Ashmore

Fed Captain and the World of Tomorrow

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Bond vigilantes 1 – 0 Fed

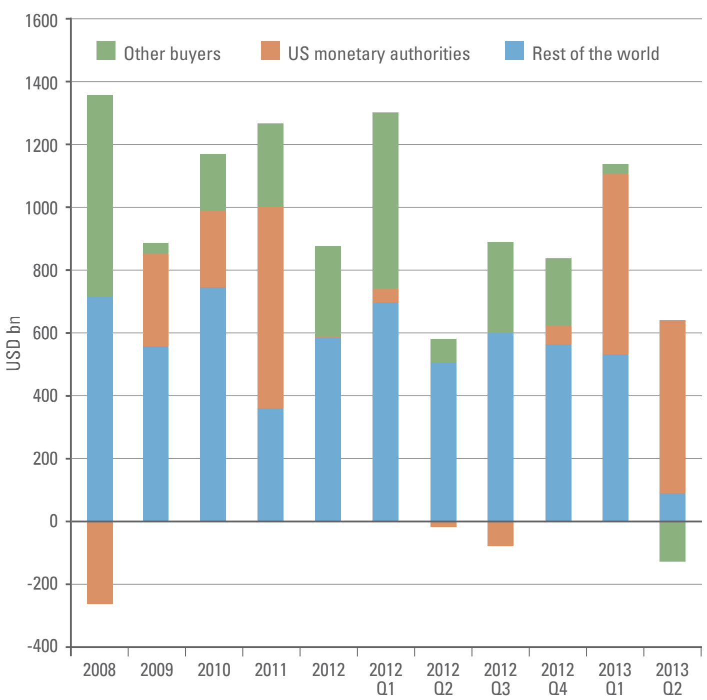
The US treasury market is already caught up in an almighty battle between bond vigilantes and the Fed. The bond vigilantes won the first round, when they forced the Fed to U-turn on tapering in September.

The risk for the Fed is the long end of the curve. The US economy is heavily indebted and higher real rates can inflict real damage. So when the Fed announced its intention to taper in May, Fed Chairman Ben Bernanke went out of his way to stress that tapering is not the same as rate hikes. Clearly he believed he could control the long end of the curve through verbal guidance.

In retrospect, this belief was hubris: Bond vigilantes ignored Bernanke's rate guidance, and proceeded to push 2s30s to near their all-time high as well as pricing in nine rate hikes by Q3 2016.

How can the bond market defeat an institution like the Fed?
The answer is that the Fed's power to influence the bond market has become very asymmetric. The Fed is (almost) the only game in town when it comes to buying US Treasuries. In Q2, for example, the Fed was the only net buyer in the market. Therefore, rates can easily go up if the Fed stops buying.

Fig 1: **Net purchases of US Treasuries**



Source: US Treasury.

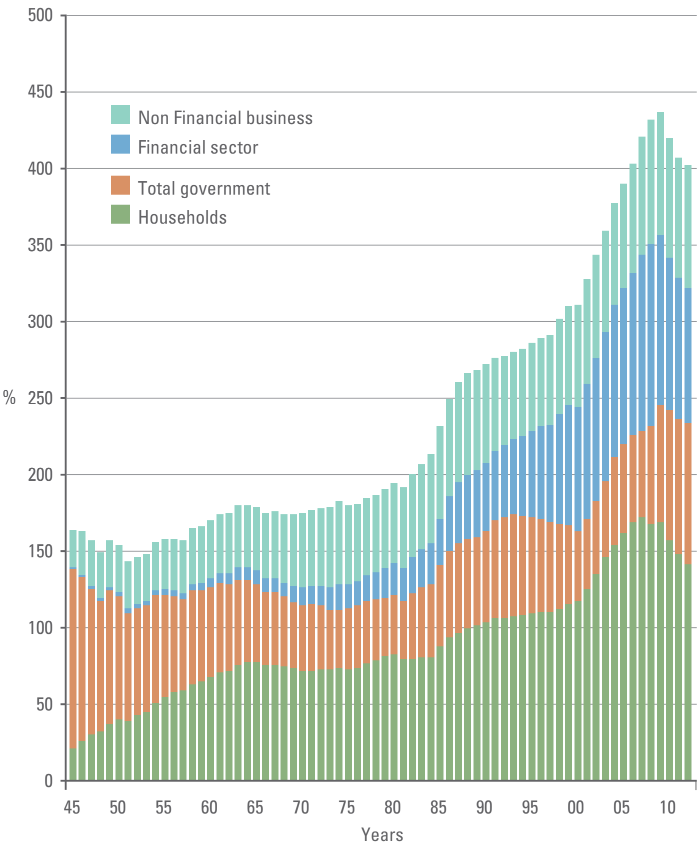
But there are limits to how high long rates will go, because higher yields have effects on the real economy. Remember that QE's success is not just felt in financial markets – QE has also had three important positive effects on the real economy:

