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WEEKLY INVESTOR RESEARCH

Ashmore

IMF view boosts global reserve currency prospects for Renminbi

By Jan Dehn

The significance of the IMF's view that China's currency is close to being fairly valued for the first time in a decade is that it brings the Renminbi a step closer to attaining global reserve currency status. Brazil returned to primary surplus in March, but the adjustment still has a long way to run. Russia's central bank cuts rates by 150bps. The door to Saudi's stock market opens on 15 June for large institutional investors. In the global section, we discuss the damage to the US economy caused by the strong Dollar and outline the policy options available to the Fed and the Treasury if markets continue to push the Dollar higher.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1043	–	-2.20%
MSCI EM Small Cap	1112	–	-0.88%
MSCI FM	603	–	0.15%
GBI EM GD	6.49%	–	-1.56%
EM FX spot	–	–	-1.27%
ELMI+	4.77%	–	-0.72%
EMBI GD	5.43%	327 bps	-0.66%
EMBI GD IG	4.23%	200 bps	-1.07%
EMBI GD HY	7.62%	559 bps	-0.05%
CEMBI BD	5.27%	333 bps	-0.26%
CEMBI BD HG	4.19%	223 bps	-0.49%
CEMBI BD HY	7.34%	542 bps	0.16%

Global backdrop	Index level/yield/ FX rate/price	5 business day change
S&P 500	2114	0.01%
VIX Index	12.85	3.55%
5 year UST	1.50%	10 bps
7 year UST	1.88%	13 bps
10 year UST	2.14%	13 bps
US HY	6.40%	0.01%
European HY	4.51%	-0.12%
EURUSD	1.1071	0.92%
USDJPY	120.3	1.13%
Brent	66.48	1.84%
Copper	291.75	13.75%
Gold	1188.78	-2.03%

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

Emerging Markets

- **China:** China's currency is close to being fairly valued for the first time in a decade, according to media reports of announcements by the IMF. The IMF's change of view, reported by *The Wall Street Journal* citing IMF officials, is significant because it adds further momentum to China's efforts to have the Renminbi (CNY) recognised as a global reserve currency.[1] An IMF committee responsible for deciding which currencies to include in the basket called Special Drawings Rights (SDR) meets every five years. The next meeting is later this year. Inclusion in the SDR would confer de facto global currency status to CNY. Meanwhile, China's sluggish growth continues at least as far as manufacturing is concerned. The official PMI was unchanged at 50.1 in April, while HSBC's PMI number – which captures more small and medium-sized enterprises – declined from 49.6 in March to 48.9 in April.

- **Brazil:** The government just managed to produce a primary surplus in March (BRL 0.2bn). While this was lower than expected, the government has now achieved 29% of its fiscal target for the year in the first three months. The 12-month rolling fiscal balance remains in deficit, but the 12-month rolling deficit declined from 0.7% of GDP in February to 0.6% of GDP in March. The primary surplus in March allowed the government to reduce net government debt from 33.8% of GDP in February to 33.1% of GDP in March. Current Finance Minister, Joaquim Levy, has to cut discretionary expenditure, such as investment, in order to rectify the mistakes made under former Finance Minister, Guido Mantega. The government will be under pressure throughout 2015 and 2016 to restore Brazil to fiscal health. Meanwhile, Brazil's central bank hiked rates by another 50bps to 13.25% with a completely unchanged statement, which implies a bias towards hiking further, though this may change if inflation momentum begins to show signs of having been broken. Unemployment rose sharply to 6.2% of the labour force in March from 5.9% in February. In another sign that domestic demand is responding to fiscal austerity and higher policy rates, the trade surplus was higher than anticipated in April at USD 0.5bn (versus USD 0.1bn consensus expectation).

- **Russia:** The central bank (CBR) cut the main policy rate by 150bps to 12.5% on the back of RUB appreciation, a slowing economy and well-anchored inflation expectations. The CBR indicated that more interest rate cuts are coming. The CBR raised rates to 17% late last year in a successful move to end an irrationally violent bout of risk aversion.

[1] See *"China moves ever closer to global reserve currency status"*, Weekly Investor Research, 2 February 2015.

