Ashmore

ANNUAL OUTLOOK 2013

Market Prospects

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Summary

When the European Central Bank decided to join the other big central banks of the HIDCs (Heavily Indebted Developed Countries) in underwriting their governments' bond markets – indeed their entire economies – by printing money the most immediate tail risks in Europe receded. This promises a less unstable global backdrop for Emerging Markets in 2013. As a result and due to other supportive factors we expect stronger Emerging Markets growth in 2013. We think Emerging Markets are likely to expand about 6% in real terms this year.

In contrast, it is likely to be another year of growth disappointments in the HIDCs. Politicians understand that their political survival demands that they take action, so we expect 2013 to be a year of greater political activism in the HIDCs. Most of this activity will be displacement activity, that is, noisy but largely harmless actions intended to distract voter attention away from failures to tackle tougher productivity challenges.

The resulting delay in the recovery of the HIDCs will be positive for Emerging Markets as increasingly sceptical (and underweight) investors continue to allocate to Emerging Markets. But the risk of more draconian policy action in some HIDCs is growing as patience with gradualism – and its fig-leaf of displacement activity – begins to wear thin.

A more decisive move away from the current policy status quo, where outcomes hinge on the relatively predictable holding actions of HIDC central banks, to a more aggressive policy environment would usher in a far wider set of possible scenarios. This is because outcomes then depend on high quality leadership, Emerging Markets central bank reaction functions, and how the markets perceive new policies.

Our base case, however, remains that the broad macroeconomic framework will hold for another year. In particular, we do not expect global imbalances to unwind this year, though the risk of a major realignment in global currency markets is material and rising. Global currency realignment will feature far more prominently on everyone's radar screens at the end of 2013 than it did at the end of last year.

A year of stronger Emerging Markets growth

Global growth declined in 2012 due to a sharp slowdown in Europe. This resulting inventory correction in global manufacturing affected Emerging Markets and HIDCs alike. Meanwhile, elevated European tail risks, the US election, and the fiscal cliff issue also contributed to uncertainty. In China, the economy slowed due to the leadership transition and ongoing efforts to steer the economy towards consumption led growth.

Many of these drags on Emerging Markets growth in 2012 are set to fade somewhat in 2013. The ECB's successful intervention last year significantly reduced perceived European tail risks, supporting business and consumer confidence, though the Italian and German elections this year will likely influence sentiment. The US election and the fiscal cliff issue are behind us though debt ceiling issue remains unresolved. Global manufacturing is picking up.

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Against this backdrop, we expect Emerging Markets to grow 6% or more in 2013 compared to just over 5% in 2012 and 6.5% in 2011. We also expect Emerging Markets to grow at or around this trend in the years immediately beyond 2013.

As 2012 showed, Emerging Markets do not rely on strong HIDC growth to have strong growth of their own. The bulk of growth in Emerging Markets is due to domestic factors.[1] Emerging Markets are not saddled with excessive debt loads, a number of countries are undertaking significant reforms, and last year's monetary easing in many countries should bear fruit this year in terms of higher growth.

China is already showing signs of getting back to work following the leadership transition. India has resumed reforms with positive implications for growth, currency, and government popularity.

[1] The origin of strong domestic demand growth drivers in Emerging Markets is now nearly a quarter of a century old. Strong domestic demand can be explained in terms of better fundamentals. Fundamentals are better due to better policies. Policies are better because politics is better. And politics is better because Emerging Markets voters – who have no access to social security, unemployment benefit, or inflation hedges – demand stability and growth. This bottom-up political pressure in favour of prudent policies has resulted in sustained sound policy across most Emerging Markets countries since the end of the Cold War. Emerging Markets strength is not a flash in the pan, it is the manifestation of a natural process of global economic convergence made possible by the secular improvement in EM politics following 1989.

Russia is well underway to launching its euro-clearable OFZ market amidst a broader rotation towards flexible exchange rates.

And Brazil is set to triple its growth rate in 2013. Asia in particular should be well supported by the pick-up in global manufacturing.

Emerging Markets are trading more with each other; financing more with each other. Their demographic factors and wealth accumulation each year helps to further reinforce domestic demand as a growth driver. As Emerging Markets currencies appreciate against HIDC currencies it is likely that intra-EM trade will expand even further as countries tap into each other's much stronger import demand without loss of competitiveness vis-à-vis one another.

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Emerging Markets opportunities in 2013

At the start of 2013, Emerging Markets assets are no longer as grossly mispriced as they were at the start of 2012. At the same time none of them are expensive, in our view.