1. QE lowered debt service costs to free up disposable income for heavily indebted households
2. QE helped to clear the mortgage market and in the process the Fed became the economy's single biggest holder of US mortgages
3. QE increased asset prices to raise wealth levels, though the impact of QE-induced asset price appreciation on wealth is probably less than prior to the 2008/2009 crisis

Scaling down QE will have important real economy effects primarily through higher real rates. Higher real interest rates inflict real damage in the interest sensitive sectors of the economy: housing crumbles, auto sales slow, and investment is postponed. Higher rates also eat into household disposable income. This resulting economic weakness undermines the rationale for tapering. And that is exactly what happened in September. Between May and September mortgage applications dropped by 65%, auto sales declined, and the recently released Q3 GDP number showed weakness in both consumption and investment. The Fed U-turned on 18 September.

The root of the problem is the economy's 405% of GDP debt burden (this number excludes about 300% of GDP worth of unfunded Medicare and other social liabilities). The high debt burden increases interest rate sensitivity and is the main reason why the economy is still sluggish six years after the subprime crisis, despite unprecedented easing.

Fig 2: **US total debt stock (% of GDP)**



Source: Federal Reserve.

A rational conclusion from this summer's Fed defeat at the hands of the bond vigilantes would be to acknowledge the need for a strategy to reduce the economy's overall debt stock. But this inevitably involves massive economic redistribution, and the uncomfortable question is who is going to pay? Austerity spares foreign creditors and savers, but would be economically (and therefore politically) costly. Inflation and Dollar depreciation shifts the burden to future generations and foreigners, sparing current consumers (voters). Hence, the domestic political cost is lower.

The Fed has yet to arrive at the conclusion that it needs to make this difficult choice. After all, there is near universal denial about the debt problem. When it U-turned on tapering in September, the Fed cited every possible reason bar debt as rationale, including housing, household deleveraging, tighter credit conditions, and fiscal drag. Though of course, the weakness in housing, households, credit conditions, and the fiscal situation all hark back to the same underlying problem of debt. The subject of debt is taboo, because no-one, including the Fed, has yet faced up to the tough choices required to reduce it.

Rates are still very low by historical standards, growth is soft, and inflation has not reared its ugly head, so the denial can continue for some time yet. The denial about the debilitating effect of debt will probably manifest itself in the shape of a fresh attempt to taper. The reasons for tapering will be the same as in May, namely that continuing QE only deepens the addiction to easy money in the US stock market, where valuations already pay more attention to the probability of the next QE sugar high than to company earnings. This is not healthy.

Like a virus, the Fed learns and adapts. Following the market's rough dismissal of Bernanke's verbal guidance in May the Fed will try stronger medicine next time it seeks to taper. Currently the most talked about innovation is to adopt a lower 6% formal unemployment threshold for hiking rates. Thus armed, the Fed is hopes to taper again, mostly likely early in 2014, without blowing up the long end of the Treasury curve.

But will a formal lower unemployment threshold really deter the bond vigilantes? We doubt it for three reasons:

- Firstly, a lower unemployment threshold is just another verbal commitment. It can be broken at any time. Is a new verbal commitment really going to be credible when the previous one was just shot to pieces? Recently the BOE (Bank of England) and the ECB (European Central Bank) have experienced similar defeats at the hands of the markets.
- Secondly, the bond vigilantes know that the Fed has very little concrete ammunition to back its verbal guidance. Once QE is gone the only other tool available to the Fed is twist operations (selling short dated securities and using the proceeds to buy long end bonds). But the Fed's room to twist has narrowed. Only 21% of the assets on the Fed's balance sheet are below five years to maturity and some 54% of the assets are already more than ten years to maturity.

