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OCD and the 'non-crisis crisis'

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It would be wise to quickly dispel the notion – popular in some circles – that the 1997 Asian crisis is upon us again. Focus on the facts. Emerging Markets is a mixed bag, but one that contains many tasty morsels. Conditions are radically different from the late 1990s. The market's other obsession – with Fed hikes – is also bordering on the compulsive. The Fed is right to try its best to make the correct decision, but investors should worry more about low growth, falling productivity, lack of investment, financial markets that are propped up by hot QE air, major medium term debt issues and lack of reform.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.0	–	6.10%
MSCI EM Small Cap	10.7	–	6.60%
MSCI Frontier	8.8	–	1.15%
MSCI Asia	10.3	–	5.38%
Shanghai Composite	11.7	–	-0.12%
Hong Kong Hang Seng	6.5	–	1.45%
MSCI EMEA	9.1	–	7.31%
MSCI Latam	12.2	–	5.15%
GBI-EM-GD	6.98%	–	0.41%
ELMI+	5.08%	–	0.69%
EM FX spot	–	–	-0.10%
EMBI GD	6.02%	379 bps	1.57%
EMBI GD IG	4.78%	249 bps	0.51%
EMBI GD HY	8.08%	599 bps	3.06%
CEMBI BD	5.94%	394 bps	0.35%
CEMBI BD HG	4.67%	265 bps	0.07%
CEMBI BD HY	8.35%	638 bps	0.87%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.1	–	4.22%
1-3 year UST	0.72%	–	-0.22%
3-5 year UST	1.50%	–	-0.73%
7-10 year UST	2.17%	–	-1.43%
10+ years UST	2.91%	–	-4.04%
US HY	7.70%	627 bps	1.17%
European HY	5.03%	496 bps	0.74%
Barclays Ag	–	225 bps	-0.77%
VIX Index*	28.43	–	-12.31%
DXY Index*	95.57	–	1.04%
EURUSD	1.1260	–	-1.43%
USDJPY	120.14	–	-0.17%
CRY Index*	202.09	–	15.87%
Brent	53.3	–	23.42%
Gold spot	1143	–	0.50%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions. Data as at 28.8.2015.

Emerging Markets

The obsession with an Emerging Markets (EM) crisis is bordering on the compulsive. The perception that EM is about to have some major fundamental crisis has everything to do with the recent bearish price action, but little to do with actual economic reality. The parallel being drawn with the Asian crisis in the late 1990s is particularly superficial, a classic case of a 'non-crisis crisis'.

EM's macroeconomic conditions are completely different today from conditions that prevailed in the late 1990s. By far the most important difference is that most EM countries now have very sizeable domestic institutional investor bases that own most of the assets. As such, foreign outflows simply do not destabilise EM economies as much as in the past. But it is also important to recognise that EM's current account positions are stronger, FX reserve coverage relative to short-term debt and imports are better, domestic credit growth is less rapid, while banks are far better capitalised, particularly in Asia. The fall in oil prices over the past year has been good for most EM countries, notably in Asia and Eastern Europe (ex-Russia and ex-Malaysia).

Yet, EM crises continue to be an easy sell with investors, despite the enormous improvements in EM's economic fundamentals over the past couple of decades. Ask 100 randomly chosen people and the odds are that 99 of them will still tell you that EM is a collection of fragile tin-pot dictatorships whose economic survival hinge on commodity prices and unreliable funding from overseas speculators. Such views survive, stamped on the collective mind of the conservative finance industry despite the fact that they are a couple of decades out of date. Perceptions change slowly.

The hysteresis in perceptions is sadly not just due to inertia. Part of the problem is that some opinion makers have strong incentives to perpetuate prejudices. For example, banks make money on flows rather than taking long-term positions, so their interests are strongly skewed. The more portfolio turnover they can generate the more money they earn. This leads banks to adopt views that are as closely correlated with the latest market moves as possible. Sometimes this gives rise to almost comical about-faces during periods of volatility – witness banks' recent U-turns on the timing of Fed hikes in response to gyrations in the stock markets.

Sections of the financial media, of course, have exactly the same incentives. Selling papers by embellishing current sentiment adds no insight but simply perpetuates outdated thinking.

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These misaligned incentives among banks and sections of the media ensure that each outbreak of negative market sentiment is accompanied by an unrelenting focus on the 'bad seeds' within the EM asset class. On the other hand, when sentiment turns positive it is almost a given that the asset class will be painted in too rosy a light with too little attention paid to the inevitable handful of troubled credits. This is simply data mining in the service of volume – a business model aimed at maximising trade volumes and sales volumes.

