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WEEKLY INVESTOR RESEARCH

Ashmore

The Fed turns to inflation

By Jan Dehn

The Fed's adoption of an average inflation target is important for EM investors; we explain why. The Weekly also provides updates on US-China relations, Chinese tech policy, Ecuadorian and Argentinian debt exchange, the potential for reforms in Oman, Peru's pension fund debacle, Malaysian trade, QE in Hungary, a change in the inflation target in Uruguay, fiscal worries in Brazil, and tensions between EU and Turkey over energy deposits in the eastern Mediterranean.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	13.6	–	-0.57%
MSCI EM Small Cap	12.1	–	1.03%
MSCI Frontier	12.8	–	2.53%
MSCI Asia	14.4	–	-0.20%
Shanghai Composite	12.6	–	0.30%
Hong Kong Hang Seng	7.7	–	-3.16%
MSCI EMEA	10.5	–	-2.02%
MSCI Latam	12.1	–	-1.32%
GBI-EM-GD	4.45%	–	0.93%
ELMI+	1.97%	–	0.79%
EM FX spot	–	–	0.95%
EMBI GD	5.06%	428 bps	-0.47%
EMBI GD IG	2.86%	203 bps	-0.96%
EMBI GD HY	8.16%	743 bps	0.13%
CEMBI BD	4.44%	388 bps	0.01%
CEMBI BD IG	2.99%	242 bps	-0.16%
CEMBI BD Non-IG	6.53%	597 bps	0.24%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	21.1	–	2.04%
1-3yr UST	0.13%	–	0.04%
3-5yr UST	0.27%	–	0.09%
7-10yr UST	0.71%	–	-0.25%
10yr+ UST	1.48%	–	-1.77%
10yr+ Germany	-0.40%	–	-2.19%
10yr+ Japan	0.00%	–	-0.21%
US HY	5.34%	477 bps	0.56%
European HY	4.96%	524 bps	0.21%
Barclays Ag	0.90%	19 bps	0.15%
VIX Index*	26.41	–	4.04%
DXY Index*	91.81	–	-1.21%
EURUSD	1.1989	–	1.50%
USDJPY	105.67	–	0.73%
CRY Index*	153.21	–	0.57%
Brent	45.7	–	-0.35%
Gold spot	1986	–	3.61%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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- **The Fed turns to inflation:** US monetary policy is important for many Emerging Markets (EM) countries for the simple reason that much of EM debt trades as a spread over US Treasuries, while the most liquid currency crosses in EM are versus the Dollar. As such, the announcement by Fed Chairman Jerome Powell that the Fed is abandoning its erstwhile inflation target in favour of a so-called 'average inflation target' should be taken seriously by EM investors.

The Fed's official rationale for moving to a de facto looser inflation target is that inflation has been running below target for some time, wherefore it should be possible to run the economy a bit hotter for a time and still maintain price stability, on average. This is, in our opinion, complete nonsense. Nerdy economists are fond of characterising average inflation targeting as having your head in the freezer and your feet in the oven; you are comfortable, on average. The problem with average inflation targeting is that inflation expectations do not assign much weight to inflation that happened ten years ago, but may respond quite significantly to the abandonment of an inflation target today.

So why is the Fed risking price stability? The answer is that the Fed is out of options. The only policy instrument still available to the Fed - which it has already employed ad nauseum over the past decade – is to print money to buy financial assets ('QE'). This is clearly problematic, because the Fed is supposed to manage the economy, not asset prices. Initially, QE had a positive impact on the economy when it was first introduced, but now it only inflates already dangerous asset price bubbles, encourages reckless government borrowing, precipitates Dollar over-valuation by inducing short-term capital inflows from abroad, and worsens an already alarming problem of income inequality on account of the skewed distribution of financial asset ownership.

The Fed's adoption of a new inflation target reflects its hope – naive or desperate, take your pick – that higher inflation may somehow induce Americans to believe that the economy is doing better. Sadly, this is not going to happen. For one, low inflation is not the key problem facing the US economy today. Aside from the temporary

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growth drags from the coronavirus shock and the US government's gross mishandling of the policy response to the pandemic, the real underlying reasons why growth is poor are that monetary policy ran into diminishing returns ages ago, the fiscal coffers are emptying, the debt burden is obscene, the business cycle very long in the tooth, there were no attempts to address any structural problems, and the Dollar is overvalued. As such, the Fed risks merely adding inflation to a long list of pre-existing conditions afflicting the US economy.

