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MARKET COMMENTARY

Ashmore

The big bad imbalance: EM FX vs. US dollar positioning

By Jan Dehn

Investors are rightly taking a fresh look at adding Emerging Markets (EM) exposure after nearly a 12 month EM bear market. Technicals are better, valuations attractive, and EM has shown fundamental resilience in the face of shrill media pessimism and two 'taper-tantrum' related outflows.

Still, one thing holds back many potential investors from putting money to work in EM, namely the fear of currency volatility. That EM FX is volatile should surprise no one, but are investors really right to fear it to the extent that they avoid investing entirely?

We think not. In fact, we think the fear of EM FX volatility is both irrational and dangerous. EM FX volatility is lower than EURUSD volatility and returns are greater.

More importantly, the fear of EM FX volatility is contributing to big imbalances in global currency positioning in favour of the Dollar and against EM currencies at a time when strong macroeconomic forces suggest investors should position the other way around.

The best way for investors to protect the purchasing power of their assets and to ensure against the impending fall in the Dollar is to exploit the current (extreme in our view) pessimism about EM FX to reduce their exposure to Dollar assets.

More volatility, less trend

Amidst the overspun reactions from the tabloid media and investment banks in response to each little change in sentiment, data release, or marginal policy change, it's easy to forget that global currencies have displayed extremely strong mean reversion since 2008. Hugely powerful fads have caused massive swings in currencies. These have included the European debt crisis, 'Abenomics', and – most recently – the obsession with a strong dollar and weak EM FX on the argument that the US will grow faster and tighten policy, while EM will descend into crisis. Whether these fears turn out to be real or merely fads is largely irrelevant in the heat of the moment; the point is that many investors believe them and that is all you need to get the herd moving. Hence, by flogging these stories you can stimulate greater trading volumes and sell a lot of newspapers.

Reality is quite different. The salient feature of global currency markets since 2008 has in fact been the absence of significant structural shifts and trends. The underlying reasons are actually fairly obvious: Growth, inflation, and policy rates have been low and stable in developed economies since 2008, so there are few directional drivers of currencies in play. And the sentiment about EM has faced significant headwinds, including general investor myopia, strong preferences for liquid assets, financial repression, and risk aversion.

Thus, EURUSD has 'obeyed' a 1.20-1.50 range since 2008. The Dollar index DXY has gyrated around the 80 level since 2007. And EM currencies have shown few signs of the strong trends that preceded the crisis.

The disappearance of trends has reduced the returns from holding currencies. The annual return to long positions in EURUSD declined from 1.9% prior to 2008 to -0.4% post-2008, while EM currency returns fell from 10% per year prior to 2008 to 2.0% in the post-2008 period. At the same time, volatility has increased.

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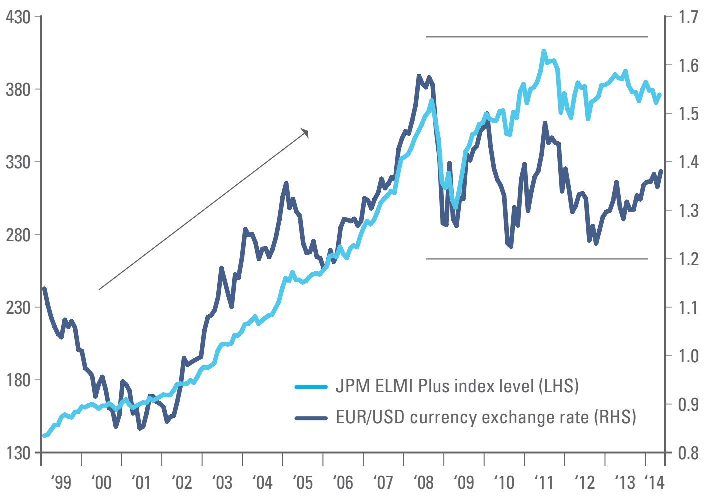
EURUSD carry adjusted volatility has risen from 9.7% to 10.9%, while EM FX volatility has increased from 4.6% to 7.8%.

This combination of lower return and higher volatility is unambiguously negative for currency investors and has reinforced a bias in favour of larger, more liquid currencies – that is, away from EM FX. This trend has also been amplified by negative EM sentiment. As such, it is actually surprising – and telling – that the 'safe haven' Dollar has not performed better than it has, given all its tailwinds and very low US inflation.