Fig 3: **Fed balance sheet**

USDmn	Up to 5yrs	5-10yrs	10yrs	Total	%
US Treasuries	685,671	889,574	558,109	2,133,354	59%
Mortgages	5	2,595	1,391,103	1,393,703	39%
Other	58,540	62	2,347	60,949	2%
Total	744,216	892,231	1,951,559	3,588,006	100%
%	21%	25%	54%	100%	

Source: Federal Reserve.

- Finally, there is plenty of liquidity to fund speculation against the Fed and the cost of shorting the long end of the US treasury curve is quite low. The table below outlines the basic calculation. A 6 month short position in long bonds funded by 3 month money market rates will only require a move higher in 5-year, 10-year, and 30-year swap rates of 34bps, 22 bps, and 10 bps respectively to breakeven. Given the low starting point for yields such price increases seem relatively easy to achieve if the Fed announces the intention to taper again.

Fig 4: **Cost of shorting US long rates**

Bonds	5yr swap	10yr swap	30yr swap
Yield	1.45%	2.82%	3.75%
3 month MM funding cost	0.24	0.24	0.24
Cost of 6 month carry	0.61%	1.29%	1.75%
Duration (years)	4.9	9.0	18.6
Breakeven steepening (bps)	0.13%	0.14%	0.09%
Roll-down cost	0.21%	0.08%	0.00%
Total cost	0.34%	0.22%	0.10%

Source: Bloomberg. Data as at 22 November 2013.

Our conclusion is that there are high odds that bond vigilantes will launch another attack on the Fed if the latter re-launches tapering, in spite of enhanced guidance. This means that the long end of the US treasury curve is in for more volatility, though probably not sustained moves higher due to the implicit ceiling on rates created by the debt stock.

What are the main risks to this view? The most important risk is probably that a Yellen Fed postpones tapering for an extended period. In that case, US treasury volatility will be less pronounced. This would be a welcome reprieve for credit investors, but the risk would be that the US dollar weakens instead, much as it did in the past 18 months or so, when it lost nearly 15% of its value against the Euro.

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EM and Tapering v 2.0

If, as seems likely, the Fed will attempt to taper again next year with the result that US treasury volatility increases how will Emerging Markets (EM) react? We see three reasons why EM will not have the same outsized reaction the next time around – technical, fundamental, and valuations. We discuss each in turn.

Better technicals

Barring an almost unprecedented reversal of the outflows from EM in 2013 we should start 2014 with significantly stronger technicals than last year. Recall that positioning in EM fixed income was already extended going into 2013 after investors had belatedly chased the opportunity created by the Greek default in Q3 2011. Lower volatility following the introduction of the ECB's OMT programme was also confused with lower risk in EM and induced additional inflows (in fact risk was largely unchanged). Then, within the first four months of 2013, technicals deteriorated further as banks and leveraged fast money began to front-run anticipated Japanese real money flows into the asset class. Against this extremely distended technical backdrop, the Fed's May tapering announcement catalysed 20 weeks of mainly retail and fast money outflows into a market with few buyers due to low summer liquidity and big uncertainties arising from US political issues, Fed succession, and expectations of tapering by September. In other words, the outsized reaction in EM fixed income relative to other fixed income markets was almost entirely due to bad technicals. By contrast, the technical picture as we approach 2014 is entirely more favourable.