This is exactly what the market reaction to Powell's announcement would appear to signal. VIX, the equity options volatility index, spiked. Term yields also popped higher, so the bond market is clearly demanding compensation if inflation is going to rise. Unfortunately, higher term yields will hurt the US economy. If the bond market now proceeds to push yields up further then it becomes inevitable, in our view, that the Fed will be forced to intervene through yield curve control to bring yields back down again. At that point, as nominal yields are forced lower in the context of rising inflation, the US currency has to fall. The fact that the Dollar initially rallied in response to the Fed announcement only tells us that investors do not believe that the Fed is quite ready yet to adopt yield curve control, but surely this is now only a question of time. Indeed, the markets are expecting a very dovish message from the Fed at the September FOMC meeting.

Our view is the Dollar is severely overvalued. The overvaluation has come about as a result of the massive capital inflows, which took place over the last decade. These flows were motivated by the desire to harvest capital gains on the back of the Fed's asset purchase program and the economic recovery made possible by bank recapitalisation after the 2008/2009 financial crisis. However, as the cyclical upswing now gives way to slump and as inflation – as a matter of policy – now looks set to rise the attractiveness of US assets will slowly erode. It is therefore likely that much of the roughly USD 10trn, which flowed into the US from overseas during the height of QE will begin to leave, pushing down the Dollar.

- US-China relations: Officials from the US and China re-confirmed their commitment to Phase One of their mutual trade accord despite widely circulated US allegations that China is not importing enough American goods, including soybeans. However, it is not clear that China is to blame. Data from the United States Department of Agriculture shows that US farmers have not increased production in more than four years. As of 12 August 2020, US production of soy beans stood at 4.4bn bushels, which is the same level as in 2017 and 2018. In 2019, US production even dipped to a low of 3.6bn bushels.[1] Inadequate US supply of soy requires China occasionally to increase purchases from other countries, such as Brazil. In any case, the practice of setting specific purchase targets is nonsensical, since imports and exports ultimately depend on macroeconomic conditions. US exports are hampered by an overvalued Dollar, while China's capacity to import depends on aggregate demand in China. For now, neither the US nor China have any incentive to dismantle the trade accord at this stage and China reassures the US that purchases will increase over time. In other areas, such as technology and Taiwan, relations between the two countries remain tense. Chinese Foreign Minister Wang Yi kicked off a week-long European tour last week in order to deepen ties as the US increasing turns inwards.

- China tech: President Xi Jinping indicated in a speech last week that China will "vigorously" pursue an independent capability to innovate. While China already innovates extensively, it still depends on South Korean, Taiwanese, and US companies for highly specialised inputs and processing facilities, particularly semiconductor equipment, such as lithography tools used to manufacture chips. Given the ongoing witch hunt against China in the US, President Xi Jinping understandably wants to break China's residual dependence on US technology firms. To this end, China recently announced a New Infrastructure Plan worth USD 180bn, which will be executed via private sector internet companies, including Alibaba, Tencent, Baidu, and other Chinese leading companies. Chinese companies are also hiring specialist talent extensively in key areas. Thus, barring a major shift away from anti-Chinese policies in the West, the most likely outcome is that the world moves towards two tech ecosystems, one in Asia and EM and the other in US/Europe. Given that more than 80% of global growth will come from EM countries over the next five years, it is likely that the Asian tech system – led by China – will ultimately emerge as the dominant player on the global stage.

- Ecuador: The IMF agreed on a new USD 6.5bn Extended Funding Facility program with USD 4.0bn disbursement in 2020, USD 1.5bn in 2021 and USD 1.0bn in 2022. The total size of the programme is unusually large, equivalent to 6.6x the country's quota, and the disbursements are front loaded, allowing for the country to fund its obligations until 2021 elections. The IMF agreement allowed the bond exchange to be settled on the 31 August with the new bonds trading at an exit yield of around 10%, implying a much higher price than priced on the old bonds prior to the IMF deal. On the political front, the Social Christian Party (PSC) announced it will support the market friendly presidential candidate Guillermo Lasso in 2021 elections, setting aside significant differences between their parties.

- Argentina: Finance Minister Martin Guzman said that 93.5% of bondholders accepted the latest debt swap proposal, allowing 99% of the eligible bonds to be restructured. Mr. Guzman said Argentina will target a primary deficit of 4.5% of GDP in 2021 with the draft budget to be presented to congress on 15 September. Fiscal data

[1] See: https://www.nass.usda.gov/Charts_and_Maps/Field_Crops/soyprod.php

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for the month of July implies that Argentina is on track for a primary deficit around 8%-9% of GDP in 2020 compared to 3.8% of GDP in 2019. Meanwhile, private sector demand is weak as evidenced by the USD 1.5bn trade surplus in July, taking the 12-month surplus to USD 19.0bn. The improvement in the trade balance has been accomplished largely through a collapse in imports. The unfortunate economic reality is that government spending has a net negative impact on growth in Argentina due to inefficient use of resources, crowding out of private sector activity, and its tendency to precipitate economic crises.

