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The Fed's Hobsonian Choice

By Jan Dehn

The Fed still has room not to act, but it is getting ever smaller. In Brazil, the government presents the 2016 Budget, while new data from China's SAFE suggests that corporate FX mismatches are quickly being reduced. Finally, Russia's Elvira Nabiullina wins Euromoney's Central Banker of the Year Award for 2015; we explain why.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.4	–	3.46%
MSCI EM Small Cap	11.2	–	3.10%
MSCI Frontier	8.9	–	-0.97%
MSCI Asia	10.7	–	3.15%
Shanghai Composite	11.9	–	-3.16%
Hong Kong Hang Seng	6.9	–	3.30%
MSCI EMEA	9.5	–	4.18%
MSCI Latam	12.7	–	2.53%
GBI-EM-GD	7.08%	–	2.16%
ELMI+	4.19%	–	1.51%
EM FX spot	–	–	1.53%
EMBI GD	5.91%	376 bps	1.03%
EMBI GD IG	4.72%	251 bps	1.03%
EMBI GD HY	7.87%	589 bps	1.03%
CEMBI BD	5.98%	409 bps	0.30%
CEMBI BD HG	4.69%	278 bps	0.34%
CEMBI BD HY	8.45%	659 bps	0.24%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.0	–	-0.13%
1-3 year UST	0.71%	–	0.09%
3-5 year UST	1.47%	–	0.31%
7-10 year UST	2.15%	–	0.50%
10+ years UST	2.95%	–	0.48%
US HY	7.70%	635 bps	-0.33%
European HY	5.10%	508 bps	-0.29%
Barclays Ag	–	226 bps	0.24%
VIX Index*	22.28	–	-0.92%
DXY Index*	95.31	–	0.06%
EURUSD	1.1287	–	-0.27%
USDJPY	120.34	–	0.09%
CRY Index*	194.18	–	-2.54%
Brent	48.1	–	3.62%
Gold spot	1137	–	2.54%

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

Emerging Markets

- **Brazil:** The country's fiscal woes continued in August with tax collections down 9.3% yoy. However, part of the misery was due to statistical reasons. Significant one-off revenues were recorded in August 2014. The failure to repeat such measures this year meant that the base of comparison was less than flattering. Even so, the underlying pace of contraction in tax revenues – due to the ongoing economic recession – remains close to -4% yoy, which is weaker than GDP growth. Core retail sales declined 1.0% mom in July, or 3.5% yoy. The greater collapse in tax revenues than the economy as a whole illustrates the pro-cyclical nature of the fiscal initiatives introduced under former Finance Minister Guido Mantega. The government is seeking to change this unfortunate state of affairs in its 2016 Budget, which proposes measures to achieve a primary surplus of 0.5% of GDP, but some three quarters of the measures required to reach this goal require parliamentary approval. Sadly for the government, things are not looking too hopeful. The impeachment process against President Dilma Rousseff has now formally begun. This does not mean, however, that the process will reach its conclusion. The process requires approval by 2/3 of members of both the Lower House and the Senate and could take months.

- **China:** New data from China's SAFE (State Administration of Foreign Exchange) shows that domestic corporates neutralised a significant amount of USD short positions in August as non-banks bought USD 128bn. This adjustment reflects part of a one-off adjustment to a flexible exchange rate regime. Given the very modest moves in the CNH/CNY, the economic fall-out from FX mismatches on corporate balance sheets is likely to be modest. There are indications that the net investment position of Chinese corporates is getting close to balanced. However, the cheapness with which it is possible to short the CNH and CNY means that considerable net short positions are now likely to have been established as tail risk hedges. We think the Chinese authorities are likely to allow domestic corporates to close their FX mismatches, but that they will intervene against pure speculation, if required. Meanwhile, the housing market continues to improve. Some 35 cities recorded rising prices for new homes in August, up from 31 in July (out of 70). Home price appreciation accelerated to 0.19% mom from 0.16% mom in July. The number of cities with declining home prices fell to 26 from 29. The pace of fiscal spending accelerated in August to 25.9% yoy from the 11.8% pace recorded in Q1 2015.

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Emerging Markets

- Russia: Elvira Nabiullina, governor of the Central Bank of Russia, was deservedly awarded Euromoney's Central Bank Governor of the Year Award for 2015. Nabiullina steered Russia through extremely turbulent waters in the past twelve months with great competence. She has prepared the institution well by building up a reserve position. She maintained flexible FX rates to protect the public finances. She resisted the temptation to impose capital controls. She implemented decisive rate hikes to bring domestic demand in line with lower national income (due to lower prices). She introduced FX lines to help corporates finance. And she launched FX repo facilities to help guide Russia's severely mispriced sovereign credit spreads lower from the peak near 700bps over UST in December. All of these actions were taken in the extremely challenging context of a triple whammy of geopolitical crisis (Ukraine), broad-based Western sanctions against Russian quasi-sovereigns and a halving of oil prices. The pace of contraction in industrial production slowed in August to -4.3% yoy from -4.7% yoy in July.