Consider Emerging Markets sovereign debt. In spread terms, this asset class still trades at nearly 50% wider spreads versus US treasuries than in 2007. It is quite remarkable that the market has *sold* Emerging Markets government bonds and *bought* HIDC bonds in net terms in the years following the outbreak of crisis, despite what we have learnt about the relative health of Emerging Markets and the HIDCs over this period. Or maybe we have not. It is worth reiterating that Emerging Markets are growing many times faster than the US, have many times less debt, far, far stronger external balances, and none of the major structural challenges facing the US in the coming years. Emerging Markets also have significant diversification benefits, of course.

In 2013, Emerging Markets sovereign debt will also be supported by very low net issuance. We expect only about $10bn-$15bn of net new issuance. At the same time, we expect another 3-4 new issuers to enter the asset class this year, taking the investable universe to just under 60 countries by the end of the year. Indeed, under the radar Emerging Markets sovereign debt is undergoing a renaissance as more and more frontier markets enter the global capital markets.

Corporates remain the most dynamic asset class in Emerging Markets. Net issuance is nearly 10 times faster than sovereigns. Cheap compared to HIDC corporates and of better quality, Emerging Markets corporates are one of the most efficient ways to gain exposure to the great global convergence of Emerging Markets with richer countries. The critical avenue of convergence is precisely via corporate access to term financing in global markets. Term financing allows corporates to exploit hitherto inaccessible medium and long term investment opportunities.

Turning to local markets, local currency government bonds pay nearly 500bps more than equivalent duration US government bonds. Correlation with US treasuries is very low, and volatility of yields is lower. The universe is 90% investment grade and set to reach a size of $20trn by the end of this decade. Local currency bonds have very substantial currency upside ahead of major global currency realignment in the coming years, in our view. Bonds should benefit directly from strong currency appreciation to the extent that currency appreciation prompts Emerging Markets central banks to cut rates.

We see an outside chance that the $4trn universe of local currency corporate debt will finally get an index in 2013, though the lack of an index should not deter investors from participating in this space, in our view.

Emerging Markets currencies and equities are both likely to perform strongly in 2013. They are cheap compared to the other Emerging Markets asset classes, compared to their own past valuations, and compared to their counterpart asset classes in the HIDCs.

Since the deeper fundamental economic factors, which drive currencies remain temporarily becalmed by the deadening cloak of HIDC deleveraging it is our view that local currency assets in Emerging Markets, including equities, today embed significant upside value via FX.

Despite less global instability than last year, we nevertheless expect regular bouts of volatility in 2013 due in large measure to the natural tension between weak HIDC fundamentals and QE-inflated HIDC asset prices. Emerging Markets equities and currencies in particular will be affected by such volatility, equities because they are still quite correlated with HIDC equities, currencies because they have become the market's favourite means of expressing risk sentiment.

Periodic HIDC risk-off events provide excellent entry points for Emerging Markets investors, in our view. They not only temporarily cheapen Emerging Markets assets with no significant increase in risk, they also create temporary distortions in the relative value of different Emerging Markets asset classes. These distortions can most efficiently be exploited in a portfolio of blended debt, in our view.

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No change in the HIDCs

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Major challenges exist in all the major regions of the HIDCs. The US still faces a few years of deleveraging in the private sector and has yet to commence fiscal adjustment in earnest. Fiscal policy is set to tighten in the UK in the coming years. Europe's banks and businesses will remain zombies pending major banking sector recapitalisation, which looks unlikely in 2013. And Japan is now more than two decades into the doldrums and showing increasing signs of desperation.

Right across the HIDCs, investment rates remain extremely sluggish. This despite corporate balance sheets bulging with cash

and extraordinary stimuli from the government and central banks. The reason is the following: HIDC businesses rightly perceive the existence of uncertainty well beyond the familiar 'known unknowns' of conventional business cycles. The current macro environment is unprecedented, its probability distribution unknown, so businesses cannot calculate odds or hedge risks. The optimal investment strategy is to invest nothing. There is no sign that this damaging variety of uncertainty is set to disappear in 2013.

Turning to specific HIDCs, in 2013 we think the United States is likely to have another '2%-year', that is, 2% inflation and 2% real GDP growth. Consumption and growth continue to be held back by a combination of household deleveraging, fiscal drags, political deadlock in Washington, and, hence, questions about long-term fiscal and monetary issues.

The recent improvement in the housing sector, a bright spot, will continue this year, but residential investment is still at such a low base that housing will not even come close to offsetting the drag from modest fiscal adjustment.

Household deleveraging is also making progress, now past the halfway point. But on current trajectories we do not see the household debt to income ratio return to pre-crisis levels until 2015 or 2016. With unemployment – a key concern of the Federal Reserve – also remaining elevated throughout 2013, we see the Fed maintaining extraordinarily easy policies in 2013.

Meanwhile, America's long-term fiscal challenges are rapidly drawing closer. US public debt rose by more than 40% of GDP in the first four years after the crisis. By the end of the second Obama administration, we expect the United States to have a public sector debt overhang approaching 50% of GDP. By then, the once distant challenges of social security and health-care deficits will have become current concerns. There are no plans to deal with these issues.