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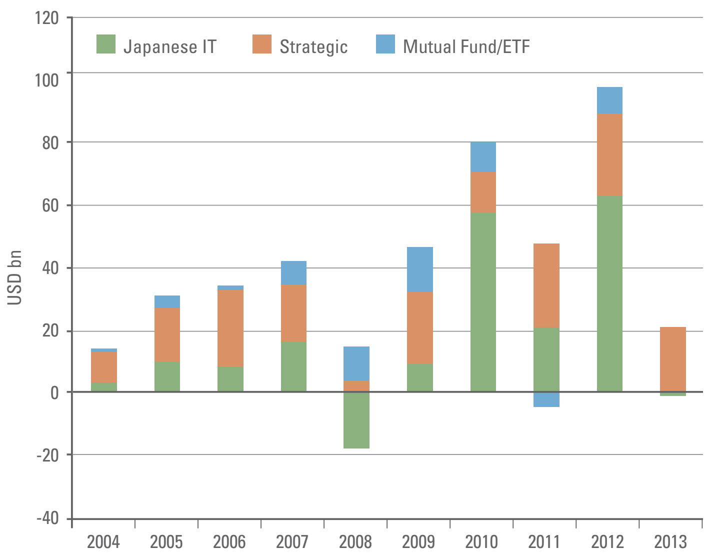
Admittedly, there are no good single good indicators that comprehensively capture the technical position in EM fixed income markets. Conclusions have to be drawn from an incomplete picture pieced together with fragments of information about the behaviour of four types of investors:

1. **Banks and hedge funds** – these investors do not benchmark and they tend to be extremely cyclical. Today many banks close or fully hedge positions at the end of each day due to recent regulatory changes. They trade on technical, bet on turning points, use heavy leverage, but care little about fundamentals.[1]
2. **Cross-over and dedicated EM funds** – these investors tend to be far less cyclical and are sometimes fully committed to the asset class. But their underlying client base can be highly benchmark aware and tends to regard volatility as a measure of risk (never recommended for inefficient asset classes like EM). Redemptions can force even the most dedicated EM funds to sell in a more pro-cyclical manner than they would wish, particularly if the client base also has a large retail component.
3. **Central banks and sovereign wealth funds** – these investors tend to be far less benchmark aware, rarely redeem, and their flows tend to be structurally motivated.
4. **EM local non-bank institutions** – local pension funds, insurance companies, and mutual funds are often restricted to domestic markets. They trade duration rather than leaving EM, so they provide a key stabilising influence on local markets.

Widely available information on US-based mutual funds and Japanese flows suggest that all the retail money that flowed into the asset class by May was out by September, while institutional inflows continued albeit at a slower pace.

Fig 5: **Publicly available data on US mutual fund and Japanese flows**



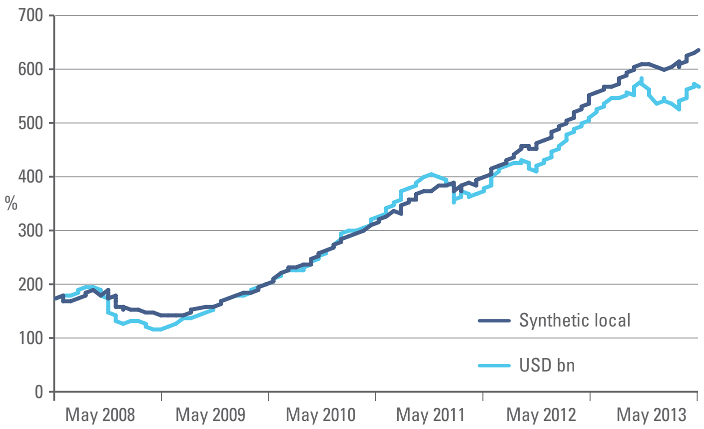
Source: EPFR, JP Morgan.

In a rare example of truly innovative investment bank research, Standard Chartered Bank has published what we believe to be the most comprehensive bottom-up analysis ever undertaken of global cross-over and dedicated EM funds into local currency bond markets.[2] Their seminal analysis shows that positioning by

[1] Which is one reason why long-term investors should be wary of investment bank research.
[2] *Local Markets Compendium 2014*, Standard Chartered Bank Global Research.

cross-over and EM dedicated investors in local government was stable during the summer sell-off, despite the fall in overall AUM of about 10%. This is illustrated in the chart below, which shows exposure in US dollar terms as well as 'synthetic local' holdings – that is, foreign holdings in nominal local currency terms which strips out the effect of changes in EM FX levels. The latter increased marginally despite the big drawdown in US dollar terms. Clearly, cross-over and EM dedicated funds were far more stable than the investors represented in US mutual fund and Japanese data.