The reality is far too complex to neatly summarise into convenient clichés. EM is a mixed bunch. Every year some 5%-10% of EM countries get into trouble for reasons that range from self-inflicted policy mistakes to external shocks. In the vast majority of cases, measures are then taken to remedy the problems. The remedies almost always work, albeit sometimes with a lag. A small number of countries have genuinely chronic problems, often rooted in deep-seated political dysfunction. They bounce from one crisis to the next. But even in these countries it can pay to invest, at the right time and in the right instruments.

- Ukraine: Ukraine is a case in point. Last week the country finally reached a deal with creditors. The deal was far more market friendly than expected. The haircut on bonds was 20%, which was at the very lowest end of forecasts. In addition, the coupon was higher and the maturity extension shorter. GDP warrants will accompany the new bonds, which will give investors additional upside when growth rises above 3% in real terms. The announcement immediately pushed prices for long bonds up by 10 to 12 points (roughly equivalent to a 20% rally in price terms). The central bank was also able to cut policy rates by 3% on the back of an expected sharp fall in inflation going forward. In the end, the government had an important choice: hurt investors badly in order to get greater upfront debt relief, or live with a higher level of debt, but with better chances of regaining access to international capital. Ukraine opted for the latter. The deal sets Ukraine on a path much like that taken by Poland; namely to become a successful economy and a strong pro-Western ally in Eastern Europe. Ukraine's journey will be tough – the country is divided and has far more deeply rooted problems that Poland ever did. However, this deal keeps alive not only the dream, but also reminds us that investing is not just about fundamental absolutes, but ultimately about what is priced in and what is not.

- China: China continues to be characterised as the main reason for global stock market volatility, yet this view does not stand up to scrutiny. Few investors paid attention to China's stock market rally and even fewer predicted a major growth bounce as a result but, now that stocks have slid lower, the airwaves are replete with dire predictions about yet another Chinese hard landing. Aside from the odd asymmetry of such views, they ignore the more important fact that the big QE trades – US stocks, European bonds and even the USD – have stopped performing. The reasons are closely related to valuations in those markets than anything happening in China. Besides, China's slowdown has been underway for some time – due mainly to the ambitious set of reforms China is trying to put in place. A hard landing looks unlikely, in our view. Overnight, China's PMI for August was in line with expectations at 49.7, while the Caixin PMI was revised up to 47.3 from 47.1. On the other hand, China services PMI weakened to 51.5 (versus 53.8 expected). China has many options to smooth the transition to a slower pace of growth and to manage the inevitable volatility arising from its attempts to liberalise its markets. Thus, last week China eased monetary policy by cutting the 1 year lending rate by 25bps to 4.6% and deposit rates by 25bps to 1.75%. Reserve requirements will also be lowered by 50bps to 17.5% with additional targeted easing for some sectors. As has been the pattern recently, the government did not waste an opportunity for further reform at the same time. They pushed the interest rate liberalisation agenda one step further by removing the upper band for rates on deposits with more than one year maturity. China's central government also extended its debt rollover swap line facility with local governments by RMB 1trn to RMB 3.2trn. The municipal bond market was started this year. Going forward, local governments will have to finance themselves with debt. The establishment of a municipal bond market is critical to creating a solid transmission mechanism for monetary policy. Swaps of the kind announced last week will likely continue until the transitional phase to a fully functioning municipal bond market has been completed. To limit speculation in the currency markets, China is also reported to have introduced USD reserve requirements for banks that put on forward positions betting against the CNY on behalf of clients.

- Saudi Arabia: As a major oil producer, Saudi Arabia has, along with other oil producers, been hit hard by the sharp fall in oil prices over the past year. To Saudi Arabia's credit, the country was well-prepared with a low debt burden and high levels of reserves. On the other hand, Saudi's adjustment has been different from that of, say, Russia. This is because Saudi's currency is pegged to the USD with few signs that this will change. Saudi Arabia must therefore rely exclusively on adjusting domestic demand. So far, Saudi Arabia has opted to smooth the domestic adjustment first by drawing down generously from its enormous foreign reserves. But there are now signs that this is changing. Foreign reserve assets declined by just USD 3.2bn in July to a still very solid USD 639bn. This was the slowest rate of drawdown this year. Instead of drawing down reserves, Saudi Arabia now appears to want to tap the bond markets. Given its very low debt levels, this should not pose problems.

- Turkey: Turkey goes to the polls on 1 November. An interim minority administration will run the country until the election. The AK party of President Erdogan decided to go 'to the people' again after failing to win a majority in parliamentary elections earlier this year. Having lost considerable votes to both Kurdish and nationalist parties, Erdogan has over the last few months pursued military campaigns on the border with Syria and against Kurds in South East Turkey. This strategy appears to be aimed at winning back disgruntled AKP voters. However, the latest polls paint a somewhat ambiguous picture about the effectiveness of this strategy. Last week one

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poll showed the momentum in favour of AKP waning. Overnight, a new poll showed AKP gaining. Hence, the election outcome remains highly uncertain. Yet, the outcome is important. If AKP fails to regain a majority, Turkey will be stuck with a hung parliament. This would make it difficult to implement a much touted economic reform program. Political noise could also rise if parliament decides to pursue various court cases against former ministers. Finally, tensions with the Kurds may end up having a more lasting impact on governability if there is a hung parliament. On a positive note, monetary policy continues to improve. The central bank announced that rates payable on Turkish lira required reserves will be raised by 50bps per month in September, October and November. This takes the interest rate on reserves to 3.83% - 5.83% from 2.33% - 4.33%.

