The vicious circle of monetary easing

By Jan Dehn

The Weekly explains why the near-exclusive reliance on monetary easing to deal with problems in developed economies only stores up problems for the future and how investors can avoid the eventual catastrophic losses. The Weekly also notes that the explicit sovereign backstops supporting Emerging Markets' (EM) national oil companies are now beginning to make themselves felt. Brazil's current account continues its dramatic improvement, but the fiscal balance will take longer to improve. Turkey drops the last pretence to adopt a sustainable monetary policy framework. Argentina slashes subsidies. China's latest PMIs are consistent with China's continued rotation from export to consumption led economy. South Africa's trade balance massively beat expectations, Mexico's consumer-led expansion continues and Philippines just racked up the strongest growth rate since the 1997 Asian Financial Crisis. The global backdrop improved as Japan joined the ECB in cutting rates to negative and the FOMC reluctantly issued a dovish statement.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	9.7	–	4.47%
MSCI EM Small Cap	10.3	–	2.48%
MSCI Frontier	8.1	–	3.07%
MSCI Asia	10.2	–	3.02%
Shanghai Composite	9.7	–	-6.14%
Hong Kong Hang Seng	5.7	–	1.68%
MSCI EMEA	8.4	–	8.81%
MSCI Latam	10.6	–	7.63%
GBI-EM-GD	6.88%	–	2.60%
ELMI+	4.48%	–	1.18%
EM FX spot	–	–	1.63%
EMBI GD	6.50%	456 bps	1.02%
EMBI GD IG	4.91%	289 bps	1.23%
EMBI GD HY	8.75%	693 bps	0.73%
CEMBI BD	6.54%	480 bps	0.74%
CEMBI BD IG	4.83%	309 bps	0.62%
CEMBI BD Non-IG	9.65%	790 bps	0.96%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P500	14.2	–	1.77%
1-3yr UST	0.79%	–	0.28%
3-5yr UST	1.34%	–	0.58%
7-10yr UST	1.93%	–	1.12%
10yr+ UST	2.75%	–	1.56%
10yr+ Germany	0.34%	–	3.02%
10yr+ Japan	0.06%	–	2.24%
US HY	9.70%	833 bps	1.07%
European HY	6.28%	646 bps	0.86%
Barclays Ag	–	227 bps	0.48%
VIX Index*	20.20	–	-2.14%
DXY Index*	99.36	–	0.00%
EURUSD	1.0876	–	0.25%
USDJPY	121.30	–	2.54%
CRY Index*	166.75	–	2.95%
Brent	35.0	–	14.89%
Gold spot	1124	–	1.43%

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

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For the second week in a row the global backdrop became more supportive for EM assets and once again it was due to an entirely non-EM central bank event, namely additional easing from the Bank of Japan (BOJ), which embarked on negative interest rates. This means that the BOJ is now following in the footsteps of the Danes, the Swiss and the European Central Bank (ECB). This leaves only the Bank of England (BOE) and the Fed yet to cut to negative rates.

Moves to negative rates in the UK and the US seem only a question of time. BOE's Chief Economist Andy Haldane signalled as recently as September 2015 that negative rates could become necessary in the UK, while the only remaining easing instrument available to the Fed – having already stated categorically that additional Quantitative Easing (QE) is counter-productive – is negative rates (unless the Fed decides to resume QE accompanied by a large steaming slice of humble pie).

Given the intensifying slump in the US business cycle negative rates may indeed be closer than markets think. The FOMC minutes issued last week showed clearly that the Fed is now retreating at a record pace from the optimistic rhetoric (and expectation of four rate hikes in 2016) that accompanied its 25bps hike in December 2015. In particular, the FOMC removed the reference to a 'balanced' outlook, which means that it has no idea what is coming next: the ship is sailing without a rudder.

Unsurprisingly, capital markets greeted the BOJ move and eventually the FOMC minutes with optimism. Sadly, such excitement is prima facie evidence of severe myopia, a disorder that infests the entire Western capitalist system to the core and whose long-term consequences can be unsettling to say the least.

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The myopia disease that afflicts the finance industry is so severe that investors simply do not appear to recognise that any strategy of economic recovery that relies solely on monetary policy easing merely ends up being a vicious circle. This happens not only because monetary easing does not address a raft of serious economic problems, but also because monetary easing itself creates its own brand of new problems. Indeed, over time as these new problems are added to the pre-existing ones and beget even more monetary stimulus the overall situation only becomes more unhealthy and dangerous. The end-result is a crisis with mass-destruction of wealth.