Figure 1. **Trend has given way to volatility in global FX**

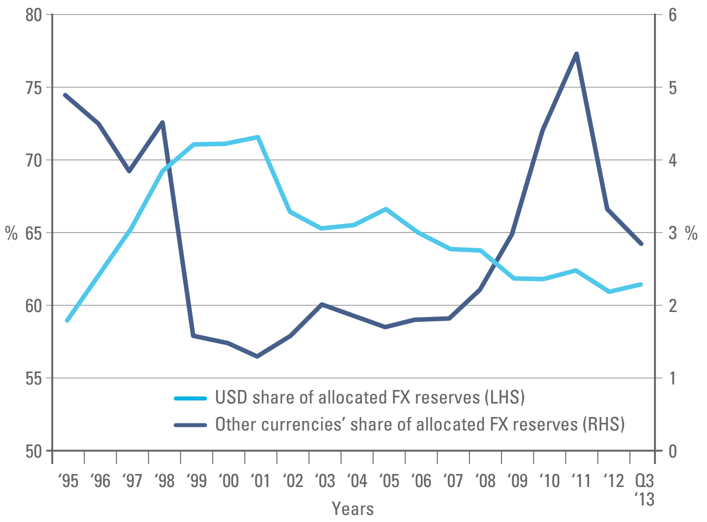


Source: JP Morgan, Bloomberg, Ashmore.

The big technical

The shift out of EM FX into more liquid currencies, notably the Dollar, is evident. For example, central banks have slowed the process of reserve diversification significantly. Central bank allocations to 'other currencies' – which include EM currencies – have sharply reversed over the past two years, while the Dollar's share of allocated FX reserves has stabilised around the 61% level after years of steady decline. Central banks today control USD 11.4trn of reserves and clearly remain extremely exposed to a potential Dollar realignment.

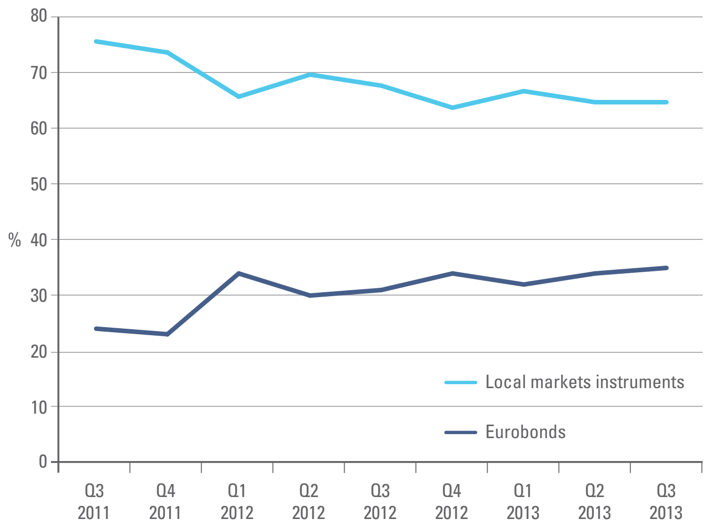
Figure 2: **Dollar and other currencies: Shares of global allocated FX reserves**



Source: COFER IMF.

Information collected by the Emerging Markets Traders Association (EMTA) also shows that trading volumes in local instruments have declined from 76% of total trade volumes in Q3 2011 to 65% by Q3 2013, while trading volumes for (largely dollar denominated) Eurobonds have increased from 24% of the total to 35% over the same period. This change has occurred despite much more rapid expansion of the local markets in issuance terms, underlining the broad shift in market making from Wall Street to local markets.