- Brazil: Brazil is clearly one of the current 'bad seeds' in EM. Poorly run and plagued by corruption allegations, the government has squandered years of benign investor sentiment, cheap funding and high commodity prices instead of preparing the economy to cope with global conditions. The public finances, in particular, are very inflexible with high levels of earmarked and statutory spending. This produces a 'double-whammy' when the economy slows. First, spending cuts have to be targeted at the most growth-sensitive areas, such as investment. This pushes the economy down further than would otherwise be necessary. Thus, the economy contracted 1.9% in the second quarter after a 0.8% contraction in Q1. Unemployment has also risen to 8.3% in June compared to 6.8% at the same time last year. Second, as the economy goes through a larger than necessary slump the fiscal situation erodes further. Indeed, the economy's weakness is now so pronounced that the fiscal targets have had to be changed. The government's 2016 budget was submitted this weekend with a primary deficit target in the region of 0.34% of GDP. This brings closer the day when the ratings agencies downgrade the country from investment grade. Also, the government's limited success in passing reforms in parliament – not least due to the ongoing corruption scandal which has engulfed both the official sector and large sections of Brazil's industrial landscape – means that Brazil's return to economic health will now take most of President Dilma's remaining term in office (assuming she survives, which is our base case, but not a certainty). There is one silver-lining, however. Brazil's slump is not an endless spiral. It is, after all, merely a business cycle, albeit one with greater than necessary amplitude for the reasons outlined above. The one area where adjustment is now clearly visible is in Brazil's external accounts, which are improving on the back of a weaker BRL and austerity measures by the government. The current account deficit narrowed to USD 6.2bn in July from USD 9.3bn at the same time last year.

- India: India was labelled a basket case just a couple of years ago. Now it is growing faster than China. At 7.0% yoy, the economy is moving ahead at considerable speed on the back of domestic demand, notably financial services, trade and transportation. The government is slowly getting its capital spending program going, so growth is likely to tick up going forward. Public investment will crowd in private investment and later give way to stronger consumption. For these reasons, there are good reasons to continue to be optimistic about India's prospects. The latest manufacturing PMI number out of India was 52.3 in August, which is marginally lower than the print for July (52.7).

Snippets:

- Argentina: A US Appeals Court rejected a ruling that had allowed holdout investors to pursue claims against Argentina's central bank. The appeals court upheld the central bank's immunity. Construction activity rose at a 12.7% yoy pace in July, according to government sources.
- Hungary: The central bank left rates unchanged at 1.35%. This was widely expected.
- Mexico: The government is improving terms for bidders in an attempt to attract more interest in oil blocks in the next round of auctions scheduled for 14 September this year. Unemployment declined to 4.72% compared to 5.47% last July.
- Indonesia: Inflation slowed to 7.2% yoy in August from 7.3% yoy in July. Core inflation was unchanged at 4.9% yoy.
- The Philippines: The economy expanded 5.6% yoy in Q2, which was broadly in line with expectations. Growth is mainly due to strong domestic demand.
- Poland: PMI for August declined to 51.1 versus 54.2 expected and 54.5 in July.
- South Korea: Exports rose at a 3.0% qoq annualised pace in August following a 7.0% decline in July. This was weaker than expected. In yoy terms, exports were down 14.7% yoy in August.
- Thailand: Inflation was negative in August. CPI declined 0.1% mom (-1.2% yoy). The main reason for lower inflation is falling energy prices.

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Global backdrop

Though still materially lower than earlier in the year, oil prices have recently bounced. The triggers include several drawdowns in US and other oil inventories, estimates of lower US output by the Energy Information Administration, falling OPEC output and speculation that OPEC members will consider talks with third parties to restrict supply.

The market remains compulsively obsessed with the timing of Fed hikes. Over the past 10 days sentiment has yo-yoed dramatically. 'Fear of the Fed' declined sharply following a suggestion from New York Fed Chairman William Dudley that the Fed may not hike in September. Clearly, this intervention was driven almost entirely by poor stock market performance. Later, after stock markets stabilised somewhat, FOMC Vice-Chairman Stanley Fischer, in comments delivered at Jackson Hole, shifted sentiment back towards a September hike. In between, expectations have shifted variously due to data releases and other news. The important developments included US growth revisions (higher for Q2, but Q3 now tracking just 1.2% annualised), solid durables goods spending, falling imports and weak PCE spending and inflation as well as developments in commodity markets and China. What all these developments had in common, however, was that they were ultimately linked back to the Fed's decision.