Long-term institutional investors should be cognisant of this vicious circle and how best to avoid getting sucked into its vortex.

The starting point for a defensive strategy has to have a clear understanding of why monetary easing-only policies will fail. Failure happens because when countries rely exclusively on monetary policy easing they specifically fail to address two particular problems, which happens to be very serious. The first is productivity. Monetary policies do not address supply-side issues. Eventually, in fact, excessive use of monetary policy impedes productivity by encouraging speculative behaviour over long-term investment, including beggar thy neighbour policies, such as devaluations. The second problem is debt. Monetary easing is 'sold' as a remedy against destructive deflation and a means of temporarily easing debt service burdens, but these benefits accrue only at the expense of savers and future generations. At the same time, easy monetary policies typically encourage even greater borrowing as is currently the situation in developed countries, where government debt burdens have gone up sharply since 2008/2009. Only when debt is repaid or written down and losses taken can debt really go down. All else is just an intertemporal shift of liabilities.

When, like now, monetary policies are used to excess in countries that face clear productivity and debt challenges they quickly lead to new problems, which only exacerbate the pre-existing ailments. The most important of these 'new' problems is that currencies and financial asset prices become heavily distorted relative to fundamentals – i.e. enormous bubbles are created.

The emergence of bubbles is hurting the economy, because participants in the real economy are not as easily hoodwinked by the lure of easy money as members of the finance industry. In the real world they curtail long-term investment and save in preference to spending when central banks print money and debt levels go up. The economy loses momentum and dynamism. In currency markets, the US dollar has now become a victim of its own success; having rallied in expectation of rate hikes and growth it is now so strong that neither growth nor rate hikes are possible, at least not nearly to the extent imagined. Long US dollar positions have become the single largest speculative position in global currency markets, precisely at a time when the odds of a US recession are rising sharply.

And herein lies the crucial point: the bubbles created by the excessive monetary easing in the QE economies will eventually burst – either through inflation or through the collapse of QE currencies or both – and when they do the economic consequences will be horrible. Not only will asset prices fall but the economic damage – impacting the ability and willingness to pay, that is real risk – will also be material. Asset prices in developed markets are today far too high relative to the economic risks in these countries. There is no value left for long-term investors, in fact with most developed market bonds paying no real yield or even negative yields it is probably more accurate to say that there is negative value.

So what to do? The best way to avoid the losses implied in current valuations in the QE markets, especially given the weak fundamental backdrop, is to leave those markets and to buy into the value created in the non-QE markets in the past few years.

One excellent reason for switching to EM is that the fundamental picture is improving in both relative and absolute terms. This may not be immediately obvious to many, but the green shoots are there to see for those that are willing to take a closer look. Perhaps the single biggest concern many have about EM is the recent slowdown in growth. EM has definitely slowed down in recent years (though it still grows twice as fast as developed markets). But this slowdown is cyclical in nature. It has been caused by financial tightening and the big shifts in global currencies that were caused by outflows from the asset class as institutional investors financed additional developed market exposure by selling EM positions. The cyclical adjustment is now well advanced. The clear improvement in EM's external balances should provide significant encouragement for EM investors. No fewer than 90% of EM countries have now experienced large positive shifts in their current account balances in the last couple of years. They have been regaining competitiveness, which will begin to push EM growth rates higher, especially versus the US. The adjustment and consequently increased inflows via foreign direct investment together with positive current accounts will not only keep EM reserves stable but actually get them to start rising again, likely this year.

Investors are understandably also focused on the possibility of more shocks hitting EM. Shocks cannot be avoided, but imagine for one second that you could be God for five minutes and that you decided to use your newfound powers to destroy EM! What would you do? Your recipe for EM apocalypse would probably comprise

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the Four Horsemen starting with a Taper Tantrum to cause massive capital flight from the asset class followed by a dramatic and sustained Dollar rally then immediately giving way to a 60% collapse in commodity prices and finally, just to twist the knife, a Fed hike. Well, EM has just had all that and is still standing!

In fact, given the magnitude of the shocks there have been surprising few casualties. Aside from the few countries in EM that screw up every year for various reasons there has only been one sovereign restructuring in Ukraine, which is hardly a typical example of the other 60+ EM countries in the main indices. Argentina also defaulted, but for technical reasons rather than anything related to global economic conditions. Corporate HY default rates in EM remain below their long-term average and are now lower than default rates in the US.

