Stocks versus flows

By Jan Dehn

China continues to confound those who predict a hard landing. In Q3, China grew 7.8% yoy, FX reserves set a new all-time high, and the Chinese currency appreciated to the strongest level since 1993. China's trade surplus was substantial, but smaller than last month. While markets tend to focus on flow variables – such as trade balance numbers – it is the stock variables – such as the level of FX reserves – that really matter. Stocks show that Emerging Markets (EM) are strong. By contrast, developed economies are extremely weak. Political fragilities only exacerbate the weakness.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,041		1.88%
MSCI FM	570		1.06%
GBI-GD	6.34%		1.91%
ELMI+	3.38%		0.73%
EMBI GD	5.56%	294 bps	1.30%
EMBI GD IG	4.65%	202 bps	1.18%
EMBI GD HY	8.96%	656 bps	1.56%
CEMBI BD	5.54%	341 bps	1.10%
CEMBI BD HG	4.68%	253 bps	0.98%
CEMBI BD HY	7.52%	543 bps	1.05%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,745	2.03%
VIX Index	13.04	-17.05%
5 year UST	1.34%	-8 bps
10 year UST	2.59%	-10 bps
10 year Bund	1.85%	-1 bps
EURUSD	1.3683	0.89%
USDJPY	98.07	-0.50%
Brent	$110	-0.69%
Copper	$336	0.49%
Gold	$1321	3.69%

Emerging Markets

China's economy expanded 7.8% yoy in Q3 2013, which was faster than the growth rate clocked in the previous quarter (7.5% yoy). This growth rate is a far cry from the 'hard landing' scenario predicted in some quarters in June at the start of this summer's technical sell-off in Emerging Markets.

In the past week we also learned that China's foreign exchange reserves rose from USD 3.50trn in August to USD 3.66trn in September. This means that China's FX reserves are now the equivalent of 22% of US GDP. The increase in reserves took place despite softer than expected trade data, which suggests, rightly in our view, that China is increasingly becoming a destination of choice for those who fear the risks in conventional 'safe havens' in developed markets. Consistent with the improving net external balance position, CNY rose to its strongest level against the US dollar since 1993 over the past week.

That is not to say that China's trade balance was poor. China racked up a trade surplus of USD15.2bn in September. However, the surplus was smaller than the USD 28.5bn surplus recorded in August. The slowdown in exports was mainly due to softer exports to developed countries combined with marginally higher imports on account of solid domestic demand in China.

The solid domestic demand story in China was also reflected in moderately higher than expected credit growth. The volume of new loans rose to CNY 787bn in September versus CNY 675bn expected. Broad money (M2) expanded faster than narrower money aggregates (M0 and M1), which shows that financial intermediation is increasing. The share of on-balance sheet lending rose to 56% from 45% last month. While the ratio of on- and off-balance sheet lending to total credit is volatile the direction of travel is consistent with the authorities' objective of moving away from in-transparent financing of the various tiers of government.

China also released inflation data. Consumer price inflation rose to 3.1% yoy in September from 2.6% yoy in August, mostly due to weather-affected food price rises, which are unlikely to be repeated. We expect inflation to remain contained on account of deflationary impulses from the on-going restructuring of the economy and continuing FX appreciation.

Sceptics argue that narrower external surpluses are a major vulnerability in Emerging Markets. This view entirely misses the fact that many EM countries have large stocks of FX reserves, the result of many years of accumulated external surpluses in the past. These reserve cushions give EM countries the ability to manage their currencies despite a gradual reduction in external surpluses. China, more so than any other country, illustrates this fact. Sure, China's trade surplus narrowed, but does anyone seriously doubt China's ability to manage the value of its own currency?

Continued overleaf

Emerging Markets

Other Emerging Markets are in a similar situation. India has USD 249bn of FX reserves, Russia has USD 464bn, Brazil has USD 375bn, Mexico sits on USD 172bn of reserves, while Indonesia and Turkey have gross reserves exceed USD 95bn and USD 105bn, respectively. Indeed, the reason why the much touted 'EM crisis' of the past few months ended not with a bang, but with a whimper is precisely because of EM's large stocks of FX reserves.