This market's unrelenting focus on the first Fed hike has all the hallmarks of obsessive compulsive disorder. It is characterised by repetitive actions that make little sense to the non-afflicted – after all, everyone agrees that the hiking cycle will be very moderate and drawn out – yet they occur with such a frequency that they actually adversely impact almost all other facets of financial life.

In light of this, why is the Fed still sitting on the fence? What explains this amazing lack of decisiveness? Is the Fed really trying to create volatility, say, in order to achieve tightening without actually hiking rates? After all, the entire recovery strategy hinges on keeping financial markets buoyant until the underlying economy has healed, which means that tightening is actually a huge gamble. Or is the Fed just waiting for one more payroll number in order to be sure? If so, it is inadvertently sending a signal that its decision hinges on just a single, often significantly revised labour market statistic.

Our view is that the Fed is desperate to hike, not to stamp out rampant demand – what rampant demand? – but to signal that another milestone has been reached on the long journey to recovery. But we also think the Fed fears the consequences. The Fed knows that the US government has failed to reform and the economy has barely begun to deleverage in aggregate. Productivity is low and asset prices are very elevated. The Fed must also be aware that increasingly the ammunition of cheap money is no longer sustaining stock prices and low bond yields. This means that the only thing that stands between success and failure, between money illusion and a market crash, is confidence in the Fed. In short, the Fed is probably right to think very hard about what step to take next.

As for the rest of us we should probably obsess a bit more about reasons why the Fed has to be cautious, including the bubble-like valuations in developed financial markets, falling productivity, lack of investment, major debt issues over medium term and an overvalued exchange rate. And perhaps we should obsess a little bit less about EM's non-crisis crisis.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-9.01%	-12.67%	-22.68%	-2.10%	-0.59%
MSCI EM Small Cap	-9.62%	-9.67%	-18.73%	1.21%	0.14%
MSCI Frontier	-5.72%	-11.65%	-22.09%	8.41%	4.04%
MSCI Asia	-9.79%	-10.80%	-15.84%	3.12%	3.24%
China A shares	-12.46%	0.55%	47.03%	19.26%	6.57%
China H shares	-12.49%	-16.41%	-8.31%	5.59%	0.45%
MSCI EMEA	-7.21%	-7.91%	-22.36%	-5.99%	-2.05%
MSCI Latam	-10.51%	-23.10%	-42.28%	-13.97%	-9.50%
GBI EM GD	-5.38%	-12.30%	-21.54%	-7.00%	-1.88%
ELMI+	-3.34%	-6.90%	-14.59%	-4.33%	-1.85%
EM FX Spot	-4.48%	-14.07%	-24.23%	-11.28%	-7.94%
EMBI GD	-0.91%	1.24%	-1.15%	2.49%	5.33%
EMBI GD IG	-1.45%	-0.53%	-0.93%	1.32%	4.45%
EMBI GD HY	-0.16%	3.62%	-2.36%	4.27%	6.62%
CEMBI BD	-1.55%	2.05%	-0.05%	3.52%	4.96%
CEMBI BD HG	-0.85%	1.70%	1.21%	3.51%	5.08%
CEMBI BD HY	-2.87%	2.68%	-2.73%	3.76%	4.89%

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Benchmark performance

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-6.03%	-2.88%	0.47%	14.30%	15.86%
1-3 year UST	-0.06%	0.53%	0.59%	0.40%	0.66%
3-5 year UST	-0.07%	1.67%	2.36%	1.18%	1.70%
7-10 year UST	0.02%	1.73%	3.85%	1.19%	3.84%
10+ years UST	-0.84%	-1.94%	4.76%	1.12%	5.68%
US HY	-1.94%	0.03%	-3.56%	4.87%	7.70%
European HY	-1.02%	2.51%	2.08%	9.80%	10.49%
Barclays Ag	-0.64%	-0.55%	0.35%	3.16%	4.23%
VIX Index*	0.00%	48.07%	137.31%	62.74%	19.00%
DXY Index*	-0.26%	5.87%	15.50%	17.69%	15.81%
CRY Index*	0.00%	-12.12%	-30.97%	-34.72%	-24.74%
EURUSD	0.50%	-6.94%	-14.25%	-10.49%	-12.00%
USDJPY	0.92%	-0.25%	-13.21%	-34.75%	-29.70%
Brent	-1.51%	-6.98%	-48.12%	-53.45%	-30.15%
Gold spot	0.86%	-3.75%	-11.16%	-32.41%	-8.26%

*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. Data as at 28 August 2015.
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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