Ashmore

A pleasant fiction

By Jan Dehn

Over the summer a consensus was established that tighter financial conditions in developed countries and in the US in particular will impact Emerging Markets (EM) adversely. The argument goes roughly like this: Fed tapering of QE is merely a precursor for higher Fed funds rates. The process of rate normalisation will take place in a non-inflationary environment. The resulting increase in real rates strengthens the US dollar, while long yields in the US treasury curve remain low by historical standards. Unlike the other developed economies, which will more or less blissfully replicate the US recovery albeit with a lag, Emerging Markets are uniquely and fatally exposed to tighter global financial conditions through a triple whammy of withdrawal of QE money, the departure of foreign portfolio flows, and higher borrowing costs for sovereigns and corporates alike. In other words, Emerging Markets are back to being a derivative asset class, which owes all its recent success to external factors, in this case easy money from QE.

This consensus is a pleasant fiction for some, but to others (such as us) it's a tiresome regurgitation of hopelessly outdated ideas about Emerging Markets. We have two main disagreements with the current consensus.

- First, we disagree with the broadly held view that the financial tightening in developed economies will be a smooth non-inflationary process.
- Second, we disagree on how financial tightening will affect Emerging Markets.

In this Emerging View we explain how we see monetary policy normalising in the US, and we explain what impact this will have on Emerging Markets. One of our conclusions is that the panic selling of Emerging Markets assets in response to Fed tapering is completely unfounded and that, as a result, Emerging Markets offer extremely good value at this point. In fact, we think it is quite likely that Emerging Markets will be the strongest performing asset class in the world over the next twelve months.

The consensus expectation for US rates

The US Treasury market is currently pricing in a very particular pattern of monetary policy normalisation. Tapering of QE by mid-2014 quickly gives way to hikes by January 2015. By the middle of 2015 the Fed will have hiked at least four times. Inflation does not feature at all in the consensus outlook, because forward 10s30s (the spread between the 10 year forward rate and the 30 year forward rate) is flat at the terminal rates of around 4.5%. This terminal rate is 150bps lower than the 60-year average 10 year yields of approximately 6% (after excluding the 5 year period from 1980-1985, when 10 year rates briefly rose to 16%).

We think the consensus is wrong about US monetary policy normalisation

We think the process of normalisation of monetary policy in the United States will be very different. In particular, we do not expect a neat linear path back towards long-term trends for growth, inflation, and policy rates. Instead, we expect to see at least three phases, an early non-inflationary phase, a subsequent inflationary phase, and finally a phase where inflation is crushed through materially higher rates.

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Phase 1 has kicked off

The first phase (non-inflationary) kicked off with Fed Chairman Ben Bernanke's tapering announcement in May. Since then, we have seen an optimistic market push the nominal yield on the US 10-year Treasury bond increased from 1.7% to 3.0%. Over the same period, the yoy rate of core PCE inflation rose from 1.1% to 1.4%, so real rates increased by roughly 100bps.

Will real rates continue to rise? Unlikely. There are signs that real rates have already reached levels where they are hurting US growth. This year's early optimistic forecasts about US growth have all been confounded, and Q3 real GDP growth is so far tracking below 2%. More telling perhaps is the recent slowdown in housing starts and in particular the collapse of mortgage applications since May. These indicators suggest that the US economy is struggling with the recent rise in real rates.

[1] Rising debt service costs impacts both the private sector and the public sector, including the quasi-fiscal position of the Fed via its balance sheet, which holds more US Treasury debt than any other single institution on the planet.

Debt: The elephant in the room

But why are such modest increases in real rates hurting the economy? The reason is that the US and other developed economies are still extremely heavily indebted. Currently, the total US debt burden as a share of GDP is in excess of 405%. For context, this is twice as much as in the early 1980s and nearly three times as in 1945. The enormous debt stock means that if real rates rise too quickly or too far the economy will slow and could even go into outright recession due to the effect on disposable income and losses on long-term savings.[2] The debt issue is largely ignored by analysts and markets, which still indulge in the pleasant fiction of a risk free US Treasury market, aided by still low or even negative real rates. However, the debt is there and as rates inexorably rise over time it will become more and more visible. Debt is de facto an 'elephant in the room', huge and imposing. The elephant is sleeping at the moment, but when it wakes up it will make a lot of commotion.

