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Summary

The fragility of popular bull market trades in the HIDCs was exposed by Bernanke's commitment to a more flexible approach to monetary policy in the United States. We believe that it will prove very difficult to unwind very easy policy in the HIDCs as long as debt levels remain at the current size.

Global

The fragile nature of the three most popular HIDC trades so far this year – long USDJPY, long S&P500, and long Nikkei – was illustrated perfectly by the market reaction to the Fed's various statements on Wednesday. All three trades reversed sharply following perceived greater hawkishness by Fed Chairman Bernanke, which suggests that they were driven as much by positioning and speculative momentum as genuine confidence in recovery. After all, the US, Europe, and Japan are heavily QE-addicted, highly indebted, and structurally impaired regions. Can such economies really stomach a scaling down of QE at a time of still massive debt levels and other drags on growth? Yesterday's strong negative reaction to the new uncertainty triggered by Bernanke – bearing in mind that it is taking place against the backdrop of a cyclical slowdown in manufacturing and following a very strong recent rally in these markets – illustrate, in our view, the dynamics of the 'phoney currency war', namely that QE money is causing market prices to move far more than is justified by underlying fundamentals. Or put differently – prices are an extremely poor proxy for risk. All the more so now that the Fed is explicitly data dependent. This means that the environment for interest rates can become a great deal more volatile, but not necessarily with a sharp change in the level of rates. Recall that the Fed's data dependence was already made clear in the previous minutes, so there was in fact little new in yesterday's statements other than the fact that Bernanke was seen to explicitly back the wider FOMC's position as set out in those minutes (in itself hardly surprising).

Our view is that we are going to be in a very easy monetary policy environment for a long time yet. The labour market may not be shedding as many jobs in the US as it did, but it is not adding a lot either. Manufacturing is slowing, inflation is falling, and of course no one is giving thought to the debt service problem, which would emerge once inflation and interest rates begin to rise. In other HIDC developments, Japan's BOJ maintained its very easy stance of QE of JPY60-70trn per year amidst weak trade data (suggesting that so far the weakness of JPY has not aided the economy). In one of the most explicit admissions that the HIDCs are pursuing financially repressive policies, senior European officials this week proposed to exclude government bonds from any future financial transactions tax in Europe in a bid to keep borrowing costs low for European sovereign issuers. Meanwhile, EU legislators voted overwhelmingly in favour of enshrining potential haircuts for large depositors in the event of future bank failures as they move towards defining a single regulatory framework for the EU. This move is happening against the backdrop of a still largely insolvent European banking system, surviving only due to life-support via LTROs from the ECB and the existing short-selling ban on European bank stocks. Finally, we note that European PMI numbers have begun to slightly beat expectations. In terms of price action, US stocks gave up all of their intra-week gains to trade 21bps lower than at the same time last week, while 10 year US treasury yields rose from a low of 1.88% to 2.00%. EURUSD weakened slightly from 1.2886 to 1.2865 and USDJPY dropped from a high of 103.2 to 101.8.

Latin America

In Mexico, retail sales declined more than expected, consistent with recent comments from the central bank suggesting an easing bias. First quarter GDP also slowed to 0.8% yoy. Inflation in Brazil was lower than expected at 0.46% mom according to the IPCA-15 (mid-month) inflation release. In yoy terms, this keeps inflation running right on the upper band of the target range (6.5%). Argentina's trade surplus was $10.5bn in April. Exports in particular rose strongly in volume terms. The parallel exchange rate in Argentina has recently begun to strengthen versus the US dollar after a bout of weakness. Colombia's central bank announced that it will maintain its program of buying dollars until year-end. Industrial production weakened, but retail sales strengthened. Chile's economy expanded 4.1% yoy in the first quarter.

Continued overleaf

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Asia

Chinese manufacturing flash PMI fell below 50 on the back of the current downturn in global manufacturing, though the broader set of macroeconomic indicators, including loan growth and house prices, suggest that Chinese growth remains robust. Indeed, we believe that China's insistence of rotating the economy from export to consumption led growth is far sighted and ultimately good for the outlook. The currency fixed at a new high of 6.1904 versus the US dollar in the past week. Thailand's economy expanded at a pace of 5.3% yoy in the first quarter. Taiwan export orders rose 2.2% in April. Singapore's non-oil domestic exports rose 1.1% mom and industrial production was up 4.7% yoy, which was better than expected. The improvement in activity took place against a backdrop of falling inflation as CPI inflation rose at just 1.5% yoy in April (versus 3.1% expected).

Eastern Europe, Africa, and Middle East

Ghana's central bank raised rates to 16% from 15% even as inflation declined from 10.7% yoy to 10.2% in the latest inflation report. South African inflation rose to 5.9% yoy in April, slightly higher than expected (5.7%). Russian industrial production rose 2.3% in April versus 2.0% expected. Real GDP was also stronger than expected. Output rose 1.6% yoy in Q1 versus 1.2% expected. This improvement relative to expectations took place despite a slowdown in manufacturing, which is part of a broader global manufacturing slowdown. Turkey's sovereign rating was raised to investment grade by Moody's, the rating agency. Poland's industrial production rose 0.8% in April, thus recording acceleration versus March, where industrial production was up 0.7% mom. This comes against a backdrop of somewhat less negative manufacturing numbers from Europe.

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