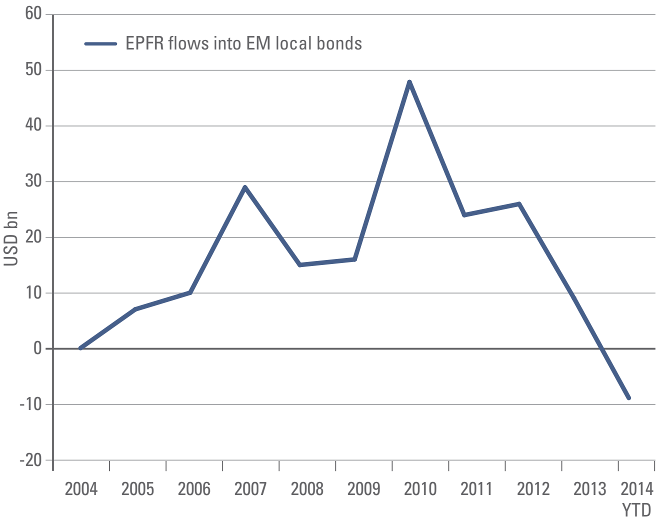
Figure 4: **Trading volumes have fallen in local bonds and risen for Eurobonds**



Source: EMTA.

Retail investors have also been reducing EM FX exposure. EPFR data shows that two thirds of all outflows this year have been from local currency bond funds. There is no breakdown for flows in rates versus FX, but most of the funds tracked by EPFR are GBI-EM benchmarked vehicles, which involve both rates and FX exposure.

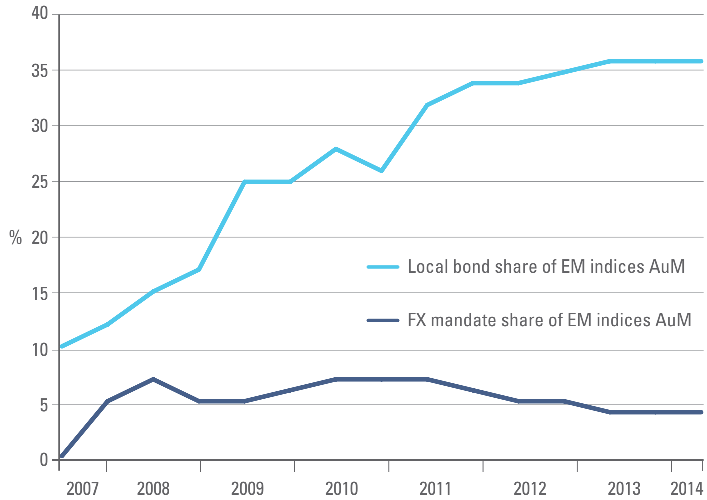
Figure 3: **Retail investors have fled local bond markets even as these markets have continued to grow**



Source: JP Morgan, Ashmore.

Finally, data from JP Morgan shows that growth in the amount of AuM tracking in its local currency bond indices has slowed to a near halt, while assets benchmarked to pure EM FX indices have declined outright. Given the poor performance of local markets in 2013 and the tendency for many institutional investors to allocate based on past performance, it is likely that these trends will continue for some time.

Figure 5: **Investors are ignoring Local Bond and FX assets**



Percentage of AuM benchmarked to JP Morgan local bond (GBI) and FX (ELMI+) indices.
Source: EMTA.

In short, central banks' 'other currencies' exposure is down, retail local exposure is down, FX mandates are down and the share of local bonds in total EM AuM has flat-lined. While these sources are by no means comprehensive they do tell a consistent story of investors fleeing local exposure, often specifically citing FX volatility.

It is noteworthy that the reduction of international investors' exposure to EM FX is taking place against a steady increase in the total universe of local currency fixed income assets in EM. For example, we estimate that the local currency government bond universe will have increased from a known size of USD 6.5trn at the end of 2012 to about USD 8.4trn this year.[1] Foreign involvement has in no way expanded sufficiently fast to match this rate of growth. In other words, when we consider the total stock of EM FX denominated assets the share that is locally held is rising.[2]

This build-up of long Dollar positions due to fear of EM FX volatility is important, because it increases the risk of a disorderly and potentially very damaging fall in the Dollar. After all, currencies can only move in a really big way if positioning is highly concentrated in favour of some currencies and against others.

Why fearing EM FX volatility is irrational

The irony of all the flight from EM FX is that investors can actually reduce their overall exposure to currency volatility and increase returns by increasing their exposure to EM FX, particularly if they do so at the expense of their exposure to developed market currencies.

The table below shows that the Sharpe ratio of EM currencies is consistently better than EURUSD for all major periods since 1993. We are basing these numbers on the carry-inclusive returns for EURUSD and JP Morgan's ELMI+ index (which began in 1993).

