the interest rate differential with rates elsewhere declines. The US slowdown has already started after a decade of expansion. Manufacturing and services activities are slowing and the US growth rate halved over the past year. High levels of political uncertainty (erratic Trump leadership and impeachment risk) as well as protectionism increase the risk of recession. Ominously, US corporate default rates have doubled this year, albeit from a low level.

When the next US recession arrives, we expect it to be of a conventional variety, a whimper rather than a bang. Fed cuts lower net interest margins, which leads to lower lending and therefore less investment spending. Strains gradually emerge up in the corporate sector and unemployment rises leading to lower consumption. However, the next recession may be longer than normal. The Fed cannot cut enough to get growth back, fiscal policy is constrained by tensions between the White House and Congress and there are no reforms planned. QE will also be less effective at today's elevated equity valuations, especially against a backdrop of falling corporate earnings.

Turning to the impact of the US fiscal stance on productivity growth, consider Figure 6, which shows that US productivity growth tends to decline when the ratio of government to private sector debt rises. When the highly unproductive US government issues more debt to finance its deficit, it takes away funds that could otherwise have been invested in the very innovative, flexible and dynamic US private sector. The net effect is to lower productivity growth. Based on the Congressional Budget Office's latest trajectory for US government debt, the American economy could subside into outright negative productivity growth within the next ten years under the inexorable rise of the public debt burden.

Fig 6: **Forward projection for US productivity growth based on CBO's forecasts for US public debt**



Source: Ashmore, CBO, Bloomberg.

[2] Recessions may in fact weaken long-term productivity growth by temporarily slowing investment rates.

The main upside risk for the Dollar

The main risk to the base case expectation of a gradual decline in the Dollar is that the US economy experiences some kind of a productivity miracle akin to the 1990s (the sustained rise in the blue line in Figure 5). A productivity miracle enhances the competitiveness of US companies to the point where Dollar strength poses no impediment to an economy, which is strong enough to grow out of its debt problem. A productivity miracle would re-ignite global investors' faith in the US stock market and push up the Dollar as they join the rally. The Dollar could easily rise another 20% in this scenario. This would detract significantly from returns in EM local markets. Indeed, even if investors locked in a compounded return of 29%, the 20% loss from FX would reduce their total return to just 9% over five years (29% less 20%). We regard a productivity miracle as a low probability event. Growing fiscal deficits, rising income inequality, trade protectionism and the approaching recession, all suggest that the 'good' productivity growth is not around the corner.

Conclusion

The slowing US economy, as well as the prospect of ever larger fiscal deficits, are likely to conspire to push down the Dollar on its own terms over the next few years. As the Dollar pulls back, investors will contemplate opportunities outside the Dollar zone.

There is a wealth of opportunity in EM local bond markets, where yields are too high, currencies are very cheap, growth prospects are superior and, as we have shown at the start of this report, inflation is now setting new lows.

We expect returns of nearly 50% in Dollar terms in local bond markets over the next five years with 20% coming from currency appreciation as EM currencies emerge from the deepest plunge in their history.

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE
T: +44 (0)20 3077 6000
@AshmoreEM
www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Dublin
T: +353 1588 1300

Jakarta
T: +6221 2953 9000

Mumbai
T: +9122 6269 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

Other locations
Lima
Shanghai

Bloomberg page
Ashmore <GO>

Fund prices
www.ashmoregroup.com
Bloomberg
FT.com
Reuters
S&P
Lipper