

# Going dotty over the Fed

By Jan Dehn

China eases liquidity conditions in a bid to ease the effects of reforms, including interest rate liberalisation. Russian consumers are happy and the Russian stock market becomes Euroclearable. Polls continue to show Marina winning in the second round of the Brazilian elections. Ukraine's parliamentary approval of a roadmap for EU accession lowers default risk, in our view. S&P downgrades Venezuela. Panama and Costa Rica replace Denmark as the happiest countries on earth, but why are the happiest countries always the smallest countries?

Emerging Markets	Index level/ yield	Spread over UST	1 week change	Global backdrop	Index level/yield/ FX rate/price	5 business day change
MSCI EM	1,045	—	-0.97%	S&P 500	2010	1.34%
MSCI EM Small Cap	1,092	—	-0.37%	VIX Index	12.11	-14.24%
MSCI FM	706	—	0.62%	5 year UST	1.81%	2 bps
GBI EM GD	6.63%	—	0.03%	10 year UST	2.57%	-2 bps
ELMI+	3.37%	—	-0.20%	US HY	5.96%	0.27%
EMBI GD	5.31%	270 bps	0.03%	European HY	4.70%	0.19%
EMBI GD IG	4.46%	181 bps	0.24%	EURUSD	1.2851	-0.63%
EMBI GD HY	7.21%	478 bps	-0.37%	USDJPY	109.05	1.70%
CEMBI BD	5.22%	286 bps	0.10%	Brent	96.17	-0.39%
CEMBI BD HG	4.38%	199 bps	0.07%	Copper	320.52	0.90%
CEMBI BD HY	7.07%	475 bps	0.16%	Gold	1215.06	-1.62%

Additional benchmark performance data is provided at the end of this document.

## Emerging Markets

- **China:** PBOC, China's central bank, extended a CNY 500bn 3 months liquidity facility to China's top five commercial banks. In addition, the central bank lowered its 14-day repo rate by 0.2% to 3.5%. The backdrop for this move is that China is in the process of liberalising interest rates, which is causing interbank liquidity conditions to tighten and the economy to slow. We think growth in the 7-8% range is likely this year following 7.7% growth last year. In order to smooth the transition to market-based interest rates, the PBOC is actively aiding liquidity and targeting easing measures specifically at vulnerable sectors.
- **Russia:** August saw retail sales in Russia accelerate to 1.4% yoy from a 1.2% yoy rate of growth in July. Hence, despite the Ukraine-related noise, the domestic economy has so far not suffered greatly, though there is likely to be an economic price to pay over the longer-term on account of higher interest rates and falling investment spending. In a positive development, inflation declined from 0.2% wow to 0.1% wow in the week to 15 September and, in another positive development, Russia's equity market has now been granted full Euroclearable settlement. This brings equity markets in line with bond markets that transitioned to Euroclearable settlement in 2013. Euroclearability increased foreign holdings in the Russian OFZ bond market from 2% prior to the change to 25% in July this year.
- **Brazil:** The latest poll from Datafolha, a credible pollster, places President Dilma Rousseff in a clear lead for the first round of the upcoming presidential election in Brazil, but still predicts opposition challenger Marina Silva to win in the second round 46% to 44%.
- **Ukraine:** Ukraine's government has submitted a bill that would grant special status to the Donetsk and Luhansk regions. Talks continue in the Minsk crisis group, although armed confrontations have not entirely ended. Rebels and the government have agreed a no-fire zone. Gas talks involving Ukraine, EU, and Russia may now go ahead in Berlin on 26 September. In another notable development, Ukraine's parliament approved a roadmap for EU accession. Appetite for another sovereign default in Europe is low following Cyprus and Greece, so EU accession lowers but does not eliminate the risk of sovereign default in Ukraine, in our view. The US may back another USD 1bn Eurobond from Ukraine following President Poroshenko's visit to the US last week.