Meanwhile, in Europe the growth outlook is even more tepid, though we expect to see some positive year-on-year base effects push numbers back in black in the second half of 2013. But this is merely a statistical quirk: Europe's growth challenge is its insolvent banks, and the solution does not look imminent.

The key to unlocking European growth is wholesale bank recapitalisation. Euro-TARP is a real potential game changer, because healthy banks lend to corporates, corporates then invest and hire workers, unemployment falls, household incomes rise, and ultimately consumption and growth begins to pick up.

The creation of a pan-European banking regulator is therefore an extremely important step in the direction of Euro-TARP. But bank recapitalisation looks a very tall order in 2013. The political cost of channelling billions of euros to unpopular banks is enormous. At best, Euro-TARP could happen after the German election in September 2013, but our base case is that it will not happen in 2013. Failure to recapitalise Europe's banks at all puts the continent firmly on a path towards Japanisation, in our view.

Displacement activity

The failure to grow after more than four full years of slump is becoming an increasingly serious political problem. Unemployment is now the hottest political issue in the HIDCs. Politicians understand that they must act, if only to conceal their impotence. We are likely to see a plethora of displacement activities in the HIDCs this year – actions taken in lieu of dealing with the real fundamental issues, either due to unwillingness or inability.

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There are numerous examples of how governments unable to tackle bigger issues look elsewhere – and almost inevitably involving foreign policy: UK EU membership, Scottish independence, secession demands in Spanish regions, tit-for-tat in the South China Sea, military intervention in Mali, etc.

Low-level antagonism makes headlines, but need not have any lasting impact on the overall investment environment other than to delay the recovery. This ought to be supportive for Emerging Markets as increasingly skeptical, impatient, and underweight investors continue to allocate away from HIDCs and into Emerging Markets.

Global Imbalances: Another year of phony currency war in a fixed income world

As we have argued, lack of reform, the drag from deleveraging, and supportive actions of central banks are likely to help to keep both growth and inflation rates in the HIDCs low and stable this year. Policy rates can therefore stay low too. In turn, HIDC government bond yields and major currency crosses should remain within established ranges.

The constellation of low growth, low inflation, and low interest rates is one we have dubbed a 'fixed income world'. It is a world of regular bouts of volatility on account of the juxtaposition of weak fundamentals and QE-inflated asset prices.

But it is also a world whose entire foundation rests on something as fickle as money, or, more precisely, the credibility of money. As more and more HIDC central banks have turned to aggressive printing of money and politicians shy away from tackling the real underlying issues in favour of displacement activity the risks that the 'fixed income world' unravels is inexorably rising.

The risk of draconian policy changes is rising

One of the threats to the deceptive calm of the 'fixed income world' is that growth-challenged governments opt for the spectacular over the mundane as political disillusionment with gradualism mounts.

Roosevelt crashed the US out of its deflationary malaise in 1933 with a truly massive five pronged medicine comprising nationalisations, fiscal stimulus, wage and price controls, currency depreciation, and extreme monetary easing. The intervention broke deflation expectations. The dollar dropped from $24 to $35 per ounce of gold. A year later the economy was recovering. On the other hand, controlled recklessness failed spectacularly in the Weimar Republic, though in both cases currencies adjusted sharply lower.

Is controlled recklessness what Prime Minister Shinzo Abe has in mind in Japan? Our base case is that Abe's ambitions exceed his means. With less than 30% of support among voters and less than perfect influence over the policies of the Bank of Japan Abe's policies could well fail to decisively shift deeply entrenched expectations of asset price deflation in Japan. This means that

Japan would fall back into the old groove after a short period of unfounded optimism. Without support from fundamentals, moves higher in USDJPY quickly burn out and eventually reverse.

The importance of Japan lies in the demonstration effect. Abe's aggressive rhetoric has reminded other HIDC politicians that the range of available policy options is far wider than hitherto appreciated. The idea that 'controlled recklessness' could shift inflation expectations and dispatch economies onto paths of recovery via inflation and export-led growth supported by significantly weaker currencies must surely be attractive to any politician in the stagnant HIDCs. The question is whether it is possible to control recklessness.

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The risk is clearly that inflation expectations overshoot to the upside and that government bond markets collapse as markets push yields sharply higher. The exit from the S&L crisis in 1994 did precisely this – crashing the US government bond market. Given huge debt overhangs, market reactions could force central banks right back into QE in a bid to stabilise yields. The result could be an extreme version of stagflation, where countries start to trade like distressed credits, and where currencies have far more downside. It is going to be important to closely watch Japan's experiment this year.

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The sum of all fears

Central bank support of HIDC bond markets, while positive, has introduced new and greater systemic macroeconomic risks to the global economy.