Snippets:

- Argentina: Opposition candidate for President Mauricio Macri has been forced to accept the resignation of one of the candidates on his list over corruption allegations. Pro-government candidate Daniel Scioli has been gaining in the polls versus Macri recently. The first round of the presidential election is on 25 October.
- Chile: The central bank left rates unchanged at 3.0%.
- Colombia: Domestic demand is stepping up to replace export demand as the main driver of growth. Industrial production rose 0.3% yoy compared to -0.8% yoy expected, while retail sales were up 4.5% yoy versus 3.0% yoy expected for the month of July.
- India: The trade deficit narrowed marginally to USD 12.5bn in August from USD 12.8bn in July. The current account deficit narrowed to just 1.2% of GDP in Q2 from 1.6% of GDP a year ago. In 2013, India's current account deficit was 5% of GDP. The rapid turnaround in the overall external balance is testament to the cyclical nature of India's problems a few years ago. CPI inflation declined in August to 3.66% yoy from 3.69% in July.
- Indonesia: Bank Indonesia left rates unchanged at 7.5%.
- Malaysia: Exports rose 3.5% yoy in July versus 3.2% yoy expected. Imports also rose sharply, but due to lumpy energy imports that are unlikely to be sustained at the currency pace (5.9% yoy).
- Panama: Real GDP expanded 5.9% yoy in H1 2015. This compares to 4.9% yoy in H1 2014. Unlike many other countries, Panama is investing heavily in infrastructure during the current soft phase of the global economy. This is likely to prove beneficial once the upswing arrives, because Panama's companies will be able to produce at lower cost than companies in countries with more myopic policies.
- Singapore: Non-oil domestic exports declined 3.0% in the month of August. Singapore's heavily trade dependent economy has slowed due to a softer global growth outlook, but a firm focus on medium term domestic wage pressures have kept the Monetary Authority of Singapore tilted to the hawkish side.
- South Africa: The current account balance is improving sharply. After reaching a deficit of 5.1% of GDP in Q4 2014 the deficit has since narrowed to 4.7% of GDP in Q1 2015 and now just 3.1% of GDP in Q2 2015. A contributing factor to the improvement in the current account is the weaker ZAR.
- South Korea: Exports in the first 20 days of September rose 22.2% mom sa to USD 26.67bn from USD 22.65bn in August. Imports rose only 4% mom sa, so the trade balance (for the first 20 days) increased from USD -388m in August to USD 3.71bn in September.
- Thailand: Bank of Thailand left rates unchanged at 1.5% citing lower prices as the reason for temporary soft inflation numbers, while the Bank of Thailand expects a weaker currency and public infrastructure spending soon to impact the economy positively.
- Ukraine: A larger than necessary majority of parliamentarians (300 versus 226 required) approved a recently negotiated debt restructuring deal. The government has yet to decide how to deal with USD 3bn of debt owed to Russia and it remains to be seen how many investors will opt to participate in the now approved restructuring.

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Global backdrop

In refraining from hiking interest rates, the Fed highlighted two reasons: events abroad and the recent trends in US trade. Both are closely related to the strong USD – the real issue that dares not speak its own name.

The USD has become a victim of its own success. The 40% USD rally of the past few years was predicated on a view that the US economy will grow faster and the Fed will hike sooner than other quantitative easing (QE) economies. While this may be true, the USD has now become so strong that it is hurting the economy and preventing the Fed from hiking rates. If the economy slows and the Fed does not hike, the USD rally stalls.

The fact that the USD has rallied to this extent constitutes a crisis moment for the QE trades of the past four years. US stocks are down for the year and European bond returns are also negative. The only ways to restore the upside for QE trades appear to be via a sudden miraculous economic cure that returns the QE economies to really strong growth or a major correction in the markets.

The former seems unlikely, while the latter is becoming ever more likely. After all, the recovery in asset prices is complete after four years of QE, but the fundamental recovery has not even begun. If anything, there are now new drags being added to the old ones, including declining productivity, the real exchange rate appreciation and soft trade numbers. Finally, the discrepancy between valuations in developed markets and their fundamentals have now reached such a wide gulf that fears of a major correction are leaving the global market place feeling rather nervous.

Granted, the choice facing Yellen and Co whether to hike was a difficult one. A hike was obviously not required for conventional monetary policy reasons – last week's core CPI inflation rose just 0.07% in the month of August for example. The real economy is on track for another year of measly 2% growth in 2015, despite the easiest policies ever.

Instead, the strongest argument in favour of a hike was that by hiking the Fed would signal confidence in the future in the hope that this in turn would lead to greater willingness in the part of the private sector to plough money into the real economy and thus help to speed up the pace of economic healing so desperately needed. The negative reaction in the equity market following the decision not to hike suggests that many people in the market actually took this view.

But the Fed remained on the side-lines, because a hike would also have been a very risky strategy. For one, the hoped-for upside was clearly speculative. Think about it: would a Fed hike really have made participants in the real economy believe that all the many unresolved structural problems had suddenly gone away? Unlikely. At the same time, the downside risks were significant. Capital markets could easy have misinterpreted as the beginning of a longer-lasting and steeper hiking path, which in turn could trigger a major correction in the equity markets and thus undermine the very fragile recovery the Fed was hoping to engender by hiking. Besides, a hike would also have pushed the USD higher, tightening financial conditions and making lives even tougher for exporters.