Finally, you get paid. There is not a bubble in EM fixed income markets, where all asset prices – in absolute terms – trade at or lower than when the Fed has interest rates at 5.375%. The last few years of QE euphoria in developed markets has cheapened EM sharply as investors made room to buy more QE assets by reducing their exposure to non-QE markets. Now is the time to reverse this trade. Remember that the purpose of an investment is not just to make money; it is also to protect capital from the losses that are coming due to the vicious circle of excessive use of monetary policies in developed markets. An EM investment today holds out the prospect of achieving both those objectives.

- EM's national oil companies: The difference between a US shale company and most EM oil companies is that the latter are quasi-sovereign companies with explicit or implicit sovereign backstops. Both types of companies will of course suffer when oil prices fall, but the existence of a sovereign backstop may make all the difference when it comes to the investment proposition. A company with sovereign backing is more likely to avoid default, so price weakness does not translate into large permanent loss. It is therefore encouraging to see that the sovereign backstops are now kicking in across a number of EM oil producers. In Mexico, Pemex, the state-owned oil company, raised USD 5bn in fresh funding from debt markets last week (demand exceeded USD 18bn) after the government explicitly stated that it is willing to back the company. In Colombia, Ecopetrol, the national oil company, is starting by divesting its petrochemical unit to focus on upstream activity. In Russia, the recapitalisation of the state-owned bank VEB has gone ahead with non-core asset sales and announced state support. In Azerbaijan, the government is taking a different route by consulting the IMF and World Bank for support. As noted in an earlier version of this weekly, Azerbaijan treated the drop in oil prices as temporary and only belatedly began to adjust once half of the country's FX reserves had been lost trying to defend the currency. This was not great policy, but it is positive that the country now seeks support from multilateral lenders, which in turn should support SOCAR, the sovereign oil company. In general, the policy responses of EM's oil exporters have varied from excellent (Russia) to horrible (Nigeria). Floating currency regimes in the majority of these countries has helped to sharply reduce costs for these companies in US dollar terms. As for investment returns, they depend not only on the movement in the price of commodities, but also on the impact on the country's overall terms of trade, how well prepared the government was for lower prices, the quality of the post-shock policy response and, importantly, how much markets have under and/or over-reacted to the commodity price shock in the first place.
- Brazil: The Brazilian government just managed to meet its revised 2% of GDP primary deficit objective for 2015. The government settled a number of arrears without which the deficit would have been lower at 1.9% of GDP. Repayment of arrears is a good thing. The 2015 fiscal result meant that the government's net debt ratio rose to 36% of GDP at the end of the year, which is deep within sustainable territory. Going forward, the primary deficit is likely to decline somewhat in 2016 and 2017. Brazil's central bank is also likely to maintain real rates at current levels as it waits for inflation to slowly decline and for the improvement in the current account to push up FX reserves, which will enable the central bank to have more confidence in stabilising BRL. The current account deficit just dropped to USD 2.5bn in December compared to USD 11.7bn in the same month last year and Brazil may well be en route to a current account surplus this year. Real wages are also falling at a pace of 8.3% yoy, so Brazil is getting cheap. Fiscal policy and reforms are unlikely to change much from the current stance in the short term, however, given the political difficulties faced by the Dilma administration. As such, Brazil still looks more like a fixed income trade than an equity trade, though that could change if Dilma is impeached.
- Turkey: The trade deficit in December widened to USD 6.2bn from USD 4.3bn in November. The deterioration in the seasonally adjusted numbers was much smaller; a USD 4.9bn deficit versus USD 4.3bn in November. Still, things are not heading in the right direction in Turkey. Last week, the central bank raised its inflation forecast by 1% to 7.5% for 2016 and postponed reform of the monetary policy framework indefinitely. This means that monetary policy in Turkey will, in effect, continue to be run by President Erdogan. In practice, this means permanently over-easy money interspersed by sharp bouts of emergency tightening during periods of elevated global risk aversion. Such instability deters investment and local savings, which in turn means that Turkey will not be growing optimally as inflation is likely to continue to drift away from the target. Erdogan will not realise his dream of putting Turkey on an Asian-style growth trajectory with this recipe.

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- **Argentina:** The government has raised electricity tariffs for the first time in more than a decade. Prices will be increased by more than 350% starting on 1 February and should improve the fiscal balance by a whopping 1.5% of GDP. Some subsidies will be maintained for poorer sections of the population, but this is a massive improvement from previous policies.