Money printing by the Federal Reserve, the Bank of England, the European Central Bank, and the Bank of Japan now underpins not only the solvency in their respective government bond markets, but also their economies, and indeed stock market valuations in what amounts to half of the world. Central banks are trying to achieve many more objectives than they have policy instruments. No one knows whether and how they will exit. No serious attempts are being made to address underlying fiscal and structural rigidities.

It is extraordinary to contemplate the riskiness of this situation, which would simply not have been conceivable just a few years ago. The potential damage from a loss of currency credibility in the HIDCs today is nearly unfathomable; it is the true 'elephant in the room' of global macroeconomics.

Unsurprisingly, the gradual slide towards monetisation of HIDC debt does not sit easy with Emerging Markets central banks, whose reserves are disproportionately invested in the HIDC bond markets. Emerging Markets central bank views are extremely important, not just because they are large holders of HIDC debt, but also because they sit at the very heart of the global monetary system. Emerging Markets central banks control 80% of the world's foreign exchange reserves.

For example, the stability of the Dollar over the past few years is entirely due to the good neighbourly behaviour of Emerging Markets central banks, which have actively supported both the Dollar and US treasuries during the tough early stages of the crisis. Since 2008/09 Emerging Markets bought more than $2trn of US treasuries.

Debt overhangs are now so large in many HIDCs that they are increasingly unlikely to be able to fix them by fiscal effort alone. It is therefore increasingly likely that the HIDCs will escape their excessive debt burdens via currency weakness, then inflation.

Not tonight dear, I've got a HIDC!

The amicable relationship which evolved between HIDC governments and Emerging Markets central banks in the immediate aftermath of the 2008/09 crisis is likely to come under further strain this year, in our view.

Emerging Markets central banks have patiently stood by as the US and other HIDCs governments accumulated significant amounts of public debt since the crisis. We estimate that debt overhangs now amount to between 30% and 50% of GDP. Many countries have far larger private sector debts, which could yet migrate to public balance sheets via bank bail outs. Moreover, our forecast is for the debt overhangs to continue increasing over the next few years.

But the debt overhangs are now so large in many HIDCs that they are increasingly unlikely to be able to fix them by fiscal effort alone. Deeper reforms also look unlikely. In the US Congress is deeply divided. Germany has an election in September. France is not inclined towards particularly business friendly policies. And the UK is saddled with a weak coalition and huge question marks over relations with Europe.

It is therefore increasingly likely that the HIDCs will escape their excessive debt burdens via currency weakness, then inflation. Indeed, this is probably an understatement. In our view, most HIDC central banks are trying desperately to achieve this very outcome. The US is now on QE Infinity, the Bank of England is onto credit QE, the ECB has committed to doing 'whatever it takes', Switzerland has pegged the CHF to the Euro, and, as discussed above, Japan has signalled much more aggressive easing.

Inflation is, of course, default by other means. Weaker currencies stimulate exports and growth and shift losses to Emerging Markets central banks.

Emerging Markets are not going to go gently into that good night.

There is a non-negligible risk in 2013 that one or more or the larger Emerging Markets central banks turn to active selling.

A system destined to fail

The markets still deem the main HIDC currencies to be credible. For now, this is keeping exchange rates within wide but stable ranges. Emerging Markets central banks are also still being good neighbours, only diversifying reserves passively.

But there is a non-negligible risk in 2013 that one or more or the larger Emerging Markets central banks turn to active selling. China just established an office specifically to oversee a more rapid diversification away from HIDC currencies. Others will likely follow China's lead.

It is not just a question of policy. The very fabric of the global monetary system has within it the seeds of its own destruction. The Triffin Dilemma, an important economic insight named after the Belgian economist, says that major reserve currencies, such as the Dollar are inevitably destroyed by their own success. This happens because the country issuing the reserve currency necessarily racks up ever larger public sector liabilities in order to export its currency to surplus countries. And these liabilities eventually undermine the currency.

The system of global imbalances – exemplified by the stock of excessive public debts in the HIDCs and the stock of excess foreign exchange reserves in the Emerging Markets – are unsustainable. It is a system, which forces Emerging Markets central banks to keep their currencies artificially weak by currency intervention, resulting in a massive build-up of foreign exchange reserves.

Yet, in our opinion it is unlikely that Emerging Markets central banks will continue to build up reserves. It is also unlikely that they will buy another $2trn of US treasuries. Not only do they incur a huge opportunity cost in terms of foregone domestic consumption and investment, the sterilisation cost is also huge. We estimate that the annual cost of sterilizing the reserves in Emerging Markets central banks is now the equivalent of Finland's GDP. But as we enter 2013 the most important concern may be that the riskiness of HIDC government debt and currencies is simply becoming too high.

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