Fig 6: **Cross-over and dedicated EM holdings of EM local currency corporate bonds (USD bn)**



Source: Standard Chartered Bank.

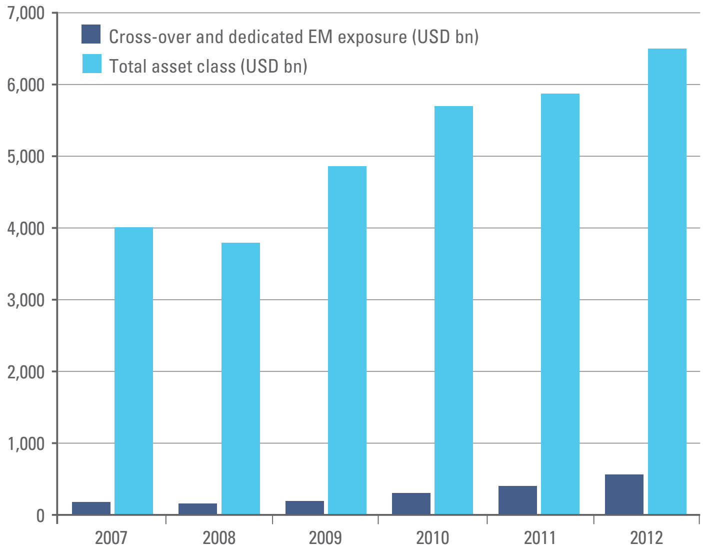
Standard Chartered Bank's analysis also shows that flows in and out of individual countries differed greatly. This underlines that cross-over and EM dedicated investors have long since stopped viewing EM as an amorphous asset class, but instead as a permanent place to be invested, albeit with explicit recognition that some credits are stronger than others.

We have combined Standard Chartered Bank's data on cross-over and EM dedicated fund exposure with data from Bank of America Merrill Lynch on the total size of the asset class to get a more accurate picture of the extent of foreign positioning in local markets. Our analysis shows that the share of cross-over and EM dedicated money in the EM local bond markets has increased from about 5% of outstanding local currency government fixed income at the end of 2007 to about 8% today. At approximately one tenth of the size of cross-over and dedicated EM flows, US mutual fund flows and Japanese flows do not materially alter this picture.

We conclude that total foreign exposure in local markets is substantially lower, but also significantly more resilient than the commonly cited 20-30% range for the foreign share in local bond markets. And the foreign share of local bonds in EM of course remains far lower than foreign share developed market bonds, which currently stands at nearly 50%.

Interestingly, but hardly surprisingly, local pension funds and insurance pools of capital have gradually been rotating from outright government bond exposures towards corporate and equity exposures over the past 10 years.

Fig 7: **Holdings in USDbn of local currency government bonds by cross-over and dedicated EM investors and the total local currency government bond universe**



Source: EPFR, JP Morgan.

There is little public information on how central banks and sovereign wealth funds traded during the recent summer sell-off, but there is some anecdotal evidence that asset managers with a large high proportion of CB/SWF money in their AUM had more stable flows than those with a higher retail component.

Finally, the role of EM local non-bank financial institutions in the local government bond markets continues to increase as part of a longer-term structural trend originating in demographics, formalisation of labour markets, financial deepening, etc. The share of EM pension fund assets in global pension fund assets has increased from 3% in 2001 to 8% by the end of 2012. Similarly, EM's share of global life insurance premium pools has increased from 9% in 2001 to 19% in 2012. Interestingly, but hardly surprisingly, local pension funds and insurance pools of capital have gradually been rotating from outright government bond exposures towards corporate and equity exposures over the past 10 years. EM pension funds now have 40% of their AUM in bonds, down from 62% in 2001, while insurance companies have 35% in bonds, down from 40% in 2001.[3]

Fundamentals

In brief, EM asset prices went down over the summer, but fundamentals improved. But this general statement fails to do justice to the complexity of the fundamental picture in EM. There are more than sixty investable countries and hundreds of investable corporates in EM. And the asset class is growing very fast, rising by USD 1.3trn in the past 12 months alone. The variation in credit quality across the vast universe is enormous, far wider than, say, that of Germany and Greece. China bears little resemblance to Paraguay, Ecopetrol is a completely different company from neighbouring PDVSA, and Korea's Samsung bears little resemblance to Nigeria's GT Bank, Ukraine's MHP, or Jamaica's Digicel, though all four are well run companies.