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## Emerging Markets

- **Venezuela:** S&P downgraded the sovereign foreign currency rating of Venezuela to CCC+, indicating that the agency feels that Venezuela has a 50% chance of defaulting within the next two years. The main rationale for this verdict is greater dependence on high oil prices given the ever more populist direction of economic policy in Venezuela. However, S&P is having its cake and eating it too by noting that Venezuela's oil production continues to be crucially dependent on working capital from global markets, which therefore gives the country a strong incentive to pay. We would add that the political elite in Venezuela also has strong private incentives to perform on external debt given the enormous FX rents conferred to those able to issue Dollar bonds. Finally, we note that the country's net debt burden is 24% of GDP, less than one quarter of the public debt to GDP ratio of the United States.
- **Panama:** The economy expanded by 6.3% yoy in Q2, up from 6.0% in Q1. No wonder, then, that Panama has replaced Denmark as the happiest country in the world, according to a poll undertaken by Gallup and Healthways Global. Costa Rica also overtook Denmark to become the world's second happiest nation. According to entirely unscientific proprietary research undertaken by Ashmore, one should not take international comparisons of happiness too seriously. We find that they tend to suffer from strong small-country bias. One possible reason why small countries tend to rank very highly in happiness polls is of course that small is beautiful. However, we suspect that the real reason is that small countries often experience a sense of vulnerability by virtue of their small size. By conveying the impression of broad-based contentment in international happiness comparison studies, small countries exude unity and thereby strength. But this outward appearance of happiness may in fact be a kind of mimicry, i.e. a thinly disguised defensive strategy aimed at giving the impression that the country can punch above its actual weight in a hostile world of large countries.

## Global backdrop

For much of past week the market obsessed about the wording of the FOMC statement ("considerable period"), but ended up being wrong-footed by the dots (the individual FOMC members' forecasts for the Fed funds rate). The dots moved higher supporting a further sell-off in the US treasury market, which in turn caused the Dollar to strengthen, particularly against JPY, but also against EM currencies. Thus, the global sentiment in Q3 has finally begun to resemble the expectation for Q1 of this year – namely stronger US growth, higher US treasury yields and a long-anticipated lift-off for the Dollar.

It would be fair to say that the US is in a better position to escape the challenges made evident by the 2008/2009 crisis than, say, Japan or Europe. After all, the US has several advantages in the shape of a fully recapitalised banking system, a more flexible economy, and the global reserve currency. A low take-up of the ECB's targeted LTRO this past week is a sign of low credit demand in the broader European economy (though there may also be technical factors at play). This underlines the difficulty Europe faces in this recovery, largely due to European politicians' failure to tackle underlying structural challenges.

Yet despite the better fundamental story in the US it is likely that the path towards normalisation of US monetary conditions will be a great deal slower and somewhat more complicated than implied by the market's enthusiasm for all things American this past week.

In particular, the market continues to ignore both inflation risks and the painfully high levels of debt. Naturally, a return of inflation would spur the Fed towards raising rates sooner, but the economy's indebtedness will act as a brake that limits the extent to which the Fed can raise real rates. This is why both inflation and debt are so pertinent.

The market is currently ignoring both inflation and debt. Indeed, it is tempting to believe that the debt problem is a thing of the past. After all, US household deleveraging has progressed a long way and we expect household debt to income ratios to return to pre- Greenspan Bubble levels of around 90% by H2 2016. Unfortunately, the US economy has hardly deleveraged in aggregate. A big chunk of debt has merely been moved from the balance sheets of households to the balance sheet of the government, while the overall debt burden is only down marginally.

A lower level of indebtedness of households is unambiguously a good thing, because consumers can be expected to spend more, thus helping GDP growth to accelerate. But stronger consumer spending will also make it likely that inflation resurfaces. Other factors also suggest that inflation could be back within the next two years. For example, unemployment is likely to be a great deal lower by 2016 (initial claims dropped to 280K last week), while we predict that home prices will have appreciated considerably more by then as QE-led financial asset price inflation spills further into real asset prices. Home price inflation is more likely to affect inflation expectations than stock prices, in our view.

