Developed economies have squandered years of hyper-easy monetary policies by neglecting reforms and barely deleveraging. Instead, they have pushed asset prices up and engaged in extensive financial repression, which has kept sentiment buoyant but done nothing to heal their underlying economies.

It is a false sense of comfort. As the effectiveness of current policies begins to wane, questions about debt overhangs and low productivity are coming back.

How will these issues ultimately be addressed? The answer is likely to involve inflation and currency debasement, which have distinct political advantage over austerity and reform because they pass the cost of adjustment onto future generations and foreigners.

Will emerging markets (EM) that are particularly exposed to developed markets—by virtue of their enormous stocks of foreign currency (FX) reserves—passively accept the bill from decades of excessive consumption in developed countries? Hardly. There will be geopolitical ramifications, some of which are already becoming evident.

This should concern investors. What are the geopolitical implications of inflation and currency debasement? Where and when do they show up and how can investors protect the real value of their capital?

Go Go Go!
One could be forgiven for thinking the 2008–2009 crisis is well and truly over. After all, investors have piled into developed-market assets with unusual gusto over the past few years. Their enthusiasm is due partly to the simple intuitive appeal of the policy mix adopted by central banks, which have been determined to keep asset prices elevated for as long as it takes the underlying economy to heal itself. The idea is that asset prices and the underlying economy will eventually reconnect at some moment in the distant future; in the meantime investors can rely on a rock-solid, confidence-inspiring central bank “put” on asset prices for a protracted period. This idea is illustrated in figure 1, which shows asset prices elevated above the value of the real economy during a protracted recovery phase.

Jumping on the Bandwagon
Even skeptics have been buying. After all, when the largest central banks in the world are buying with printed money it is costly—maybe even career-threatening—not to jump on the bandwagon.

Fact or Froth?
How justified is the optimism? Hyper-stimulatory policies have impacted asset prices far more than the underlying economy. Low interest rates across the curve have reduced debt service costs to almost zero but also have led everyone to ignore the debt issue. Asset price inflation has made people feel better but taken away any incentive to reform. A ratings-based regulatory system that consistently assigns the highest ratings to the most indebted countries has avoided a major debt crisis, but it also has ensured that more good money has been thrown after bad. The result has been slower than expected economic healing, which in turn has required greater than expected monetary easing, including multiple generations of quantitative easing or QE (see figure 2).

Signs of Trouble
For the first time since the start of unconventional monetary policies, signs are appearing that valuations are getting out of line with fundamentals. Symptoms are evident in both U.S. and European markets. The United States is showing early symptoms of...
American-style “Dutch disease,” a rapid real effective exchange rate (REER) appreciation caused by USD euphoria. Even Fed Chairman Janet Yellen and other Fed officials now regularly bemoan the rapid rise of the greenback. European bond markets also hit barriers this year when even hardened momentum traders balked at buying bonds with zero or negative yields.

Another 30–40-percent USD rally now looks very unlikely. Another rally of several percentage points in core European bond markets looks equally unlikely. As consensus bullish views on the USD and developed-market bonds promise less upside, more volatility, and lower liquidity, the room to stimulate these markets to gloss over underlying problems shrinks.

Political Warnings
Recent market volatility reflects these signs of stress, and the masses are stirring, too. The constant neglect of reform in favor of short-term palliatives has increased inequality: Quantitative easing has made the rich wealthier and left the less well-off languishing. Voters are scurrying to the political extremes and populists are in search of answers. The United States is more polarized than ever with a lame-duck president at the center, and Europe’s core and periphery countries are respectively turning to right-wing and left-wing populists for answers. Populist prescriptions offer no cure—they only reduce the odds of solving the underlying problems.

New Policies on the Way
Where will policymakers turn next? They must now once again confront the heart of this crisis: How will countries with very low productivity get rid of overhanging debt without inflicting horrible pain on their voters?

Politically, the answer is simple: Make sure costs are passed to those who don’t vote. In economic terms this means inflation and debase-ment of currencies. Politically, these are both vastly preferable policies compared to austerity and structural reforms—they spare current voters from pain and pass the cost of adjustment to future generations and foreigners, neither of whom get to vote in the matter.