[3] The data on EM pension fund and life insurance premia has also been compiled by the team at Standard Chartered Bank.

At 4.5%, EM growth in 2013 has been disappointing. But EM growth disappointed for the same reasons that growth in developed economies disappointed. The main culprit was a dip in the global manufacturing cycle, which took hold in late 2012 and extended into Q1. Europe and the US were similarly very weak in Q1. For example, US growth was expected to be 3.5% growth in Q1 but was revised to just 1.7%.

Both Europe and the US began to pick up in Q2, when Europe finally moved out of recession by Q2 (although underlying growth in both the US and Europe in Q3 have proven once again to be sluggish). EM PMIs began to turn higher in July, one month behind developed economies. EM GDP growth also began to improve sequentially in Q2, ironically just as the sell-off in EM asset prices got underway.[4] China has continued to pick up over the summer months, and the recent decision by the Chinese leadership to give greater role to market forces in the allocation of resources is bullish for the medium term outlook. We think Q3 GDP prints from EM will be broadly positive and that the momentum in manufacturing will carry on into year-end. This leaves the cyclical dynamics quite different from the situation at the end of 2012. This view is consistent with the IMF's October *World Economic Outlook*, which predicts a moderate pickup in economic growth in every single region in EM in 2014.

Fig 8: **IMF growth forecasts for 2014 vs 2013**

Region	2013	2014
World	**2.9**	**3.6**
Developed Economies	1.2	2.0
US	*1.6*	*2.6*
Eurozone	*–0.4*	*1.0*
Japan	*2.0*	*1.2*
Emerging Markets	4.5	5.1
CFF	*2.3*	*2.7*
Asia	*6.3*	*6.5*
China	*7.6*	*7.3*
India	*3.8*	*5.1*
Latin America	*2.7*	*3.1*
Brazil	*2.5*	*2.5*
Mexico	*1.2*	*3.0*
MFA	*2.3*	*3.6*
SSA	*5.0*	*6.0*

Source: IMF WEO October 2013.

What about growth rates in EM over a slightly longer time horizon? EM economies certainly go through inventory cycles like all other countries, but EM economies are ultimately likely to grow faster over the cycle than developed economies due to lower debt levels, better demographics, better fiscal balances, and healthier external balances. We think, however, that investors should not expect the same rates of growth as in 2010 and 2011, because growth rates in those years were exceptional due to the enormous spare capacity created by the crisis in 2008/2009. The world should anticipate somewhat more moderate growth rates going forward, in developed and EM alike.

Finally, a word on the special cases Turkey, South Africa, Indonesia, Brazil, and India. These so-called 'Fragile Five' were singled out for special derision during this summer's EM sell-off. We wish to make the following general remarks about these countries:

- At least 10-15% of EM countries will at any point in time undergo some kind of macroeconomic adjustment. Like developed countries, EM countries elect bad leaders, make policy mistakes, and go through business cycles. Active management can reduce or entirely eliminate exposure to such countries, or they can be traded from the short side.
- There is no reason to leave the entire asset class because of a lack of uniformity across credits. In fact, it is precisely this diversity which is one of the attractions of the asset class.[5] Most of the other sixty or so investable countries in EM do not resemble the 'Fragile Five'. Most are better, some are far worse.
- The problems faced by the 'Fragile Five' countries are largely self-inflicted. Their challenges have nothing to do with changes in the global economic environment, which have been minimal.
- Significant policy adjustment is already underway in most of the 'Fragile Five'. Fortunately, their problems are relatively simple to solve. Unlike the huge debt challenges in developed economies, the 'Fragile Five' mainly face simple demand adjustment. Excess demand is resolved via rate hikes and/or fiscal restraint, and devaluation. Most of the five are already far down this path.
- Macroeconomic adjustment is not the same as crisis. A crisis is when debt is unsustainable, when reserves run out, when banking systems collapse, or when corporate sectors go down. There are certainly examples of genuine crisis-prone countries in EM, such as Venezuela, Argentina, and Ukraine, but the 'Fragile Five' are not among them. If anything, the adjustment underway in most of these countries now points to modest upside for these beaten up credits in 2014.