- **South Africa:** The trade surplus was much better than expected in December, rising to ZAR 8.2bn versus ZAR 4.9bn expected. The budget balance was also stronger than expected (ZAR 32.6bn versus ZAR 29.7bn expected). The 2016/2017 Budget will be presented on 24 February. It will be a major test for the credibility of Finance Minister Pravin Gordhan, who was recently re-instated following a failed attempt by President Zuma to put a 'yes man' into the finance minister post. Meanwhile, the South Africa Reserve Bank increased the credibility of its already well-established inflation-targeting regime by hiking interest rates by 50bps to 6.75%, whereas most analysts expected a more modest 25bps hike. Long end bonds benefited from this orthodox shock as 10 year bonds rallied in the aftermath of the decision.

- **Mexico:** Real GDP rose at a pace of 2.5% yoy in Q4 2015 compared to 2.3% in the same quarter the previous year. Mexico's economy is driven by a steady and gentle expansion in consumer spending. Retail sales rose 0.5% mom (sa) in November versus 0.3% mom expected. Real private sector credit growth expanded at a pace of 11.7% yoy in December, up from 3.9% yoy in December 2014. The trade deficit in December was USD 0.9bn, roughly in line with expectations.

- **Philippines:** The economy just racked up its strongest growth rate at least since 1998. Q4 2015 GDP increased by 6.3% yoy, accelerating from an already strong growth rate in Q3 2015 of 6.1% yoy. Domestic demand rose by 10.7% yoy. The expansion is led by private investment and public infrastructure investment in particular.

- **Nigeria:** The Central Bank of Nigeria (CBN) made no changes to monetary policy in January. This means that there has still not been a substantial adjustment in domestic demand in Nigeria while oil prices have collapsed globally. This failure to adjust is only storing up problems for the future.

- **China:** The latest services and manufacturing PMIs present a picture of a moderately slowing economy that is in the process of rotating from export to domestic demand led growth. The official PMI for January softened to 49.4 from 49.7 in December, but the Caixin PMI, which features smaller enterprises more heavily was stronger than expected (48.4 versus 48.1 expected). The PMI for the service sector remained firmly in expansion territory at 53.5 in January. These are all indicators of the supply-side of the economy. The demand side is likely to be driving growth going forward, particularly consumer demand. China's supply-side is slowing due to significant structural reforms rather than an uncontrollable debt as is often claimed. Despite the short-term challenges posed by reforms, China's producers remain productive relative to producers in other countries as evidenced by the country's growing share of global trade and its large current account surpluses.

- **Russia:** The Central Bank of Russia (CBR) left rates unchanged, and surprised the market with its hawkish statement. CBR expects inflation to fall below 7% this year, but indicated that it may hike again if this does not materialise. Real GDP declined 3.7% in 2015 illustrating just how tough the CBR was last year in response to the fall in oil prices.

Snippets:

- **Costa Rica:** The trade deficit shrank to 11.3% of GDP in 2015 compared to 12.1% of GDP in 2014.
- **Hungary:** The central bank left rates unchanged and sent the market a dovish impression.
- **Panama:** Real GDP growth slowed to 4.1% yoy in the January-November period. Last year the growth rate was 4.9% yoy over the same period.
- **Paraguay:** Remittances from foreign workers reached 1.6% of GDP in 2015 from 1.4% of GDP in 2014.
- **South Korea:** Industrial production increased 1.3% mom (sa) versus -0.3% mom expected. Q4 2015 GDP growth accelerated to 3.0% yoy from 2.7% yoy in Q3 2015.
- **Thailand:** Economic activity rose strongly in December, including private investment, private consumption and tourism receipts. The trade surplus expanded to USD 1.5bn versus USD 1.3bn expected.

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Global backdrop

BOJ cut interest rates by 20bps to -10bps. This followed the resignation of Economy Minister Akira Amari due to corruption, sharp declines in household spending in December and declines in core CPI and weak production. The economy has in any case been sluggish lately as the temporary effects of Prime Minister Shinzo Abe's two arrows began to fade (the third arrow – reforms – never left the quiver). The impact of the rate cut was to significantly weaken JPY versus the USD, which means that Japan's policy directly and adversely impacts the US economy.

The US economy only expanded 1.8% in 2015, slowing towards year-end. This means that yet another year has passed without the elusive 'exit velocity'. The Q4 2015 GDP print pointed to a continuing deterioration in domestic demand conditions and inventory levels remain very high, which bodes poorly for Q1 2016 GDP.