The effectiveness of inflationary policies will be particularly high in the United States, Europe, the United Kingdom, and Japan, because these four countries issue the most-dominant global reserve currencies (together they account for more than 95 percent of all global central-bank reserves). True, central banks in these countries will lose credibility if they tolerate inflation, but history shows that credibility can be restored, albeit painfully.

The International Angle
A greater reliance on inflation and currency realignment in developed markets brings EM directly into the mix. Developed economies make up only 43 percent of global gross domestic product (GDP) but have issued 87.5 percent of the world’s bonds (see figure 3). Because they control nearly 80 percent of the world’s foreign-exchange reserves (US $9.4 trillion), emerging markets’ central banks are major holders of these bonds. Holdings of USD-denominated assets are particularly dominant in central banks’ portfolios. By contrast, developed economies hold almost no FX reserves; Japan and Switzerland alone account for nearly 80 percent of the total reserves held by developed-market central banks. In short, policies to debase developed-market currencies will almost exclusively hurt emerging-market economies.

Will Emerging-Market Countries Pick up the Tab?
EM countries are unlikely to passively agree to pay for 30 years of consumption in developed economies. The ability of developed markets to make EM do their bidding is much reduced in all areas compared to just a few years ago. Emerging economies now source four-fifths of all their financing from home markets. Even frontier states are becoming less financially dependent—16 African countries are in JP Morgan’s index of sovereign bond issues and others will follow. China is a major source of financing and will grow more important as Chinese savers get access to investment opportunities abroad.

The scope for Western military coercion of the emerging world also is diminishing. Economic constraints and past misadventures
in Iraq and Afghanistan have damaged the ability of developed economies to engage militarily around the world. China is directly challenging the United States for influence in the South China Sea and in Africa. Sanctions against Russia have not crippled Putin but they have deepened his ties with other EM countries. Even Arab states increasingly are going it alone in their fight against the Islamic State of Iraq and al-Sham (ISIS).

**Last Dollar Standing**
The USD stands out as a last bastion of developed-market strength. But the USD's strength owes much to emerging markets, whose central banks have remained impressively loyal to the greenback. Emerging markets are fiercely protective of their reserves, so their loyalty will end when inflation arrives and the USD starts to fall. Besides, new global reserve currencies are becoming available, which will turn large EM central banks from buyers into outright sellers of the greenback.

The United States is fighting reform of the International Monetary Fund and other Bretton Woods institutions, but these efforts will be futile. EM countries are responding by setting up rival institutions, such as the Asian Infrastructure Investment Bank, the New Development Bank, the Chiang Mai initiative, etc. Here, too, the sides are moving apart rather than together.

**Not a New Cold War**
These tensions are not over competing ideologies, so they do not represent a new Cold War. After all, most EM countries are capitalist, arguably even China. Instead, the tensions will play out in the global economic arena. The weapons will be bad policies, such as exchange-rate manipulation, restrictions on trade, and slower globalization. The main casualty will be global growth.

The challenge facing emerging markets is a lack of unity. Collective action has not been the strong suit of EM countries, but their ability to mobilize collective economic muscle is improving under pro-active Chinese leadership.

**How to Trade on the Rising Tensions**
It is somewhat ironic that EM markets have struggled following the 2008–2009 developed-market crisis. After all, it wasn't their crisis. But a distinction must be made between economic performance and returns in financial markets. No central banks have bought EM investments, but trillions of USD of QE money has bought developed-market assets. Investors have jumped on the developed-market bandwagon and ignored EM. Still, EM countries have not imploded. Sentiment and economic reality simply have parted ways, but this has created value. The tide has not yet turned back in EM's favor, but it is only a question of time. After some tough years the EM value position is now beginning to become compelling.