Besides, current account deficits are not necessarily a big problem for three reasons:

- Firstly, EM should be running deficits! Emerging Markets economies should be capital importers, not capital exporters. Capital should flow to EM because EM countries have lower capital-labour ratios than developed economies. Capital inflows would help EM to finance the investment required to sustain their economic convergence with developed economies. The gradual erosion of current account deficits is desirable, not something to be afraid of
- Secondly, EM current account positions should gradually decline over the next few years due to macroeconomic policies pursued by heavily indebted economies, notably the US. Inflation and currency weakness in the US will cause currency appreciation in EM regardless of whether EM likes it or not. EM countries must transition from export-led to domestic-led growth as a result
- Finally, current account deficits only become a problem if they cannot be financed. Global capital markets will finance EM deficits if warranted by the quality of investment opportunities in each individual EM country. EM countries are, in most cases, likely to pursue investment friendly policies for political reasons, that is, their domestic populations will continue to demand growth and stability. As this summer has shown, EM countries are generally willing to act if their external balances deteriorate for the wrong reasons, such as temporary bouts of excess domestic demand. Adjustment in the so-called 'Fragile Five' EM countries is already having a positive effect

Analysts, policy makers, the media, and other interested parties continue to pay too much attention to flows and too little attention to stocks. From a risk perspective, the all-important balances in the world today are stock balances, namely the huge stocks of debt in developed economies – for example the US economy's 405% debt to GDP ratio – and the enormous stocks of FX reserves in Emerging Markets (currently USD 8.89trn, or 53% of US GDP).

As long as EM has large stocks of reserves, the main source of vulnerability in EM is not from current account imbalances – except in specific idiosyncratic cases where domestic policy is clearly mismanaged. Rather, the main risk is that EM reserves are overwhelmingly invested in extremely risky assets, such as US Treasuries and government bonds and currencies of other HIDCs (Heavily Indebted Developed Countries).

Global backdrop

The main global news of relevance to Emerging Markets in the past week was the last-minute resolution of the debt ceiling and budget funding impasse in the US Congress. In the end, the Republicans in the House of Representatives had to give up their demands to defund Obamacare, but they did achieve material concessions in the shape of very short-term extensions to government funding and the debt ceiling.

Specifically, Congress agreed to fund the US government only until 15 January and to raise the debt ceiling only until 7 February. The funding deadline for the government is a hard deadline beyond which non-essential services may once again be shut down. The debt ceiling deadline can probably be extended to early March through various "extraordinary measures".

Congress also set itself a deadline of 13 December to report on progress towards a longer-lasting fiscal deal. The idea is that both the government funding and debt ceiling deadlines can be rendered obsolete if a broader deal can be reached.

The good news is that last week's deal reduces the risk of a near-term US default. The re-opening of government will also support the economy. But the deal struck last week is hardly the stuff of long-term solutions. In our view, the growing polarisation in US politics along increasingly ideological lines reflects the continuing weakness of the economy and the very limited choices open to policy-makers. The economy's total debt burden is 405% of GDP, the room to change fiscal and monetary policy is very limited and Congress is completely unable to pass long-term structural reforms. Full-on money printing and the pleasant fiction that government debt is risk free are the only two band-aids holding everything together.

It is the same impotence in the face of weak growth which has produced populist (and in some cases extremist) politics in parts of peripheral Europe in the past few years. And it is ultimately the same impotence which gave rise to dictatorships in Europe and isolationism in the USA in the 1930s.

We do not expect Congress to make any material progress towards a broad sustainable fiscal deal by 13 December. This means that the next budget and debt ceiling deadlines will continue to weigh on both investor and consumer sentiment – and hence economic growth – in the coming months. In turn, this should keep the Fed on the side-lines regarding tapering of Quantitative Easing, let alone monetary tightening.

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