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Developed economies are causing trouble again

By Jan Dehn

Most spikes in global risk aversion can be attributed directly to events in developed economies, where risks are not adequately priced in and fundamental economic problems repeatedly get swept under the carpet. Greece is an extreme manifestation of these problems, but they exist in most developed economies. Investors would therefore be wise to begin to distinguish between risk and volatility. The last time Greece defaulted, Emerging Markets (EM) presented a major buying opportunity. The same is likely to apply this time. Meanwhile, in EM, China cuts rates to support its economy as it undertakes unprecedented reforms, while Brazil tightens its inflation target. Venezuela prepares for elections, Romania cuts VAT and it is still raining in India.

Emerging Markets	PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	13.8	–	0.85%
MSCI EM Small Cap	21.1	–	0.03%
MSCI Frontier	10.9	–	0.28%
MSCI Asia	12.5	–	0.73%
MSCI EMEA	13.1	–	1.10%
MSCI Latam	22.8	–	-0.63%
GBI-EM-GD	6.76%	–	-0.50%
ELMI+	4.28%	–	-0.68%
EM FX spot	–	–	-0.83%
EMBI GD	5.77%	327 bps	0.01%
EMBI GD IG	4.57%	200 bps	-0.46%
EMBI GD HY	7.88%	553 bps	0.69%
CEMBI BD	5.49%	324 bps	0.06%
CEMBI BD HG	4.43%	217 bps	-0.14%
CEMBI BD HY	7.49%	525 bps	0.43%

Global Backdrop	PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	18.6	–	-0.37%
2 year UST	0.64%	–	0.03%
5 year UST	1.64%	–	-0.08%
7 year UST	2.34%	–	-0.22%
10 year UST	3.12%	–	-0.10%
US HY	6.81%	526	-0.24%
European HY	4.52%	442	0.99%
Barclays Ag	–	440	-1.32%
VIX Index*	14.02	–	0.06%
DXY Index*	95.67	–	1.34%
CRY Index*	224.88	–	2.75%
EURUSD	1.1122	–	-2.12%
USDJPY	122.85	–	0.37%
Brent	61.5	–	-2.97%
Gold spot	1179	–	-0.58%

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

Greece and Emerging Markets

It is worth paying attention to events in Greece this week, not because they matter a great deal to EM fundamentals, but because Greece provides yet another warning about the real riskiness of investing in developed economies. This week we are likely to witness, once more, how crises in developed countries that ought to be local affairs, turn out to have ramifications in global markets. Crises in developed markets have effects in markets well beyond their own borders, because the true risks of investing in developed economies are simply never adequately priced. When crises then materialise, investors are caught off guard and resort to 'rules of thumb' trading that lead them to sell assets that most likely have nothing whatsoever to do with the crisis itself – often because they suspect others might do the same. Such inefficiencies create opportunities. EM investors should stand ready to buy into the dips to the extent that any arise from the situation in Athens. The last time Greece defaulted in March 2012 it was a great opportunity to buy EM – with the local currency bond index falling at first and rebounding 20% in the subsequent twelve months. Price reaction to the weekend news has been relatively muted this morning, with credit spreads 10-20 bps wider on average and EM currencies down one percent in line with EURUSD. A more pronounced drop should be viewed as an opportunity to buy EM debt assets.

Why do developed economies continue to have crises? The answer is that they, for the most part, repeatedly fail to address their underlying structural and economic problems. The policy mix in developed economies can almost be defined as a tendency to sweep the most difficult problems under the carpet of short-term monetary stimulus.

As the Greek debt crisis continues to unfold it is worth recalling that most other developed economies also face massive debt problems. The 2008/2009 crisis was a debt crisis – the culmination of 30 years of debt fuelled consumption in the West fuelled by a sustained period of falling interest rates that saw US 10 year Treasury yields decline from 16% in the early 1980s to less than 2.5% today. Rather than recognise the central role that debt played in the crisis – and still plays today – policy makers across the developed markets have, for the most part, opted to issue even more debt and to ignore the need for structural reform. Instead, they have reflated the asset price bubbles with zero interest rate policies and the largest spree of orchestrated purchases of developed market bonds by central banks the world has ever seen.

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Greece and Emerging Markets

Keen not to miss a great momentum trade, global asset allocators were quick to jump on the central bank band wagon. The resulting surge in developed market asset prices made many feel better, but unfortunately it also allowed governments to ignore the painful fixes required to restore economic health.

Until this year, that is.

The policies of asset price reflation in developed markets have recently run into some headwinds. Firstly, the strength of the Dollar has begun to impede US exporters in what one can think of as the early signs of 'American style Dutch Disease' that is the erosion of competitiveness due to exchange rate appreciation in the context of sluggish productivity gains. Secondly, long bond yields in Europe staged a revolt this year when the term premium was eroded to zero in a region that clearly needs one.

