

The Fed's 405% problem

By Jan Dehn

The past three months have provided a useful illustration of how Emerging Markets (EM) respond to external shocks from developed economies. As in previous similar episodes, asset prices over-reacted, while fundamentals remained solid. Value has been created in the process. Meanwhile, the Fed's decision not to taper smashed the consensus view that the US is on track to strong recovery and materially higher real rates. Still, most market participants and policy makers are unlikely to grasp the reasons for the US economy's weak performance until they acknowledge the role played by the 405% of GDP debt burden.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	1,013		1.19%
MSCI FM	557		0.92%
GBI-GD	6.43%		2.50%
ELMI+	3.65%		1.04%
EMBI GD	5.72%	295 bps	2.03%
EMBI GD IG	4.81%	202 bps	2.03%
EMBI GD HY	8.88%	633 bps	2.04%
CEMBI BD	5.72%	343 bps	1.13%
CEMBI BD HG	4.88%	257 bps	1.04%
CEMBI BD HY	7.63%	538 bps	1.03%

Global backdrop	Index level/ yield/ FX rate/price	1 week change
S&P 500	1,710	0.74%
VIX Index	13.12	-8.76%
5 year UST	1.48%	-14 bps
10 year UST	2.73%	-13 bps
10 year Bund	1.95%	2 bps
EURUSD	1.3543	1.54%
USDJPY	98.98	-0.08%
Brent	\$110	-0.62%
Copper	\$339	3.40%
Gold	\$1330	1.27%

Emerging Markets

The last three months showed what happens to EM asset prices and fundamentals when a shock occurs in developed countries, this time in the shape of expected monetary policy tightening in the United States.

The effects were almost identical to similar events in the past. Firstly, EM asset prices massively over-reacted to the global shock as banks, cross-over investors and hedge funds once again found themselves unable to resist the urge to dump EM assets. Secondly, EM fundamentals defied all the hysterically calamitous predictions of an 'EM crisis'; they were far more resilient than the moves in asset prices would suggest.

The fact that investors still overreact to global events shows that Emerging Markets is still misunderstood in many quarters. The actual fall-out from three months of severe outflows, currency volatility, sovereign spread widening, rising domestic bond yields, monetary policy tightening and fiscal retrenchment can be summarised as follows:

- No Emerging Markets government defaulted or even came close to serious sovereign funding problems. Instead, a number of new countries entered the main benchmark indices and unloved Indonesia was able to issue with great success amidst the worst of the anti-EM sentiment
- No Emerging Markets central banks ran out of reserves or had to seek IMF support or lost control of their currency, even Turkey, Brazil, and Indonesia that were singled out for special punishment because of external deficits. In fact, at no point did the cumulative intervention by Asian central banks exceed \$20bn (Asian central banks ex-China have firepower of more than \$2trn of FX reserves)
- No banking system in Emerging Markets faced serious stress which could challenge the capacity of central banks and fiscal authorities, despite very large moves in FX and rates. Central banks only stepped in to provide liquidity support in a few selected cases. In the most publicised case, that of China, the motivation to intervene was to manage a specific regulatory arbitrage case, not to alleviate stresses arising higher global rates
- As of yet no EM corporate has defaulted due to tighter global financial conditions

Thus, the experience of the past three months re-confirmed that EM is still one of the most inefficient asset classes on the planet, where asset prices can be extremely poor proxies for risk. Emerging Markets are clearly still regarded as a derivative asset class, perceived to have no value unless conditions are supportive in developed economies. Fear exceeds knowledge.

Global backdrop

The broadly held consensus of strong US growth and higher rates took a bit of a knock in the past week, when Fed Chairman Ben Bernanke delayed tapering of QE. The markets had fully priced the policy change. What monster on the horizon prompted the U-turn?

The official reason is that the economic data in the past three months was weaker than expected. Indeed, the economy slowed from an already sluggish pace in H1 and modestly higher mortgage rates threatened to inflict material damage in the housing market.

Time will show if this U-turn was a policy mistake. On one hand, the Fed must taper if it wants to wean already strongly QE-addicted stock and bond markets off the drug of money printing. Critics prefer gradual 'methadone' treatment now to brutal 'cold turkey' later.

On the other hand, the loss of QE as a policy instrument would leave the Fed impotent if long-end yields rise sharply, thus potentially jeopardising the housing market recovery. Indeed, the rapid decline in mortgage applications since May could have prompted the Fed to hold on to its option to drink from the endless fountain of its own liquidity creation. The room to employ further 'Twist' operations is severely restricted by the long duration of the assets on the Fed's balance sheet.

Tapering could easily come back. Janet Yellen, if chosen as the next Fed Chairperson, may want to launch tapering to boost her inflation fighting credentials. It could happen under Bernanke. Either way, the market is likely to be more sensitive to officials' commentaries until the Fed restores credibility to its communication policy, in much the same way that markets became hyper-sensitive to European officials' statement during the early phases of the European debt crisis.

To us, the debate whether the tapering U-turn is a policy mistake or not misses a more important question, namely why the US economy once again has failed to perform in line with the bullish expectations of analysts and the Fed. The weakness that prompted the tapering U-turn took place against a backdrop of improving manufacturing, cashed up corporate balance sheets, a fully re-capitalised banking system, and major progress in household deleveraging.

We think the fundamental reason for the many bad forecasts is that most analysts ignore the enormous debt stock in the US. Total US debt is 405% of GDP, twice as much as in 1980. Even the government's debt of about 100% of GDP is unsustainable, according to the latest IMF Article IV report. Growth is, and will likely continue to be anaemic because the economy is drowning in debt. If interest rates rise, the debt burden could move from tolerable to unbearable.

Yet no one talks about debt. Why? The reason is that almost everyone with a direct stake in developed fixed income markets has strong incentives to ignore or belittle the problem.

- The Fed cannot blame the debt for its poor forecasts, because if it acknowledged the debt problem it would have to enter into a discussion about how the debt stock can be reduced. The only feasible solution is inflation, but inflation would conflict with its mandate as a central bank
- Ratings agencies and regulators are silent on the subject because the entire regulatory system rests on the notion of risk free bonds with zero capital requirements. When Standards & Poor's downgraded the US in 2011 it did so with reference to political dysfunction, not to the debt dynamics
- The US Administration is silent because it is impotent. It has neither the stomach for nor means to undertake fiscal reform
- Banks are silent, because long-term problems like debt do not generate daily trading volume
- The media knows that debt does not produce 'news' until it results in crisis
- Emerging Markets central banks are hugely exposed to the developed market debt, especially US treasuries, but see no alternative investment destinations with comparable liquidity

This means that long-term investors have to do their own thinking on the question of developed market debt. By responding to what is in fact a debt-related problem by printing more money, the Fed is putting in place the building blocks for more future inflation and a weaker US dollar once the inflation surfaces.

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