Return, volatility, and Sharpe Ratios for EURUSD and ELMI+

EURUSD	1993 - 1998	1999 - 2007	2008 - Today
Annual return	0.6%	1.9%	-0.4%
Volatility	9.8%	9.7%	10.9%
Sharpe Ratio	-0.25	-0.12	-0.31

ELMI+	1993 - 1998	1999 - 2007	2008 - Today
Annual return	6.8%	10.0%	2.0%
Volatility	6.0%	4.6%	7.8%
Sharpe Ratio	0.63	1.53	-0.13

Source: JP Morgan, Ashmore.

Why EM FX pessimism is dangerous

The build-up of long Dollar positions versus EM FX is taking place at a time of rising macroeconomic risks to the Dollar (and in favour of EM currencies).

Indeed, there is an eerie inevitability about the big build-up in long Dollar positions. A big technical imbalance in favour of the Dollar is necessary in order to bring about the eventual Dollar debasement needed to reduce the US debt burden by 200% of GDP. There have to be major long Dollar positions to be unwound for this to happen.

The Dollar therefore offers a distinctly dangerous, false sense of security. Investors are now at risk of being sucked into adding further to Dollar longs, reducing already light exposures to EM FX exposures precisely at a time when we believe inflation – and ultimately Dollar weakness – is approaching in the US.

We think it is inevitable that developed economies will experience an extended period of higher inflation. Thirty years of debt-fuelled consumption followed by nearly a decade of rampant money printing is unlikely to give way to a smooth return to long-term equilibrium. Business cycles will return with a vengeance. Inflation can be expected to resurface as soon as household deleveraging is over.[3]

The Dollar is especially at risk because of its status as the dominant global reserve currency. This confers onto the US the extraordinary privilege of being able to pass the cost of adjustment onto foreigners by debasing its currency.[4] The risk of this happening to the EUR and JPY is much lower, because they are not global reserve currencies (meaning much of the currency is held by foreigners).

The macroeconomic case in favour of EM currencies remains entirely intact: EM has better growth, lower debt, higher carry, and larger FX reserves. Of course, individual EM countries will have their ups and downs due to normal business and political cyclical dynamics. However, as a group, EM currencies stand to gain when the QE countries begin to generate the inflation required to reduce their debt stocks. Indeed, inflation expectations are normalising in EM following the macro-adjustment undertaken by some EM governments over the past year. By contrast, inflation expectations are only likely to rise in the US over the next few years.

A big unknown is how EM central banks will respond: They hold approximately USD 9trn of developed market currencies and bonds, far more than developed investors have invested in EM. EM central banks are likely to be required by their political masters to protect the purchasing power of their external reserve assets and this can only be done by resuming currency diversification. The unanswered question is whether they will coordinate their actions.

The better way

Long-term investors should not concern themselves too much about short-term volatility. Volatility is not the same as risk, especially in inefficient markets. Risk is all about large permanent loss. When it comes to currencies, this means purchasing power. EM FX forwards pay a decent yield – currently just under 4% for 56 days duration – but their main attraction is that they can help investors to protect the real value of their assets when the Dollar decline begins. Risks to the Dollar are approaching from two sides – the technical side and the fundamental side. The best way for investors to shield themselves against the impending falls in the Dollar is to exploit the current (extreme in our view) pessimism about EM FX to reduce their exposure to Dollar assets. Buying when things are cheap is, after all, the key to making returns. After a 12 month bear market in EM this is a great time to break away from the herd to buy cheap insurance against the impending Dollar crash.

[1] *'The Emerging Markets fixed income universe'*, The Emerging View, August 2013.

[2] Investment banks often publish figures that point to high and relatively stable foreign involvement in EM local markets. We do not dispute these figures, but they tend to measure only the foreign share of a subset of the EM local universe, usually securities traded by those banks or included in the main benchmark indices. EM fixed income indices only cover 11% of the total EM fixed income market cap.

[3] *'The Phony Currency Wars'*, The Emerging View, February 2013.

[4] See for example *'Disequilibrium and the Dollar'*, The Emerging View, May 2013 and *'A Pleasant Fiction'*, The Emerging View, September 2013.

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