The Greek crisis is merely the latest – albeit more extreme – manifestation of the same problem. Fundamentally, when a country has an unsustainable debt burden, no amount of monetary stimulus or liquidity assistance will make the debt go away. This is particularly true in the absence of negative real yield – which were never realistic considering Greece's need to embark on large-scale 'internal devaluation'. This insight ought to have formed the starting point for any policy designed to help Greece, yet no policy maker wanted to face the Greek debt problem head on.

Part of the blame for this error belongs to the IMF. After all, the IMF is supposed to be the organisation of experts that provides the objective analysis for European politicians to make informed and viable choices. But the IMF failed to call for much larger haircuts, probably because the institution continues to be led by European politicians, bringing inevitable conflicts of interest.

As a result, what began as an economic infection in Greece has now festered into a disease that threatens to engulf the entire Eurozone and will almost certainly also weaken investor sentiment in the rest of the world.

With the 'blame game' already underway, it is easy to point fingers at Alexis Tsipras and his Syriza party for the current mess, but remember that history is littered with examples of populists rising to power on the back of persistently neglected economic problems. Populists gain power when serious politicians fail do to their jobs properly. History, of course, also shows that populists tend only to lead their countries to even greater ruin.

So what next for Greece? After the Greek government's own refusal to accept the deal on offer from the Troika (EU, ECB and IMF), it passed the final decision on the bailout proposal to Greek voters. In response, the EU has refused to renew the bailout as it views the Greek government's referendum idea as an abdication of duty and a breach of trust. This has invariably landed the ECB in hot water, because the ECB now looks like the institution that may have to trigger a Greek exit from the EUR. To avoid this most political of decisions, the ECB has said it will maintain the current level of Emergency Liquidity Assistance (ELA) to Greek banks, but it has also called on the Greeks to impose capital controls and a bank holiday, just in case the ELA is not sufficient.

What happens now? Without new money, a default on Greece's loans to the IMF which fall due on 30 June now looks very likely. However, this does not guarantee Greece's excommunication from the EUR. This coming Sunday, Greeks will go to the polls to vote on whether they want to accept the Troika's draft agreement proposal from 25 June (the deal rejected by Tsipras and Co.). If voters go along with Tsipras' recommendation to reject the agreement then Greece will likely exit the EUR. The ECB will then have to scramble to avoid contagion spreading to other heavily indebted countries in the European periphery.

On the other hand, if voters accept the draft agreement proposal presented by the Troika – and the latest polls suggest that a majority of Greeks favour staying in the EUR even if it means more austerity – then Tsipras will have to resign and call new elections. Amidst the many possible alternative scenarios that then emerge, one possibility is that a technocratic transition government – much as we saw in Italy after Berlusconi's demise – will be put in place to implement the Troika program and avoid a Greek exit from the EUR. This scenario would be positive for markets, but time is short because Greece will have to repay its loans to the ECB by the second half of July unless some special arrangement can be found.

And even if Greece does avoid exit from the EUR the economic problems in this small European country will not be solved. The debt is still too large. And what political constellation will emerge next?

The Greek crisis continues to 'punch above its weight' in terms of the volatility it inflicts at home and abroad. Greece epitomises the ultimate consequence of failing to fix fundamental problems and instead adopting short term policies aimed at placating voters and markets. Ultimately the crisis comes back and it comes back worse than before. The conditions of excessive debt, insufficient reform and excessive monetary stimulus prevail in in almost all developed countries today. It is high time that investors hop off the central bank band wagon and seek out securities whose value derives from sound economics rather than money printing. Those securities only exist in EM and any volatility around the Greek crisis just may offer the best possible of entry points.

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Emerging Markets

- China: The PBOC responded to slowing economic growth and declining inflation rates by cutting both policy interest rates and reserve requirements for financial institutions. Benchmark interest rates were cut by 25bps, while reserve requirements were slashed between 50bps and 300bps depending the sector. While it is possible that developments in Greece and recent volatility in the Chinese stock markets weighed in on the decision to ease policy, we think the main reasons are to be found elsewhere. China is currently undertaking reforms of unprecedented scope, including interest rates liberalisation, financial market liberalisation, capital account liberalisation and making the RMB a global reserve currency. This is creating considerable uncertainty, resulting in the postponement of both consumption and investment decisions pending greater clarity about the eventual outcome of all these reforms. The good news is that China has some of the highest real rates in the world as well as plenty of other levers to regulate the speed of the economy. As such, we remain comfortable with the direction of travel in China and the country's ability to weather whatever shocks will continue to be imparted upon the country from crises in developed economies. In other news, the government forged ahead with further reform measures. Loan to deposit ratios (LDRs) will now no longer be a legal requirement. Presently, LDRs are not binding, but banks have in the past poached each other's deposits in order to meet the LDR requirements. Regulators will still monitor LDRs.

