Ashmore

Convergence in the time of imbalances

By Jan Dehn

In October's 'Emerging View' we discussed the outlook for Emerging Market fixed income from now into the medium term. This month we look further into the future to explore how global asset managers with long-term investment objectives should position for the unwinding of the global imbalances.

In our view, the single most important long-term economic issue facing managers is how to help preserve the real value of assets, when the global imbalances begin to unwind. Emerging Markets will face particular challenges when the HIDCs (Heavily Indebted Developed Countries) begin to inflate and devalue their way out of debt.

We anticipate Emerging Markets to continue to converge with richer countries, but asset allocation across themes within Emerging Markets will change significantly and credit calls will become more important for alpha generation.

Happy 23rd, Convergence Process!

When East German border guards opened the border crossings to West Berlin in November 1989 they also kick-started a massive global convergence process. Up until that point, poor countries had been falling further and further behind rich countries due to bad policies. Policies were bad because politics were bad. And politics were bad because of the Cold War.

The end of the Cold War started a political transition in Emerging Markets. Super-power sponsored puppet regimes gave way to home-grown and largely democratic governments. Poor electorates demand stability and growth, so political success suddenly depended on delivering steady improvements in living standards, and that required better policies. In the 1990s, Emerging Market voters supported a decade of fiscal adjustment and deleveraging. In the early 2000s, they supported policies to introduce inflation targeting, to establish pension systems, to build domestic yield curves, and to accumulate foreign exchange reserves. Today they are supporting prudent debt management in the face of record low borrowing costs. The results have been impressive:

- Emerging Markets have ten times less external debt than the HIDCs
- Domestic financing sources now exceed foreign financing by a factor of ten
- Emerging Markets are growing 5% per year five years into worldwide growth crisis
- Emerging Markets de facto control global currency markets as holders of 80% of the world's foreign exchange reserves

But global imbalances are still growing…

What are the global imbalances? In our view, they are a stock problem of excessive stocks of debt on the part of the HIDCs and excessive stocks of foreign exchange reserves on the part of Emerging Markets. The stock imbalances are the accumulation of years and years of excessive spending in the HIDCs financed by bond purchases by Emerging Market central banks.

The global imbalances have widened dramatically in the years since Lehman, because neither side wished to see a disorderly dollar crash or a blow-up in the Treasury market. HIDCs embarked on expansionary fiscal policies to help avoid depression with the result that public debt levels exploded. For example, US public sector debt has increased by 40% of GDP in just four years. President Obama's re-election suggests that recent policies will continue.

Emerging Markets supported the HIDCs by buying dollars and US treasuries through currency interventions and participating in auctions. They also stimulated their economies with rate cuts at the first sign of growth fears. Foreign exchange reserves in Emerging Markets have risen by an average of 13% per year between 2009 and 2011.

…But all good things come to an end

The global imbalances can run for a bit longer, but, in our view, they are fundamentally unsustainable for three reasons:

First, HIDC fiscal policies are not sustainable. It is not possible to increase public debt indefinitely. Several HIDCs have already hit the debt buffers. Others will likely default slowly to future generations via financial repression, to savers via inflation, and to foreigners via currency depreciation.

Second, Emerging Market central bank policies will not continue to be supportive indefinitely. Emerging Market central banks will not buy another $2trn of US treasury bills. Their reserves already average 27% of GDP, money which could be used for consumption and investment. Sterilization costs now exceed the annual GDP of Finland each year. Indeed, the entire premise for QE rests on the idea that government bonds will not suffer significant losses, but it is only a question of time before this condition no longer applies. Interest rates will rise and the dollar will decline in response to rising inflation.

Thirdly, consumer spending will eventually recover. This will be positive for investor sentiment and trigger selling from extremely distended positions in so-called 'safe haven' currencies, especially the US dollar. Non-dollar G10 currencies such as CAD, AUD, NZD, NOK, and SEK will rally strongly alongside the larger Emerging Market currencies, such as Mexican Peso, Chinese Yuan, South African Rand, and Korean Won as central banks still put too much weight on liquidity over diversification.

The return of consumer spending also restores the link between money supply and inflation. When inflation expectations rise against a backdrop of historically low rates and sky-high public debt this is just bad news for bonds. For this reason, it is not a homerun for equities either; rising government refinancing costs, massive losses on central bank balance sheets, and interest rate volatility will be challenging for investment and push yield curves into bear steepening mode, and will likely trigger a second wave of debt crises in the most vulnerable HIDCs.

Timing

While not an exact science, we believe that US consumer demand should pick up around 2016, when household debt to income levels potentially return to the 90% pre-crisis level. Consumption should also be picking up in Europe around the same time if, as we anticipate, Euro-TARP materializes and begins to ease refinancing for Europe's firms and hiring starts again. 2016 is also the year the Fed is signalling that it might raise interest rates. This is unlikely to be a coincidence.