By contrast, deleveraging of the economy as a whole will take much longer to achieve. This means that inflation is likely to arrive long before the economy as a whole has recovered from its 30-year debt binge. The arrival of inflation will therefore impale the Fed on the horns of a genuine dilemma. Does it prioritise higher real rates to kill inflation the moment it appears, or does it prioritise economic recovery by sacrificing some price stability in recognition of the large debt stock?

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## Global backdrop

The good news is that the Fed does not face this dilemma now. After all, inflation is still benign (core CPI was 1.7% in August versus 1.9% expected) and likely to remain so for another 24 months. During this time, there is plenty of scope for the market to jump on 'exit velocity', 'strong Dollar', and 'rate hike' bandwagons multiple times as, indeed, it is doing right now.

But such outbursts of exuberance are likely to be short-lived and in any case strongly related to positioning in the market rather than fundamentals. US rates are likely to be contained at relatively low levels for the foreseeable future. After all, the market has already priced a path towards normalisation, which is nearly as aggressive as that implied by the Fed 'dots', while low inflation in the near-term keeps the scope for major Treasury weakness in check. And since the economy is also not going to achieve 'take off velocity' under the current debt stock, current market conditions probably reflect an unwinding of the Treasury rally earlier this year rather than meaningful changes in the outlook, in our view. Indeed, if the US economy grows 3% in Q3 and Q4 the economy as a whole should deliver about 2% growth for the year as a whole after a weak Q1.

But when the Fed eventually does face the dilemma of rising inflation in the context of heavy debt, what will it do? We think the Fed will 'discover' good reasons to continue to be dovish and to justify a gradually higher inflation rate. Low real yields – which can be consistent with gently rising nominal yields – and rising inflation help the economy greatly by making debt service affordable, eroding away outstanding debt by inflation and by making exports more competitive through a weaker Dollar.

This, after all, is the whole idea behind QE, financial repression, and the other self-serving policies that have prevailed in developed countries since 2008/2009. Of course, healing would have been aided greatly if politicians in these countries had also taken advantage of the easy monetary conditions provided by central banks to raise GDP growth rates through supply-side reforms and other productivity enhancing measures such as infrastructure investment. But such policies have only been pursued to a very limited extent in the European periphery (reforms are far more prevalent in EM economies). The absence of supply-side reforms only shifts the path of adjustment towards more inflation.

Global markets are likely to be surprised by the arrival of inflation. It will be even more surprised when the Fed doesn't do very much about it. And it will be both surprised and suffer pain when the US yield curve bear steepens and the US dollar declines as a result. By the time these market developments take place we fully expect myopic markets to be positioned heavily for bear flattening of the yield curve in limit-long Dollar positions.

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-3.70%	7.50%	5.90%	6.60%	5.70%
MSCI EM Small Cap	-1.70%	11.20%	11.60%	8.00%	7.70%
MSCI FM	1.50%	22.60%	31.20%	16.70%	8.80%
S&P 500	0.46%	10.39%	19.15%	21.21%	15.87%
GBI EM GD	-2.77%	2.46%	-2.10%	2.12%	4.93%
ELMI+	-1.77%	-0.45%	-1.79%	0.42%	1.09%
EMBI GD	-1.25%	8.64%	9.47%	7.02%	8.29%
EMBI GD IG	-1.39%	8.66%	8.75%	5.43%	7.05%
EMBI GD HY	-1.00%	8.66%	11.04%	9.76%	10.24%
5 year UST	-0.88%	1.62%	1.28%	0.60%	3.41%
7 year UST	-1.37%	3.89%	2.82%	1.10%	4.83%
10 year UST	-1.94%	7.26%	5.93%	1.86%	5.65%
CEMBI BD	-0.51%	6.62%	8.55%	6.64%	7.72%
CEMBI BD HG	-0.66%	6.93%	8.58%	6.09%	7.20%
CEMBI BD HY	-0.21%	5.91%	8.46%	8.15%	9.24%
US HY	-0.85%	5.08%	8.58%	10.86%	11.65%
European HY	-0.41%	5.96%	10.83%	16.72%	13.81%
Barclays Agg	-2.43%	2.02%	2.30%	0.94%	2.90%

Source: Bloomberg, total returns. Figures for more than one year are annualised.

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### Fund prices

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