Phase 2: Inflation

It is the existence of debt which makes an inflationary phase in the normalisation of monetary policy in the US extremely likely. It is the debt stock which has made the recovery from the crisis of 2008/2009 so anaemic. Only when the debt stock has been materially reduced in size will a solid recovery take root.

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The most important question in international macroeconomics today is therefore how the US will reduce the size of its debt stock. We have discussed this question in other publications; our conclusion is that the only politically and economically realistic way to reduce the debt stock is through inflation, financial repression, or, more likely, both. Financial repression and inflation help by making debt service cheaper and eroding away outstanding principal in real terms. We do expect nominal interest rates to rise during the inflationary phase, but this is entirely consistent with larger negative real rates, because we think inflation will rise faster than nominal rates.

Phase 3: Volcker II

After a protracted period of inflation the debt load of the US economy will have been reduced to a size that is consistent with a return to long-term trend growth rates, long-term trend real rates, and a non-accelerating inflation rate of unemployment (NAIRU). However, the preceding period of inflation will have undermined the credibility of the Fed and entrenched expectations of higher inflation in the minds of Americans, so a short, sharp shock of materially higher rates will be required to crush inflation. Volcker II. Akin to the experience of the 1980s, the Fed will be in a position to crush inflation through rates hikes precisely because the debt stock is now low enough that the Fed will not destroy the economy in the process.

Global FX in phase 1

The three phases of monetary policy normalisation have radically different implications for currencies. The early non-inflationary phase, which we are experiencing now, involves only moderately higher real rates. These support the US dollar, but only to maintain the currency within its established ranges. Indeed, the US dollar has not moved decisively higher since May despite the prospect of tapering and despite the ECB's move to forward guidance and Japan's big push to weaken the Yen. This underlines our view that we are still, despite the volatility, in a phoney currency war, where low real interest rates, low real growth rates, low inflation, and low risk appetite ultimately keep developed market currencies supported. The phoney currency war is also characterised by strong risk aversion, high liquidity preference, and regulatory pressures, all of which bias investors against less liquid exposures in Emerging Market currencies. It is a world characterised by a lot of volatility, but very little in the way of sustained directionality in currencies.[3]

Emerging Markets Local Currency in phase 1

Emerging Market currencies and bond markets have underperformed developed market currencies and bond markets significantly since May. We believe this is for technical rather than fundamental reasons. As recently as April of this year, the demand for Emerging Markets local currency exposure was still so strong that, by way of example, Polish 10 year local bonds rallied from 4% yield to 2.7% yield in just one month. Several other liquid local markets in EM experienced similarly strong rallies. This ought to have been telling for anyone with a focus on value. We like Poland, but it is hard to imagine how the fundamentals in Poland – or any other EM country – could improve rapidly enough to justify such a decline in long term borrowing costs in just one month.

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Indeed, the subsequent summer sell-off was highly technical in nature, in our view. It was caused by the attempt by hedge funds with huge speculative positions to leave a market, whose liquidity had suddenly collapsed. The onset of summer holidays (low trading volumes) and looming uncertainty over the FOMC meeting in September, Bernanke's replacement at the Fed, and the debt ceiling helped to sustain the selling over the summer. However, over the same period Emerging Markets fundamentals have begun to improve. Emerging Markets are far less sensitive both to tapering and the modest 100bps rise in real rates we have seen than, say, developed economies. Note that the Emerging Markets pick-up in growth now evident in the data is taking place against a backdrop of average local bond yields of 7%. The last time Emerging Markets local bond yields sat at 7% on a

[2] Rising debt service costs impacts both the private sector and the public sector, including the quasi-fiscal position of the Fed via its balance sheet, which holds more US Treasury debt than any other single institution on the planet.
[3] See *"The Phoney Currency Wars"*, Emerging View, February 2013.

sustained basis was when the US 10 year treasury yield was at 5%. We do not think 10 year US treasuries return to 5% anytime soon, though when they do it is a big deal for the US. By contrast, 7% is about the average borrowing cost faced by Emerging Markets over the past decade. It is therefore not a problem for them to cope with yields at these levels. But relatively speaking Emerging Markets fixed income has clearly been grossly oversold, in our view.