- Oman: Sultan Haitham has completed a major reshuffle of key positions within his government since assuming power after the death of Sultan Qaboos in January of this year. The objective of Haitham's changes appears to be to distribute the responsibilities for governance more widely among his close allies as a precursor for deeper economic reforms over the coming year. Oman's fiscal balance and debt metrics have deteriorated significantly in recent years. As such, the apparent preparations for deeper economic reforms should be viewed positively, in our view.

- Peru: The Parliament approved a one-off withdrawal from the government's pension fund in order to help contributors through the economic downturn caused by the coronavirus pandemic. The government has indicated that it will put up a legal challenge. Parliament recently approved a similar measure for contributors to private pension funds. Similar policies have been put in place in Chile and the United States. Brazil is also mulling similar measures. By undermining the backbone of the domestic financial system, the pension withdrawals may, if they become more widespread, pose serious challenges to economic and financial stability, in our view. The silver lining is that pension withdrawals are a kind of self-financing, wherefore government fiscal spending can be cut back in equal measure.

- Malaysia: Malaysia recorded the largest trade surplus in its history in July. The surplus was a whopping USD 5.9bn, up from an already impressive USD 4.9bn surplus in June. The further improvement in the trade balance was achieved by rising exports, while imports slowed modestly. In other news, the Lower House of Malaysia's parliament has approved a temporary increase in the debt ceiling from 55% to 60% of GDP. The addition to the debt ceiling will allow the government to soften the economic impact of coronavirus. The government is already committed to reducing the fiscal deficit to below 4% of GDP over the next few years and the Budget for 2021, which will soon be presented to Parliament, is likely to contain new revenue measures to that effect.

- Hungary: The National Bank of Hungary increased the pace of asset purchases ('QE') to HUF 40bn per week from HUF 15bn per week previously with purchases targeting the long end of the government yield curve. At the same time, the government is cutting long-term collateralised liquidity injections. In net terms, liquidity injections will increase by about HUF 20bn per week. The announcement follows weak GDP growth in Q2 and an expected increase in the fiscal deficit to be financed by issuance of long-dated bonds.

- Uruguay: The government has aggressively lowered the inflation target to a range of 3% to 6% percent with a midpoint of 4.5%. The lower inflation target is meant to be achieved over the next two years. To support the objective of lower inflation, the government is signalling a lower fiscal deficit target and greater openness about monetary policy. However, dollarisation levels are high in Uruguay, reflecting years of tolerance for high single digit inflation on the part of the government. The current economic team is aware of this problem and keen to address it. Greater confidence in the Uruguay Peso would enable the government to rely more on issuance of nominal bonds to finance the fiscal deficit. In other news, the rate of unemployment rose by 1 percentage point to 10.7% in June.

- Brazil: The fiscal outlook remains uncertain following President Jair Bolsonaro's rejection of his own Finance Minister's proposal for a social support program. Finance Minister Paulo Guedes' proposal respects the cap on spending mandated by the Constitution, but Bolsonaro seems to want net positive spending. Meanwhile, the economy now looks distinctly better. The current account swung into surplus to the tune of USD 1.6bn in July. This is the first time Brazil has had a current account surplus in July since 2006. On a 12 months basis, the current account deficit has declined to 2.0% of GDP from 2.7% in June, while foreign direct investment was positive at USD 2.6bn, or 4.0% of GDP on a 12 months rolling basis. Mid-month consumer prices index (CPI) inflation is also low, at 0.23% for first half of August, or 2.3% on a yoy basis. Mid-monthly core inflation was 0.14% or about 2.0% on a yoy basis. A 10-year bond in Brazil yields about 7.2%. The only thing standing in the way of a rally is clarity on the fiscal outlook, in our view.

- Turkey: The European Union is stepping up pressure on Turkey following a dispute between Greece and Turkey over right to access to energy deposits in the eastern Mediterranean. EU ruled out anything other than diplomatic measures, but hinted at possible sanctions, which will be discussed at the upcoming EU summit in September. Turkey's current account deficit is financed with short-term loans from mainly EU-based banks.