Emerging Markets

- **Saudi Arabia:** Institutional investors with more than USD 5bn in assets under management will be granted access to the Saudi stock market in the first wave of liberalisation of the country's capital account. The market opens on 15 June. The gradual opening of the market with an emphasis on granting access initially only to large institutional investors is consistent with previous announcements and sensible policy. A 10% cap on holdings by qualified foreign investors implies about USD 57bn of total potential foreign demand. We expect the opening of the Saudi Arabian market will pave the way for inclusion in the MSCI EM index. While the Saudi weight in the index will depend on a number of factors, including the liquidity of individual stocks, a rough guideline suggests that Saudi will eventually be roughly 4% of MSCI EM or 21% of MSCI EM EMEA. These are significant numbers that illustrate the importance of the Saudi market within the wider Emerging Markets (EM) world.

Snippets:

- **Argentina:** Recent surveys put Daniel Scioli of the Peronist Party clear of opposition candidate Mauricio Macri. The latest poll, by M&F, gives Scioli 33% of voting intentions compared to 29% for Macri.
- **Indonesia:** April inflation rose to 6.8% yoy in April from 6.4% in March. The increase was directly related to gasoline and diesel price hikes by the authorities. Meanwhile, core inflationary pressures remain benign enough that Bank Indonesia has room to cut rates. Growth in Q1 was 4.7% yoy versus 4.9% yoy expected.
- **Mexico:** Banks are once again extending more credit to the private economy. Credit to the private sector was growing at a rate of 10.1% yoy in March compared to 8.2% yoy in Q4 2014. Unemployment declined to 3.9% in March compared to 4.8% a year ago. The trade balance was in surplus to the tune of USD 480m in March. This is roughly half of last year's surplus in March due to lower oil prices.
- **Philippines:** Inflation was 2.2% yoy in April versus 2.4% yoy expected. Core is 2.7% yoy.
- **South Korea:** The trade balance set yet another record of USD 8.5bn in April (USD 8.4bn in March) as imports declined faster than exports. Both imports and exports were down sharply. KRW has rallied sharply against JPY since the Bank of Japan (BOJ) stepped up QE operations. Industrial production weakened 0.4% in March.
- **Thailand:** The core inflation rate was 1.02% yoy in April versus 1.2% yoy expected. The headline inflation rate was -1.04% yoy compared to -0.9% yoy expected. The weaker than expected inflation numbers vindicated the Bank of Thailand's decision to cut rates by 25bps to 1.5% earlier in the week. Thailand's trade balance in March was USD 1.5bn versus USD 0.5bn expected.
- **Turkey:** Inflation was higher than expected. April's 7.9% yoy print exceeded expectations by 20bps and was largely due to food prices.

Global backdrop

The US economy expanded a mere 0.2% qoq annualised in Q1, or about 0.05% on a non-annualised basis. The economy would have been in outright contraction if it had not been for an inventory build, which will now likely detract from growth in the current quarter. It is tempting to – and we suspect the market will – dismiss the weak growth rate in Q1 as a blip due to weather effects and a port strike. The FOMC also took this line in a statement issued last week. The reality is that the weak growth number is just the latest manifestation of generalised economic weakness that has seen the US economy eke out just 2.2% real GDP growth per year since 2010, despite the backdrop of hyper-easy monetary policies.

Additionally, there is 'news' in the Q1 GDP number in that it is the first time that the strength of the USD has had a serious detrimental impact on the US economy with exports and investment accounting for the bulk of the lower than expected growth. Objectively, this should not surprise too much. After all, the USD has strengthened no less than 25% against the EUR, 37% against the JPY and 30% against EM currencies since 2011. The strong USD has also contributed to pushing down commodity prices by 38%, which has hurt some of the most investment intensive sectors in the US economy, such as shale.

The consensus forecast for Q1 GDP was five times larger than the actual number, yet this consensus number had already been revised down sharply from the expectations that prevailed at the tail end of 2014. The extent of the surprise shows that the market operates with naively optimistic assumptions about the US economy; the risks are simply not priced in.

The soft growth number in 2015 tells us that the USD is going to become a serious problem for the US economy, because most investors strongly believe that the USD will continue to rise against both the EUR and the JPY over the next couple of years – a view that is predicated on expectations of more easing from the ECB and BOJ and hikes from the Fed. If this is the case, then the Fed may have to hike even later than the market participants expect, perhaps as far out as 2016.

This view has granted the USD some relief in the last few weeks. Help also arrived from the German bond market, where a poor auction triggered a sharp backup in German yields last week. European government bond investors have experienced a strong rally since the start of 2014, but last week's price action wiped out about four years of carry. Again, this should hardly surprise given the level of real yields.