As for EM currencies, we do not expect strong appreciation though they can stage stunning rallies over short periods of time, especially after big sell-offs in bonds. But for the real push higher in EM currencies we believe we have to wait until inflation returns in developed economies, that is, until phase 2 in the normalisation of monetary policy in the US.

FX in phase 2

The return of inflation in the US will have a profound effect on global currencies, one which is barely even contemplated by mainstream analysts. The reason why currencies will be so impacted by inflation is that currency markets ultimately care about real returns. Materially lower real rates due to inflation will therefore unambiguously undermine the demand for US dollars. In the 1970s, US real 5-year yields declined to -5%, while inflation rose to 12%. The Dollar depreciated 500% against gold.

EM currencies were not actively traded in the 1970s, but the currencies of the re-Emerging Markets of the day – Europe – certainly were. So was Japan. Their currencies rallied strongly against the US dollar. The Deutschmark rallied 52% against the US dollar in the 1970s and the Japanese yen 47% between 1970 and late 1978. Today's surplus countries are mainly in Emerging Markets. Their surpluses are far larger and the US debt load far greater than in the 1970s. It is likely that currencies will have a lot of work to do once inflation returns.

Inflation as a policy objective in the US: Why it makes sense

Fed Chairmen Miller and Burns oversaw the rise of inflation in the 1970s. This may have been an inglorious period in the Fed's history, but Miller and Burns spared US consumers a great deal of painful fiscal adjustment. Instead, they ensured that losses caused by inflation and a weaker US dollar were borne by today's pensioners (the savers of the 1970s) and Europe's surplus countries, respectively.

When does inflation return in the US?

Inflation will not return like turning on a switch. The best guide to when inflation returns is US household deleveraging. At the current pace of deleveraging, US household debt to income ratios will return to pre-Greenspan bubble levels by Q2 2016. At that time, it is highly likely that inflation will pick up. US banks are already prepared to lend, having been recapitalised early in the crisis. Firms, loaded with cash, are ready to invest on a sign of sustained demand pick-up. GDP will be propelled higher and inflation expectations rise. Markets will push nominal yields higher, but the Fed will have to lean against the treasury market – as a matter of policy. Because of its size, the Fed will not be able to rapidly reduce its balance sheet and it will find itself unable to raise rates materially due to the size of the debt stock. The US dollar begins its multi-year adjustment lower as inflation rises amidst low nominal rates.

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The other 'elephant in the room'

The other 'elephant' – Emerging Markets excess central bank reserves – wakes up once the US dollar begins its unilateral march of depreciation. Losses from rising nominal US Treasury yields and the weaker US dollar force Emerging Markets central banks into diversifying reserves in a bid to maintain their purchasing power. With USD 8.7trn 'under management', Emerging Markets central banks entirely control global currencies. Remember that it only took USD 35bn of speculative short positions in EUR to move EURUSD from 1.50 to 1.20 and less than USD 20bn in speculative short positions in JPY to move USDJPY from 80 to 100.[4]

When they diversify, Emerging Markets central banks will have strong preferences for the most liquid currencies. This will favour larger Emerging Markets currencies over smaller ones. The resulting appreciation in large, liquid and capital-control free Emerging Markets will justify lower policy rates, making their local bond markets attractive at this time. In smaller Emerging Markets where currency appreciation is less pronounced, equity markets become particularly attractive, especially in the context of a faster growing world with limited supply of commodities and a falling US dollar.

After 'The Great Inflation'

Mainstream economists are just beginning to contemplate the prospect of the 'Great Inflation'.[5] This is a necessary step. But there is also life after the 'Great Inflation'. In the 1980s, Fed Chairman Paul Volcker successfully crushed inflation by raising real rates. He was only able to do so because of the stellar job his predecessors Miller and Burns did to bring down the size of the real debt stock. At the end of the coming 'Great Inflation' the Fed will similarly restore its tattered reputation by raising real rates. And once crushed, the US economy will re-appear shiny and new. Debt levels will be low. The US dollar will be highly competitive. And inflation expectations will be low. It will be the start of the next 30 year credit bubble. But it will also be a multi-currency world, where the US dollar still rules as the most important reserve currency, but alongside a much greater ranges of global currencies, including the larger Emerging Markets crosses.

[4] According to data from Nomura.
[5] See for example David Rosenberg's article in the Financial Times on 9 September 2013 entitled *"Don't bet against Bernanke's inflation quest"*.

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