A big currency adjustment

By 2016 the stock of US public debt is expected to be nearly twice as big as is consistent with healthy trend growth in a typical developed economy. The scale of the problem – 50% of GDP – is too large to be solved by fiscal adjustment alone. Congress is unlikely to support deeper fiscal reform and the Fed is focused on its employment objective. Inflation and currency adjustment will do the dirty work. Again.

The Bretton Woods system of exchange rates collapsed following US Treasury Secretary John Collany's famous comment that "the dollar is our currency, but it's your problem". There was not enough gold and the dollar depreciated from $35 per ounce of gold to $189 per ounce in just four years.

It is immaterial that today the dollar is not pegged to gold. When any single country's currency is the global reserve currency the only way that currency finds its way to other countries is through ever-wider deficits, but as the deficits widen the reserve currency itself is undermined, destroyed by its own success. It is therefore not a question of whether, but rather when the US dollar falls. And as the main holders of the world's reserves it is down to Emerging Market central banks to decide the timing.

Competition or coordination – the challenge for central banks

If each central bank narrowly seeks to preserve its currency from appreciation against the dollar it is quite possible that the world will head towards a very disruptive real as opposed to phony currency war. This would be one Emerging Market central bank versus another in tit-for-tat competitive interventions, each seeking to protect its competitiveness.

Emerging Market central banks can help to unwind the global imbalances in an orderly fashion only if they coordinate. They must recognize that they all need to appreciate together against the HIDC currencies. The good news is that Emerging Market central banks are already actively buying each other's currencies as they diversify out of dollars and Euros. But the process is still very young.

Emerging Markets in the Great Unwind

All Emerging Markets governments face the same central challenge of how to balance inflation risks if they resist currency appreciation with the short-term growth risks if they revalue and reform.

Voters will make this choice. Most will likely continue to vote for policies, which ensure stable inflation and sustainable growth, i.e. reform and currency appreciation. But it is not an easy choice. China's growth rate has declined from 12% to 7.5% and inflation has declined from 6% to less than 2% as China seeks to rotate from export to consumption led growth. Vested interests object (witness the Bo Xilai saga). But the pay-off will be that China's next big growth epoch lies just a few years ahead.

Brazil, India, Panama, and Indonesia are focusing more on infrastructure investment. Mexico, Colombia, Peru, and Uruguay have reformed to increase economic flexibility. Central banks from Nigeria to South Korea are diversifying foreign exchange reserves. Corporate bond markets – key to increasing productivity in the private sector – have been developing faster than any other market in the world. But some will be late to the game. Others will miss the boat altogether. Country calls will soon become far more important to alpha generation in Emerging Markets than has been the case in recent years.

We would expect that the countries that have historically shown the strongest bottom-up pressure in favour of long-term sustainable policies will perform the best. Those with unrepresentative governments or intractable domestic political conflicts will struggle.

Asset allocation in the Great Unwind

Our strongest convictions for asset allocation during the Great Unwind are the following:

- **Rotate strategically to local currency bonds from hard currency bonds.** Economic reforms increase the non-inflationary rate of growth and prompt central bank easing. In the context of stronger currencies this is an ideal set of conditions for local currency bonds. The universe of local currency government bonds may grow to USD20bn by 2020, making it more liquid. Yields have been higher and more stable than US Treasuries or German bonds (a diversified local currency bond portfolio with 5-year duration pays 500bps more than a US 5-year Treasury bond). Local bonds are also uncorrelated with US treasuries and German bonds due to different investor bases (some 80% of local currency bonds are owned by local institutions).
- **Favour selective exposures to dollar securities.** So-called higher beta countries and corporate high yield bonds trade with sufficient spread cushions to make them attractive even in the face of rising treasury yields. Opportunities outside the narrow confines of the indices also present upside in a world of low convictions and high risk aversion. New issuers from Frontier Markets are likely to benefit strongly from a better global growth environment and add diversification and capital gains.

- **Insure against dollar weakness with outright long positions in Emerging Market FX.** The phoney currency war gives way to material dollar weakness. Currency appreciation is likely to be most strongly felt in the larger Emerging Markets due to the strong liquidity preference of central banks, strengthening the case for being long local bonds in these domestic bonds markets.
- **Frontier Market Equities.** Higher global growth rates, higher commodity prices, and relatively less currency appreciation due to the smaller currencies makes for very benign conditions for equities in Frontier Markets, particularly in Africa.

Sources: Bank of International Settlement, IMF, OECD, Reinhart & Rogoff 2011, US Treasury, Ashmore.

Contact Information

Ashmore Investment Management (US) Corporation
122 E 42nd Street, 50th Floor, New York, NY 10168
T: 212 661 0061
F: 212 661 0334

www.ashmoregroup.com

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