Valuations

The final reason why we think investors should be less wary of tapering by the Fed in 2014 is that EM valuations are far more attractive. Local currency bond yields have re-priced back to 2003-2007 average levels. The last time EM bond yields were at these levels was when 10-year US treasury yields were close to 4.5% and 5-year US treasury yields averaged nearly 4%. Today, the latter are trading closer to 2.7% and 1.4%, respectively. Corporate bonds in EM have also cheapened significantly compared to identically rated US corporates. EM corporate high-yield and high-grade corporate bonds are trading at 1.6 and 1.9 times wider spread than identically rated US companies, respectively. Finally, EM sovereign bond spreads have blown out to more than 300bps over US treasuries. Current valuations today and at the start of 2013 are shown in the table below.

Fig 9: **Yields in EM fixed income**

Asset class	Start 2013	Now
Local government bonds	5.46%	6.72%
External sovereign debt	4.38%	5.94%
Corporate high grade	3.82%	4.85%
Corporate high yield	6.67%	7.60%

Source: JP Morgan, Bloomberg.

[4] We urge our readers to re-visit our weekly research and our other reports published over the summer period for examples of these improvements.
[5] Interestingly, once it became clear that these five countries were not going to have outright crises many analysts have begun to refer to them as the 'Flimsy Five'.

On the threshold of the next phase in the evolution of EM investing…

EM has been through three major phases in the past forty years (see panel). Today, EM investing is not about whether or not to be invested in the asset class but rather where in EM to be invested, when to be there, and in which asset classes. EM is diverse enough, stable enough, and healthy enough to justify permanent exposure.

The analysis of the previous section suggests that an element of the investor base is becoming more mature how it views volatility in the asset class. Many investors now view simplistic in/out (of the EM asset class) arguments as old hat. They are increasingly recognising that volatility is not the same as risk and that chasing short-term price movements without regard to underlying risks only plays into the hands of banks and fast money. Strategic investors see that taking a value approach to EM investing is superior to chasing momentum.

If real money investors stop chasing after momentum traders then momentum trading itself becomes less profitable, and therefore less prevalent. And if that in turn causes the asset class as a whole to become less volatile then it is a big deal, because asset price volaility is still the single largest deterrent to investing in Emerging Markets. Lower volatility will therefore beget more inflows, greater liquidity, and a new era in EM investing, where asset prices reflect more closely actual risks rather than mindless herd dynamics.

The three phases of EM investing

Reflexivity

1 This phase largely comprises the Cold War period. During this period price volatility often caused economic crises in EM. Fundamentals were rotten. There was no local institutional investor base. No foreign investors were long-term or dedicated to EM. Most EM countries looked similar, fitting either a pro-Western or pro-Soviet model of development, so the potential for contagion was high. Hedge fund selling or buying inflicted massive volatility.

Adjustment

2 In the decade immediately following the Cold War EM governance changed from Superpower sponsored dictatorships to more representative government. The switch to local political accountability resulted in widespread adoption of inflation targeting, debt reduction, reserve accumulation, and establishment of pension funds. Asset price volatility gradually lost its power to destabilise EM economies, though only after the last of the big EM contagion events had played out. By 1998 EM had seen the last great contagion.

Disconnect

3 Post- 1998 EM asset price volatility has not had the power to destabilise EM countries as a group. Argentina's USD 120bn default in 2001 and Lula's election in 2003 both failed to trigger contagion. The Subprime Crisis in 2008/2009 was an even bigger test, which EM conomies passed with flying colours, despite massive price volatility. Lesser bouts of asset prices volatility caused by Greece, US debt ceiling issues, or tapering similarly reconfirmed EM's fundamental resilience in the face of extreme price volatility.

[6] When asset price volatility causes fundamental destruction it is called 'reflexivity'. This term was coined by George Soros. In the Cold War period reflexivity was widespread in Emerging Markets due to unstable politics, bad economic policies, lack of domestic institutional investor base, and the dominant role played by fleet-footed hedge funds in financing governments in Emerging Markets. But this view of Emerging Markets is now hopelessly out of date.

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