Faced with this dilemma the Fed decided not to move. Attention will undoubtedly now shift to the Fed's October, December and March meetings as if it really mattered which of these meetings is the one where the Fed finally moves. The myopic fascination with pinpointing the precise meeting at which the first hike takes place entirely misses the real lesson investors should glean from the Fed's decision last week, namely that it will be almost impossible for the Fed to undertake any meaningful monetary tightening as long as financial asset prices are so inflated, as long as the economy is so unproductive, as long as there is so much debt and as long as the USD is so strong.

If you can see this, then try to think further ahead – what will happen when inflation returns in earnest? None of the factors that prevented the Fed from hiking last week are likely to have gone away. Hence, the return of inflation will only serve to remove the Fed's remaining freedom to do nothing – a freedom it exercised last week.

Returning inflation will force the Fed to choose between preserving a fragile economic recovery and crushing inflation. Both are not possible at the same time due to the state of the underlying economy. Hence, this is really a Hobson's Choice, that is, given the prevailing conditions in the economy and the bloated state of capital markets the Fed actually has no choice at all. It will have to support growth even if it means higher inflation.

Inflation is the inevitable albeit lagged consequence of printing money. As inflation slowly marches higher, as a dovish Fed holds down yields at the short end and as financial repression holds yields down at the long end real yields must fall, not rise. And that in turn marks the start of the USD's long-awaited U-turn.

When does inflation show up? Best guess: late 2016, provided that the markets do not crash due to sudden loss of confidence in the Fed or a recession in the real economy. Between now and then range-bound USD is more likely than the surging USD of the last four years. After all, the Fed just told us that much through its lack of action last week.

In other global news, we note that Japan's sovereign credit rating was reduced by Standard and Poor's to A+ with stable outlook from AA- with negative outlook. France was also downgraded. Moody's downgraded the country sovereign bond rating by one notch to Aa2 from Aa1, but changed the outlook to stable from negative. In Greece, SYRIZA was rewarded for its policy objective of achieving debt relief but while remaining within the institutional framework of the European Union. As such, this outcome will be remembered not just as a success for party leader Alexis Tsipras, but also more broadly for the institutions of Europe.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	1.59%	-11.29%	-19.25%	-3.61%	-1.62%
MSCI EM Small Cap	3.68%	-6.34%	-14.21%	0.75%	-0.71%
MSCI Frontier	-0.14%	-11.77%	-23.21%	7.43%	2.98%
MSCI Asia	2.69%	-8.40%	-11.58%	1.98%	2.18%
China A shares	-3.32%	-2.79%	36.08%	17.60%	6.13%
China H shares	3.17%	-13.76%	-4.26%	5.08%	-0.29%
MSCI EMEA	-0.18%	-8.08%	-21.70%	-8.16%	-3.14%
MSCI Latam	-2.16%	-24.76%	-39.81%	-16.36%	-10.81%
GBI EM GD	-0.15%	-12.44%	-19.40%	-7.83%	-2.40%
ELMI+	0.87%	-6.09%	-12.37%	-4.76%	-2.12%
EM FX Spot	-0.12%	-14.17%	-22.33%	-11.99%	-8.32%
EMBI GD	1.11%	2.36%	1.45%	2.44%	5.56%
EMBI GD IG	0.76%	0.23%	1.40%	1.36%	4.60%
EMBI GD HY	1.57%	5.25%	0.51%	4.03%	6.95%
CEMBI BD	0.08%	2.13%	0.62%	3.13%	4.82%
CEMBI BD HG	0.12%	1.82%	2.08%	3.28%	5.04%
CEMBI BD HY	0.00%	2.68%	-2.45%	2.99%	4.54%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.59%	-3.46%	-0.63%	12.65%	14.07%
1-3 year UST	0.22%	0.75%	0.83%	0.50%	0.70%
3-5 year UST	0.53%	2.21%	3.63%	1.43%	1.86%
7-10 year UST	0.93%	2.68%	6.80%	2.08%	4.45%
10+ years UST	0.85%	-1.10%	10.51%	3.45%	7.21%
US HY	0.29%	0.32%	-2.37%	4.29%	7.34%
European HY	-0.15%	2.36%	2.10%	8.80%	10.06%
Barclays Ag	0.63%	0.08%	2.21%	3.40%	4.48%
VIX Index*	-21.63%	16.04%	83.98%	59.37%	-0.31%
DXY Index*	-0.54%	5.58%	12.48%	20.14%	18.48%
CRY Index*	-3.91%	-15.56%	-30.50%	-37.15%	-30.24%
EURUSD	0.68%	-6.70%	-12.16%	-13.04%	-14.91%
USDJPY	-0.73%	0.47%	10.57%	53.95%	41.43%
Brent	-11.27%	-16.19%	-51.16%	-56.87%	-38.73%
Gold spot	0.21%	-3.97%	-6.40%	-35.86%	-11.66%

*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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