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Snippets:

- **Africa:** Africa's Regional Certification Commission has declared the continent of Africa free of so-called 'wild' polio.[2]
- **Chile:** Moody's changed the outlook to negative from stable for Chile's sovereign credit rating, while affirming the current A1 rating for long-term local and foreign currency debt.
- **China:** Industrial profit growth surged at a yoy rate of 19.6% in July compared to 11.5% yoy in June and 6.0% yoy in May.
- **Colombia:** The central bank cut policy rates by 25bps to 2.0%, in line with consensus expectations. The unemployment rate rose to 20.2% in July from 19.8% in June.
- **Indonesia:** The manufacturing PMI survey rose to 50.8 in August from 46.9 in July. The yoy rate of CPI inflation declined to 1.3% in August from 1.5% in July
- **Ivory Coast:** Supporters of Laurent Gbagbo, who is currently on trial at International Criminal Court for human rights violations in connection with a previous election, said last week that they would file Laurent Gbagbo as a candidate for October's election.
- **Mexico:** The current account was in precise balance in Q2 2020 compared to a surplus of 1.4% of GDP in the same quarter last year. Real GDP growth was -17.1% qoq in Q2 2020, but recovery was already underway by June, when real GDP was up 8.9% for the month. Industrial production rebounded by 17.9%, while services were up 6.2% in June.
- **Morocco:** The government rejected a normalisation of relations with Israel under the terms of a US brokered deal, arguing that the terms of the deal do not give adequate protection for Palestinians.
- **Nigeria:** The pace of contraction of the real economy slowed in Q2 2020. The Q2 2020 contraction was 5.0% qoq compared to the contraction of 14.3% qoq in the first quarter.
- **Poland:** The government's 2021 Budget proposes a fiscal deficit of 3.4% of GDP, which implies a small possible upside risk to growth next year.
- **Singapore:** Industrial production increased by 1.6% in the month of July (seasonally adjusted). The increase was led by production of electronics, while pharmaceuticals was a drag.
- **South Africa:** The yoy rate of CPI inflation increased to 3.2% in July from 2.2% in June after the generalised price level went up 1.3% in the month. The increase was mainly driven by rising funeral expenses, so not broad-based. The price level for core goods in the index went up 0.7%, taking the yoy rate of core inflation to 3.2% as well.
- **South Korea:** The Bank of Korea left the policy rate unchanged at 0.5% and lowered its growth estimate for the economy.
- **Sri Lanka:** Several senior government officials confirmed that the government faces no problems in repaying the USD 1bn sovereign bond maturing in October.
- **Taiwan:** Industrial production increased by 2.7% on a yoy basis in July versus 3.5% yoy expected.

Global backdrop

- **US:** New home sales rose sharply in July. Similar levels of strength have been seen in other measures of activity in the US housing market and in other countries as well, including the UK. The reason for the strong housing data is that pent-up demand and pent-up supply are both being unleashed at the same time as a result of the lifting of lockdowns, thus pushing up volumes temporarily. However, as any honest real estate agent will tell you volumes will soon come down again as activity in the housing market once again reflects the underlying pace of economic activity. Based on the confidence of the great US consumer, things are not so great in the underlying economy. US consumer confidence fell sharply to 84.8 in August from 92.6 in June. The market was expecting a print of 93.0. This was the second consecutive monthly decline, although initial claims improved somewhat relative to the sharp unexpected rise last week and durable goods spending also picked up in the ongoing rebound from the +30% collapse in GDP in Q2 2020. In politics, the Republican National Congress endorsed President Donald Trump as candidate for the Republican Party in the upcoming US presidential election. The marked shift towards greater emphasis on law and order as a re-election strategy seems to amount to an argument that only President Donald Trump can save America from President Donald Trump's America.

[2] There is also a viral version of polio, which mutates from the oral polio vaccine and can then spread to under-immunised communities. However, this version is very rate.

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Global backdrop

- **Rest of the world:** Japan's Prime Minister Shinzo Abe resigned on health grounds. His prime ministership will be seen as broadly successful. Politically, he will be remembered for being the longest serving Prime Minister in Japan's history and for resurrecting Japanese nationalism. In terms of economic policy, his 'Abenomics' policy revolved around the 'three arrows' of monetary stimulus, fiscal stimulus, and structural reforms. Like most other leaders in developed countries, he successfully fired the first two arrows, but the third arrow never left the quiver. Abenomics was also associated with a weak JPY/strong USD. This could now change. In other news from Japan, the Tokyo core CPI fell 0.3% on a yoy basis in August after increasing 0.4% yoy in July. The market had expected positive yoy inflation of 0.3% in August.

