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MARKET COMMENTARY

Ashmore

The green light for EM local markets just got significantly greener

By Jan Dehn

The US mid-term election outcome was broadly in line with expectations as the Democrats took control of the House of Representatives, while the Republicans retained the Senate. The surprise, if any, was the greater than expected margin of victory for the Democrats in the House.

The uncertainty surrounding the US mid-term election is now out of the way. More balanced US politics should prove supportive for EM currencies versus the Dollar

The most obvious implication for Emerging Markets (EM) is that the second of three major risks, which have been holding back investors from returning to EM local markets in H2 2018, is now behind us (and has had a favourable outcome). The first of these risks was the Brazilian election (which also had a fortunate outcome from an investment perspective). The third and final risk this year is position squaring, which typically occurs towards year-end, but which has no lasting or fundamental implications. In short, the green light for EM local markets just got significantly greener.

In addition to eliminating an important source of uncertainty, the passing of the mid-term election has three additional implications, which are also broadly positive for EM. First, the US political horizon now lengthens to two years as politicians begin to focus on the 2020 election. The key to success in 2020 is to keep the US economy going, so rationally Republicans should now push the Trump Administration to pursue more cautious economic policies, particularly with respect to trade. Secondly, the overall political landscape will clearly become noisier as Democrats look to launch various investigations into Trump. Thirdly, although the probability of additional fiscal stimulus is far from zero, since the Democrats may support infrastructure spending, the likelihood of very large stimulus measures has now declined. For example, Trump's promise of a 10% tax cut for the middle class now looks dead. As such, investors could consider lowering their expectations of US growth and the Fed may do so as well. The probability of recession is also higher at the margin. All in all, these factors will weigh on the Dollar and give support to EM currencies.

Looking ahead to the next two years, the *probability* of an imminent US recession is clearly not very high, but it is rising. Big stock market corrections, such as the one in September/October, are fairly reliable indicators of slower future growth. Even if the probability of imminent recession is still low, investors should pay attention to *risk* of recession (probability times cost), which is far higher due to the very limited room for additional stimulus.

Recession, while not quite *guaranteeing* a turning point for the Dollar, implies a very high probability of a much lower Dollar. This is clear from Figure 1, which shows the history of the broad Dollar index (DXY) from 1970 until today, as well as US recessions (shown as vertical bars). The chart shows that all US recessions bar the 1981-1982 recession are associated with significant turning points for the Dollar. The Dollar can also turn without a recession, such as in 1984, which was due to the Plaza Accord, which ended a major Dollar overshoot, which would probably have pushed the US into recession had it not been corrected.

Fig 1: **US recessions and USD turning points**

Source: Ashmore, Bloomberg.

Continued overleaf

The Dollar looks expensive against a backdrop of weaker growth in the US over the next couple of years. A more serious slowdown could trigger a precipitous fall in the Greenback

It has not escaped anyone's attention that the Dollar has gone up over the past eight years since its last turning point after 2008/2009. This rally was due to inflows from global investors, who positioned for a strong and sustained recovery in the US economy, aided by zero-interest rate policies, Quantitative Easing (QE), massive fiscal stimulus (40% of GDP) and bank recapitalisation. Positioning in Dollars is enormous after such a long rally, but if the economic outlook turns less positive, then clearly much of this money is in the wrong place and must move elsewhere.

Our view is that the Dollar already began to turn following the first Fed hike in December 2015. The broad Dollar is lower today than two years ago. Granted, the Dollar received a boost this year, especially versus EM currencies, but future economic historians will recognise this year's surge in the Dollar as a mere interruption in a longer-term decline attributable to election-related policy interventions. Neither the fiscal splurge nor populist trade policies form the basis for a sustained Dollar rally.

We expect the gradual unwinding of QE distortions in global currency markets to resume in 2019 and that the Dollar should decline about 20% versus EM currencies over the next few years almost regardless of what the US economy is doing, barring a major productivity miracle, which seem unlikely. Of course, if recession strikes – which is clearly a tail risk – the fall in the Dollar could become far more precipitous.

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