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WEEKLY INVESTOR RESEARCH

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Signs of growth in Mexico as US political noise returns

By Jan Dehn

China bears fear over-investment more than anything else. But China's statistics systematically overstate investment and understate consumption. Once suitable adjustments are made China's economy looks more balanced. High frequency data begins to turn positive in Mexico as key political battles over reforms draw closer. Meanwhile, across the border in the United States the White House and Congress are once again holding the world's capital markets hostage to short-term political considerations over the funding of government and raising the debt ceiling. Politics briefly looked better in Europe until tensions re-surfaced in Italy, also over fiscal matters.

Emerging Markets	Index level/ yield	Spread over UST	1 week change
MSCI EM	990		-2.51%
MSCI FM	557		-0.54%
GBI-GD	6.57%		-1.74%
ELMI+	4.25%		-0.63%
EMBI GD	5.81%	315 bps	-0.46%
EMBI GD IG	4.85%	219 bps	-0.28%
EMBI GD HY	9.26%	681 bps	-0.87%
CEMBI BD	5.73%	354 bps	0.09%
CEMBI BD HG	4.86%	264 bps	0.20%
CEMBI BD HY	7.74%	559 bps	-0.21%

Global backdrop	Index level/yield/ FX rate/price	1 week change
S&P 500	1,692	-0.55%
VIX Index	15.46	8.04%
5 year UST	1.38%	-7 bps
10 year UST	2.60%	-10 bps
10 year Bund	1.75%	-16 bps
EURUSD	1.3487	-0.04%
USDJPY	97.86	-1.01%
Brent	$109	0.00%
Copper	$336	0.98%
Gold	$1339	1.21%

Emerging Markets

China continues to confound expectations and divide opinion. The most common criticism of China is that the government over-invests, so capital is misallocated, saddling the nation with a mountain of bad debt.

China is partly to blame for this impression because its own data shows that at nearly 50% of GDP, investment rates are very high, even by Asian standards. By implication, consumption rates are very low (sub-40% of GDP).

Yet the over-investment thesis does not gel well with other observations. For example, China's economy continues to do too well. The often predicted hard landing continues to elude the bears. Indeed, last week China's flash PMI showed that that economy is continuing to pick up (up to 51.2 from 50.1 previously against the 50.9 expected). China will release its official PMI numbers for the month of August later this week.

There is understandably considerable interest in a pending government audit of its own debt situation, covering all levels of the public administration. The results of this audit will certainly throw some light on the over-investment thesis – a welcome development. After all, if the government is not sure about its debt levels, then who is?

In the meantime, investors must arrive at their own conclusions by other routes. New research this week provided an interesting new perspective, which could help to reconcile the economy's stronger performance with the over-investment scenario suggested by official data. This research shows that official data may be overstating investment rates and understating consumption rates.[1] Firstly, consumption may be understated to the tune of 6% of GDP because consumption measures do not include residential services (these are wrongly counted as investment). Secondly, private consumption estimates fail to include the many consumer services provided in kind by state employers. Thirdly, a material share of household income – and the consumption which springs from that income – is unreported. When consumption numbers are adjusted for these factors the rate of consumption in China rises to about 50% of GDP, putting it in line with other Asian economies at a similar development stage.

After a sharp and rather sudden slowdown in economic growth earlier this summer, Mexican economic indicators are now beginning to surprise to the upside. The USD 234m trade deficit for August was substantially narrower than the USD 1.2bn print expected. The unemployment rate of 5.17% was lower than the 5.3% expectation. Retail sales picked up sharply from -1.9% yoy in June to +1.3% yoy in July (versus 0.5% yoy expected), and the monthly GDP proxy (IGAE) was 1.69% higher than last year, up from -0.39% yoy in June. Inflation also rose to a still modest 0.3% rate from 0.01% previously.

[1] *"Masterclass – China is not really that imbalanced"*, Standard Chartered Bank, 24 September 2013.

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Emerging Markets

Having now become accustomed to very long business cycles in developed economies due to deleveraging and lack of structural reform, it is sometimes startling to be reminded of the speed of normal business cycles.

The pick-up in economic activity in Emerging Markets (EM) began in Q2.[2] As financial markets have somewhat stabilised, investment banks are now also beginning to acknowledge this improving growth picture. Thus, the Emerging Markets research teams from both Deutsche Bank and Credit Suisse this week published their projections for Emerging Markets growth in 2014. Both houses forecast economic growth in Emerging Markets to accelerate by 1% in the next 12 months to about 5.4%-5.5% next year.

As we noted in a recent publication, we share this view of better growth next year.[3] The main reasons for the stronger outlook are:

a. The global manufacturing cycles are improving

b. Larger economies such as China, Brazil, and Mexico are looking stronger

c. Even EM economies with adjustment challenges are 'merely' facing conventional cyclical adjustments, which are already underway

Global backdrop

The US is currently the main source of uncertainty in the global economy. The uncertainty emanates both from the monetary and the fiscal policy fronts.

On the monetary policy side, the disparate interpretations of the Fed's U-turn on tapering by a plethora of voting and non-voting FOMC members over the past week have only served to reinforce the impression that there is no consensus on the committee.