- **Coronavirus:** China's State Council approved emergency use of the coronavirus vaccine on June 24 following an application for permission from the coronavirus task force in April. The vaccine was officially dispensed for the first time for emergency use on July 22, according to Chinese officials. Russia has also launched a vaccine. Reuters reported last week that AstraZeneca has started trials of an antibody-based cocktail to prevent and treat COVID-19. In other news, the prospect of repeat infections of the COVID-19 coronavirus has increased after researchers in Hong Kong proved a person has had the illness twice. Other viruses, such as SARS and MERS produced protection for several years, but the result from Hong Kong implies that COVID-19 behaves more like common cold coronaviruses, which typically cause re-infections within a year. Given that the Hong Kong result is based on one individual only it is advisable to await confirmation in other studies before drawing firm conclusions as to the seriousness of the finding and its implications for the potential of the illness to spread. Meanwhile, Abbott, a pharmaceutical company, has received FDA approval for an antigen test. Antigens reveal if patients are *currently* infected in contrast with anti-body tests, which reveal if a patient has or has had the illness at some point in the past.

Benchmark performance

Emerging Markets	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
MSCI EM	2.24%	11.45%	0.67%	14.85%	3.18%	9.06%
MSCI EM Small Cap	4.14%	13.82%	-0.60%	11.09%	-0.26%	5.20%
MSCI Frontier	8.29%	7.61%	-9.32%	-5.16%	-1.21%	3.19%
MSCI Asia	3.58%	12.45%	7.22%	21.94%	5.66%	10.87%
Shanghai Composite	2.70%	14.99%	13.83%	20.45%	2.77%	3.46%
Hong Kong Hang Seng	-0.27%	3.97%	-7.33%	3.09%	-0.23%	4.53%
MSCI EMEA	1.33%	4.62%	-17.63%	-8.46%	-4.54%	1.27%
MSCI Latam	-6.20%	4.08%	-32.49%	-23.37%	-9.50%	1.82%
GBI EM GD	-0.33%	2.68%	-4.39%	1.55%	0.74%	4.57%
ELMI+	0.63%	2.46%	-3.02%	1.75%	-0.01%	2.48%
EM FX Spot	-0.08%	1.91%	-9.24%	-5.89%	-6.24%	-3.20%
EMBI GD	0.51%	4.25%	1.37%	2.74%	4.14%	6.26%
EMBI GD IG	-0.96%	3.21%	6.43%	6.39%	6.85%	7.04%
EMBI GD HY	2.38%	5.55%	-4.58%	-1.72%	1.04%	5.30%
CEMBI BD	0.90%	3.24%	3.08%	6.02%	5.02%	6.13%
CEMBI BD IG	0.47%	2.79%	4.78%	5.62%	5.61%	5.62%
CEMBI BD Non-IG	1.50%	3.86%	0.68%	6.50%	4.21%	7.00%

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Benchmark performance

Global Backdrop	Month to date	Quarter to date	Year to date	1 year	3 years	5 years
S&P 500	7.19%	13.23%	9.74%	21.92%	14.49%	14.43%
1-3yr UST	-0.02%	0.07%	3.09%	3.49%	2.59%	1.87%
3-5yr UST	-0.12%	0.15%	6.20%	5.80%	3.89%	2.99%
7-10yr UST	-0.83%	0.03%	11.16%	8.59%	6.17%	4.76%
10yr+ UST	-4.31%	-0.27%	20.88%	13.00%	10.91%	8.53%
10yr+ Germany	-2.74%	-1.18%	4.65%	-4.37%	6.32%	5.41%
10yr+ Japan	-0.91%	-0.24%	-2.35%	-6.22%	1.48%	3.16%
US HY	0.95%	5.68%	1.67%	4.71%	4.88%	6.44%
European HY	1.59%	3.13%	-2.98%	-1.22%	1.56%	3.56%
Barclays Ag	-0.15%	3.03%	6.11%	5.54%	3.90%	4.10%
VIX Index*	0.00%	-13.21%	91.65%	39.15%	160.71%	-15.89%
DXY Index*	-0.37%	-5.74%	-4.76%	-7.19%	-1.09%	-3.82%
CRY Index*	0.00%	11.05%	-17.53%	-10.06%	-15.33%	-21.83%
EURUSD	0.38%	6.64%	6.77%	9.25%	1.09%	6.37%
USDJPY	0.14%	2.04%	2.75%	0.44%	4.33%	13.36%
Brent	0.93%	11.06%	-30.76%	-24.38%	-13.36%	-7.79%
Gold spot	0.69%	11.32%	30.39%	29.83%	49.83%	74.00%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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