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Global backdrop

In addition to reminding investors of the obvious bubble in developed market fixed income, the rise in German bond yields and the stronger EUR also raise some interesting questions for the ECB. Recall that ECB President, Mario Draghi, embarked on QE principally in order to have in place a defence against a future European bond market rout caused by Fed hikes. On the back of weak US growth, the Fed is now likely to hike later than previously anticipated, so the ECB may well want to keep some of its powder dry. If not, the ECB's policies could easily be construed as deliberately targeting a weaker EUR, particularly since the European economy continues to perform well. Thus, a signal from the ECB now would be telling. Lesser dovishness would imply that the ECB is mainly concerned with Fed hikes and protecting Eurozone bond markets. Greater dovishness would imply that the ECB is more concerned with the stronger EUR. Ambiguity, of course, allows the ECB to have its cake and eat it too, so this points to a steady course from Draghi in the immediate future, barring major data surprises or extreme market moves.

Investors should be concerned about the stronger Dollar, though not because of its much touted, yet poorly supported, alleged negative implications for EM. Indeed, the evidence strongly suggests that EM benefits from a stronger Dollar.[2] Now that currency intervention by the ECB and the BOJ is beginning to have real-economy implications for the US, we may soon begin to see US businesses complain to their elected representatives about USD strength. If demands for protection from overseas currency intervention mount, US policy makers will eventually respond – whether it be via more QE, via trade protection or through a change in USD policy.

There would be no easy choice. QE would increase already serious bubble risks without doing much for the US' beleaguered exporters. Trade protection would provide targeted relief for the export sector but at the expense of a dangerous erosion of the overall quality of economic policy. Thus, strictly from a US national interest perspective, a weak USD policy may eventually emerge as the preferred choice. A weaker USD would:

- Neutralise deliberate currency intervention efforts by the Japanese and the Europeans
- Improve the competitiveness of US exporters
- Help the US to grow faster as the domestic economy battles with deleveraging
- Pass a great deal of the cost of deleveraging onto foreign holders of US debt, particularly EM central banks

It makes macroeconomic and political sense for the US to weaken its currency. Yet, with long-USD being the world's most crowded trade, a change in US dollar policy would be an even greater surprise than weak US growth. Whether it comes about through a deliberate change in policy on the part of the US Government or happens as a result of returning inflation, say, in late 2016 is anyone's guess. The outcome, however, is the same. Those with assets in USD will see the purchasing power of their wealth dramatically eroded. In our view, the best way to reduce exposure to this risk is to diversify steadily into the currencies of the world's largest reserve holders, because they will ultimately become the largest sellers of USD.

Market data	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	0.05%	10.17%	7.28%	4.02%	3.96%
MSCI EM Small Cap	-0.04%	12.95%	9.16%	7.37%	4.67%
MSCI FM	-0.11%	-0.03%	-6.35%	11.58%	5.41%
S&P 500	1.39%	3.34%	14.70%	18.06%	14.88%
GBI EM GD	-1.01%	-2.16%	-10.72%	-3.51%	1.23%
ELMI+	-0.43%	0.22%	-7.75%	-2.37%	-0.33%
EM spot FX	-0.75%	-4.46%	-17.08%	NA	NA
EMBI GD	-0.16%	3.51%	5.59%	5.09%	7.31%
EMBI GD IG	-0.29%	2.71%	6.94%	4.22%	6.65%
EMBI GD HY	0.02%	4.50%	2.77%	6.45%	8.31%
5 year UST	-0.35%	1.40%	3.42%	1.13%	3.39%
7 year UST	-0.58%	1.38%	5.25%	1.58%	4.97%
10 year UST	-0.93%	0.97%	7.25%	2.84%	6.51%
CEMBI BD	-0.06%	4.04%	5.20%	5.50%	6.30%
CEMBI BD HG	-0.18%	3.04%	5.95%	5.38%	6.39%
CEMBI BD HY	0.15%	5.93%	3.37%	5.92%	6.22%
US HY	0.11%	3.91%	2.07%	7.41%	8.77%
European HY	-0.04%	3.97%	4.95%	12.04%	11.14%
Barclays Agg	-0.37%	-1.24%	-4.26%	-0.36%	2.56%

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

[1] See *"The myth of Emerging Markets' vulnerability to external shocks"*, The Emerging View, February 2015.

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