The higher frequency data in the US was mixed. Consumer confidence was marginally softer than expected. Initial claims for unemployment benefit declined and Chicago PMI was strong, albeit this may partly be due to a very weak print the month before. Services PMI declined. The durable goods report was plain nasty (down 5.1% versus -0.7% expected). Home prices rose and new home sales were solid, but pending home sales were softer than expected. Dallas manufacturing survey crashed to -35 in January from -21.6 in December and -5.4 in November. It ought to be a source of concern that Texas has been the epicentre of job creation in the US since 2008/2009. Non-farm payrolls will be released this week. Thus far, the labour market data has held up in the face of the deepening manufacturing recession and energy sector problems. A weak payroll print will likely lead to a further shift in a dovish direction by the Fed.

In other noteworthy news:

- Donald Trump now leads other Republican candidates in the key states that vote early in the election of the Republican presidential candidate.
- European bank lending to non-bank corporates dropped sharply. The series is volatile, so worth watching closely, because the drop in lending was large even relative to the normal levels of volatility of the series.
- Oil prices bounced on speculation that OPEC and Russia will renew efforts to coordinate a cut in production.

Finally, the IMF has shifted 6% of voting rights from developed to EM countries, but the reform is largely meaningless, because both the US and Europe's share of voting rights remains such that they can still block attempts by EM countries to effect more meaningful change. In a more important development, however, the IMF also boosted its capital from USD 369bn to USD 659bn. This money will be needed when the developed markets crash. Sadly, it will not be nearly enough.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-6.49%	-6.49%	-20.72%	-8.99%	-5.27%
MSCI EM Small Cap	-7.87%	-7.87%	-15.35%	-5.00%	-3.98%
MSCI Frontier	-6.84%	-6.84%	-17.11%	-0.22%	-1.13%
MSCI Asia	-7.65%	-7.65%	-18.03%	-3.58%	-1.29%
Shanghai Composite	-22.65%	-22.65%	-13.38%	7.50%	2.09%
Hong Kong Hang Seng	-14.69%	-14.69%	-27.52%	-8.72%	-4.73%
MSCI EMEA	-4.19%	-4.19%	-23.16%	-14.32%	-8.48%
MSCI Latam	-4.58%	-4.58%	-29.69%	-21.43%	-14.22%
GBI EM GD	0.35%	0.35%	-14.91%	-10.08%	-3.12%
ELMI+	-1.15%	-1.15%	-6.08%	-6.22%	-3.33%
EM FX Spot	-1.27%	-1.27%	-16.15%	-13.63%	-9.58%
EMBI GD	-0.18%	-0.18%	0.07%	1.38%	5.45%
EMBI GD IG	0.82%	0.82%	-2.08%	1.07%	4.78%
EMBI GD HY	-1.48%	-1.48%	3.47%	1.80%	6.48%
CEMBI BD	-0.36%	-0.36%	0.26%	1.65%	4.31%
CEMBI BD IG	0.06%	0.06%	-0.06%	2.36%	4.92%
CEMBI BD Non-IG	-1.07%	-1.07%	1.05%	0.22%	3.26%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P500	-4.96%	-4.96%	-0.67%	11.31%	10.90%
1-3yr UST	0.75%	0.75%	0.90%	0.58%	0.72%
3-5yr UST	1.70%	1.70%	1.20%	1.74%	2.11%
7-10yr UST	3.16%	3.16%	0.87%	3.05%	5.54%
10yr+ UST	5.25%	5.25%	-5.14%	5.87%	10.33%
10yr+ Germany	6.41%	6.41%	-0.36%	9.45%	10.93%
10yr+ Japan	3.31%	3.31%	5.82%	6.98%	6.01%
US HY	-1.81%	-1.81%	-7.13%	0.59%	4.48%
European HY	-0.73%	-0.73%	-0.49%	6.07%	8.63%
Barclays Ag	0.46%	0.46%	-2.15%	2.85%	4.64%
VIX Index*	0.00%	10.93%	-3.67%	56.59%	14.58%
DXY Index*	-0.25%	0.74%	4.80%	25.57%	28.93%
CRY Index*	0.00%	-5.33%	-23.80%	-45.34%	-51.27%
EURUSD	0.42%	0.13%	-4.10%	-20.26%	-21.35%
USDJPY	0.13%	0.90%	3.17%	30.75%	49.11%
Brent	0.86%	-6.01%	-33.87%	-69.99%	-65.56%
Gold spot	0.50%	5.91%	-11.82%	-32.60%	-16.22%

*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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