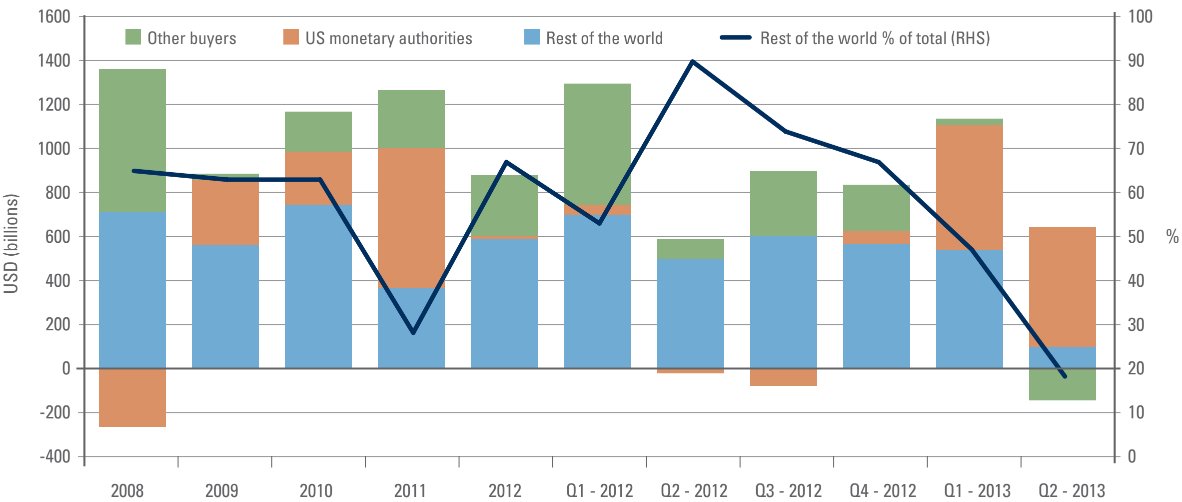
Cue a 'Specfest' on timing for tapering. To commence tapering in October is widely regarded as risky due to the fiscal challenges in Congress (more on this below). Meanwhile, a December decision (the FOMC is on 16-17 December) could also be tricky, because the proximity of Christmas means liquidity is likely to be very poor and financial conditions could therefore tighten more than intended if the Fed begins to taper at this time.

Thus the 27-28 January 2014 FOMC suddenly comes into play. But some argue that the next Fed Chairperson may not want to announce such a major policy change in their very first meeting. Others argue exactly the opposite view. Either way, depending on your view, tapering could be pushed all the way to the FOMC meeting in March 2014 (there is no February meeting). If so, Treasury rally roll on.

Apart from the short-term speculation which is amusing but ultimately less important for strategic investors, there is the more serious question of who replaces Fed purchases if it steps back from the market. The Flow of Funds data released last week showed that funding for the US government has changed materially in the past six months when compared to previous quarter and years.

After buying an average of 57% of net supply of US Treasuries from 2008-2012, purchases by the rest of the world dropped sharply in the past six months to just 18% – see chart. As a result, the Fed had to step in to replace the fading foreign bid. But how is such an increase in Fed purchases consistent with tapering? The circle can be squared if the US engages in material and continuous fiscal retrenchment or if the Fed is happy to see sharply increasing real yields, but neither seem realistic to us. Ultimately, we think the real choice is between printing money and having inflation or taking a big economic hit through austerity and much weaker growth.

Fig 1: **Net purchases of US treasury securities (USD bn)**



Source: US Treasury.

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[2] See *"Signs of a modest cyclical upswing in EM"*, Weekly Investor Research, 19 August 2013.

[3] *"Emerging Markets after the summer sell-off: Hold or add?"*, Market Commentary, 24 September 2013.

Global backdrop

Meanwhile, the fiscal situation is likely to continue to influence global sentiment ahead of two critical votes in Congress: one to approve budget spending and the other to raise the debt ceiling. We do not know how the stand-off between the White House and Republican-controlled House of Representatives will end, but it is clear that the risk of a technical default in the US Treasury market is once again increasing.

Both sides have made it clear that they do not support a default, but it remains to be seen how they can overcome deep ideological differences on the road to a compromise. Past experience suggests that political confrontation matters more to ratings agencies than debt sustainability issues, but also that the bigger the risk of a technical default on US Treasuries the more investors want to buy.

The news on the economic front has important silver linings. There is a clear improvement in initial claims for unemployment benefit, which are now down to just over 305K. The question is now whether new jobs are going to be created at sufficient speed to absorb the labour force growth coming from population growth and immigration. The willingness of companies to make permanent hires will probably depend on the broader demand picture rather than short-lived manufacturing cycles or QE-sugar highs.

This means that last week's household balance sheet data was also important. The data shows that the ratio of debt to household income continued to decline last quarter albeit only by 1% to 104%. In our opinion, this means that US households probably need to shed another $1.7trn of debt (about 10% of GDP) before they return to credit markets in earnest.

We recognise that this is a controversial view. Many analysts argue that household net worth is a far better indicator of spending than looking only at liabilities, because rational agents ought to take account of both assets and liabilities when they make spending decisions.

We agree, but we also think that one of the legacies of 2008/2009 is that households apply greater discount to higher home prices and stock market gains than they do to their liabilities, which they may even be discounting negatively for fear of the ramifications of, say, unemployment. Seen in this light, the stagnation in household deleveraging in Q2 is somewhat disappointing.

Finally, a word on Europe: Angela Merkel won a decisive victory in the German elections on 22 September. This means continuity in Europe. If anything, a coalition with the very pro-European Social Democratic Party, which now seems possible, will make German policies more pro-European at the margin, because the SDP will favour more domestic spending and push for somewhat less austerity in the European periphery. In Italy, the government coalition fell apart over a fiscal measure without which Italy could miss its 3% deficit target and therefore become ineligible for support from Europe's ESM (European Stability Mechanism) and OMT (Outright Monetary Transactions) programmes.

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