- Brazil: Underlining the determination of the economic team to restore credibility to policy making in Brazil, the Monetary Council of Brazil (comprising the ministers of finance and economics as well as the governor of the central bank) last week tightened the inflation target for the first time since 2006. While the mid-point of the target for 2017 was maintained at 4.5%, the range surrounding the target was narrowed to 1.5% from 2.0% previously. The move is impressive given the headwinds facing the government right now. It will likely lead to a more rapid return to the target, in our view. Unemployment reached 6.7% in May, up from 4.9% in May 2014. The combination of labour market weakness and still high inflation caused in the main by deregulation of prices is now having a severe impact on real wages, which were declining at a pace of 5% yoy in May compared to -2.9% yoy in April. The current account deficit for May was lower than expected, but the fly in the ointment is that the weakness in the economy means that the government is still behind on its very ambitious fiscal targets.

- Venezuela: The government last week formally announced that the congressional election will be held on 6 December, not on the 27 September as had been indicated by a leading opposition candidate. The fact that the election will be held some two and half months later than earlier indicated is negative news; a much needed adjustment of macroeconomic policies will now be delayed. Our view is that Venezuela will still be able and willing to service debt, but the delayed adjustment means that the government will face an even greater political storm further down the road. Formal campaigning will take place between 13 November and 3 December. Polls show opposition parties with a strong lead over the government coalition.

- Romania: Following hot on the heels of recent political turmoil involving Prime Minister Ponta, the Romanian parliament last week approved a 5% cut in VAT rates from 24% to 19%. The move was not, so far, accompanied by spending cuts and was opposed by both the EU and the IMF. The tax cut will stimulate growth at a time when the economy is already moving along quite strongly.

- India: It is still raining. The Monsoon has now delivered some 28% above average rainfall in June to date. Rainfall has a major impact on food prices in India and the RBI recently adopted a hawkish position citing, among other factors, upside inflation risks arising from warnings of below average rainfall from the Indian Meteorological Department. The better than expected rainfall so far puts the RBI in a very comfortable position with options to act in its own time, should it choose to do so.

Snippets:

- The Czech central bank left rates unchanged
- Hungary's central bank cut rates by 15bps to 1.5%

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-1.90%	3.72%	-3.80%	5.44%	3.51%
MSCI EM Small Cap	-2.80%	10.29%	3.19%	9.84%	5.36%
MSCI Frontier	-0.19%	-3.55%	-13.60%	13.03%	6.67%
MSCI Asia	-2.89%	6.34%	5.62%	11.23%	7.51%
MSCI EMEA	0.41%	4.07%	-13.80%	0.27%	1.53%
MSCI Latam	2.08%	-5.25%	-22.44%	-6.14%	-5.11%
GBI EM GD	-1.06%	-4.73%	-14.94%	-3.04%	0.91%
ELMI+	-0.36%	-1.10%	-9.89%	-1.56%	-0.09%
EM FX Spot	-0.66%	-6.83%	-19.03%	NA	NA
EMBI GD	-1.40%	1.83%	0.60%	4.58%	6.81%
EMBI GD IG	-1.95%	0.44%	2.02%	3.32%	5.91%
EMBI GD HY	-0.61%	3.69%	-2.63%	6.56%	8.12%
CEMBI BD	-0.75%	3.87%	2.54%	5.43%	6.29%
CEMBI BD HG	-0.94%	2.26%	3.12%	4.91%	6.12%
CEMBI BD HY	-0.38%	6.90%	0.96%	6.71%	6.80%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	-0.13%	3.10%	9.57%	19.27%	16.73%
2 year UST	-0.03%	0.80%	1.16%	0.62%	0.78%
5 year UST	-0.67%	1.11%	2.35%	0.89%	2.50%
7 year UST	-1.64%	0.07%	2.72%	0.92%	3.73%
10 year UST	-3.89%	-5.55%	2.14%	-0.24%	4.91%
US HY	-0.99%	3.15%	-0.35%	7.27%	9.00%
European HY	-0.82%	3.31%	2.90%	11.86%	11.56%
Barclays Ag	-1.06%	-3.68%	-7.35%	-0.83%	2.01%
VIX Index*	1.30%	-26.98%	24.51%	-17.92%	-58.92%
DXY Index*	-1.28%	5.98%	19.53%	17.20%	11.21%
CRY Index*	0.76%	-2.21%	-27.65%	-20.87%	-12.25%
EURUSD	1.24%	-8.08%	-18.76%	-12.20%	-8.90%
USDJPY	1.06%	-2.45%	-17.55%	-35.05%	-27.89%
Brent	-6.25%	7.20%	-45.75%	-37.16%	-18.53%
Gold spot	-1.00%	-0.78%	-10.60%	-26.22%	-5.19%

*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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