**Emerging Markets Now?**
Is this then a good time to put money to work in EM? Probably. Markets will view EM with caution for some time to come. The strong USD view still has many adherents. Fed hikes still scare people. The playing field is leveling as the QE trades of the past few years begin to lose steam. The cautious sentiment toward EM has also had some distinct advantages: Policymakers have been forced to deal with economic challenges instead of ignoring them, and investors are now getting paid well for the risk. Investors in EM can also be sure they are not buying into a bubble. The same cannot be said for developed markets after years of QE-fueled rallies.

**EM as a Hedge**
The case for EM as a hedge against policies in developed markets is quite strong. Early signs of rising wages and tighter labor-market conditions in the United States suggest that inflation is no longer a very distant prospect.

The arrival of inflation will be highly destabilizing. It will force the Fed to choose between an interest-rate hike that could crush market confidence and damage an unproductive economy or allowing inflation to rise to maintain tepid growth.

Faced with this dilemma, the more likely outcome is that the Fed protects growth. Disappointment with the Fed—or relief, depending on how you are positioned—triggers bear steepening of the U.S. Treasury curve as a higher-term premium gets priced. Financial repression will then have to be stepped up to prevent a housing downturn, but this pushes down the USD due to repressed real yields in the face of rising inflation.

The Bank of Japan and the European Central Bank already are actively managing their currencies to “beggar their neighbors.” With the U.S. economy already hurting from the strong dollar, a change in USD policy is no longer a conceptual impossibility.

Currencies are destined to play a greater role than rates in restoring the health of developed economies. Investors can protect their capital by getting out of the conventional reserve currencies before inflation and currency debasement begin in earnest. It is worth moving early, because markets are extremely long dollars, which means that the exit will be narrow. A dislocation equivalent to or exceeding the 50-percent fall in the USD seen in the 1970s is not impossible; today’s global imbalances are at least twice as big as they were in the 1970s.

**Fixed Income’s Role**
So, should investors sell all their fixed income and buy equities instead? After all, the 30-year rally in fixed income is probably over. The problem is that business cycles, the uncertain timing of the bond rout, and the simple fact that maybe the fixed-income rally will continue argue for a portfolio with at least some fixed income. The question then becomes: What criteria should one apply to identify which fixed income to buy?

The guiding principle for allocations to fixed income should be to invest in countries where (1) currencies are going to appreciate,
(2) inflation is falling, and (3) central banks are cutting rates. Once inflation begins in the countries issuing conventional reserve currencies, these conditions will prevail in EM local markets—particularly in those countries where currencies are, or have the potential to become, new global reserve currencies.

**Chinese Fixed Income**

Bonds in China look especially interesting. The RMB already is on track to take the mantle from existing global reserve currencies and could double in value over the next decade, recent volatility notwithstanding. This would weaken Chinese growth and push down inflation, so the People’s Bank of China would have room to cut rates. At 150 basis points, real five-year bond yields are among the highest in the world; the technicals are also very attractive because the market is just opening up and foreigners have barely set foot onshore.

**Active Management in Stocks**

Equity investing must emphasize stock picking and growth. Volatile global conditions and currency appreciation will challenge growth prospects in some EM countries but offer opportunities in others. Active management with a focus on exposure in countries that reform, invest in infrastructure, and open their capital markets should ensure strong equity returns in countries with high-trend growth rates. Commodity-dependent frontier markets also offer exceptional opportunities because many commodity producers are small economies. Central banks with strong preferences for very liquid currencies will buy their tiny currencies, which limits appreciation; they also will benefit from a falling USD amid rising U.S. growth. In larger EM countries, the focus should be on domestic demand-oriented small-cap stocks.

**Back to Basics**

It is easy to forget what EM investing is about. Chasing value and hedging against bad policies in developed markets are themselves good enough reasons to invest in EM but, ultimately, EM is a convergence trade (see figure 4). EM countries will continue to outgrow developed markets with occasional important structural leaps forward. Their financial markets will more than double in size by 2020 and include 80 sovereign index names with another 80 countries waiting in the wings (see figure 5). Allocations to EM are investments in the truest sense of the word as opposed to speculation in overvalued assets based on the anticipation of the latest central-bank inventions.

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