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MARKET COMMENTARY

Ashmore

The time for a Dollar Accord has arrived

By Jan Dehn

When Muhammad Ali graced the boxing ring he would let himself be beaten to a pulp for eleven rounds only to floor his exhausted opponent with a single knockout blow in the twelfth. Ali's strategy is known as the rope-a-dope, where, instead of moving around the ring the boxer fights for extended periods leaning back into the ropes in order to soften the heaviest blows.

Emerging Markets (EM) have been doing the rope-a-dope for several years, absorbing huge punishment. The pummelling of EM began in the currency markets soon after the onset of QE policies in developed markets. Since 2011, markets have landed a succession of vicious blows on EM, including a mean Taper Tantrum upper cut, a bare-knuckle collapse of commodity prices, the Dollar hook and a stinging jab from the Fed.

EM should have hit the canvas after so many knocks, but a decisive knockout blow was never dealt. The price action may not have been pretty, but EM never went down for the count. Look up: where are all balance of payments crises, where are the sovereign defaults, where is the litany of emergency IMF programs? Only two sovereigns defaulted – Argentina for technical reasons and Ukraine due to a war with Russia. They are hardly typical of EM. Corporate HY default rates in EM are now lower than US HY default rates.

EM is now starting to look the stronger fighter. After years of feinting and weaving, ducking and diving, adjusting as needed, EM is slowly regaining the upper hand. Fundamental competitiveness is being restored on the back of major currency adjustments and financial tightening. Current account balances across EM are improving dramatically. 2016 looks set to be the first year since 2011 when EM growth re-accelerates away from developed economies.

Critically, EM countries never lost their core strengths of high levels of reserves, much lower debt levels, inflation under control, excellent demographics, and, above all, no QE. They retain key policy tools such as room to cut rates and increase fiscal spending, if required.

And EM bonds now pack a serious punch; yields are higher today than when the Fed had rates at 5.375%.

Things do not look so hot in the other corner. Developed economies are showing signs of serious fatigue after years of arrogant posturing and hot air. European banks are in trouble and Brexit looms over Europe which is unable even to deal with a refugee problem.

The slump in fitness of the prize fighter, the US, is a greater concern. The country is heading for a potential outright recession with manufacturing already mired in contraction and services – the far larger sector – weakening too. The energy sector, once the strongest, is seriously out of breath amidst sharply rising default rates.

Above all, the Dollar is now draining every ounce of strength out of the American economy without offering anything in return. Fiscal deficits, and therefore funding needs abroad, are lower so there is no longer a need to keep the Dollar this strong.

Developed market firepower is also waning fast. Some 40% of European bonds now trade with negative yields. Bond yields have turned negative as far out as 10 years on the Japanese curve. US stock markets delivered negative returns last year and the problem has only been getting worse – much worse – this year.

It is not just that developed economies are looking exhausted and their markets lacking punch; their central banks are also running out of tricks. Most have close to nothing in reserve. Dovish rhetoric from ECB President Mario Draghi and a move to negative rates in Japan did not improve market sentiment nor weaken EUR or JPY as hoped.

A sip of the energy drink – more QE – could provide brief relief, but does not get to the root of the twin problems of insufficient fitness and too much weight. Productivity is far too low, debts far too large.More sugar at this stage would only push more money into already over-inflated bets on US equities and European bonds. The Dollar would briefly spike versus the EUR and, perhaps, EM currencies, but this only worsens the problem. US stocks are already overvalued, European bond yields already too low, EM already too cheap. Above all the Dollar is already weakening the global economy, including the US economy. The traditional trades of the QE period are over[1].

The growth problem in developed economies is rooted in low productivity and excessive debt, but the growth problem on a global level is rooted in a gross misallocation of capital.

1. For more discussion of the end of the QE trades see "The View from Kilimanjaro: EM FX in a QE world", The Emerging View, September 2015.

This misallocation of capital has become significantly worse since the start of QE programmes and it was led by central banks. Between them, the Fed, the ECB, the Bank of England and the Bank of Japan have bought more than 10% of all outstanding fixed income securities in developed economies, and institutional investors jumped on the band wagon by chasing the same securities. The only way to finance the purchases of QE securities was by outright selling the non-QE assets, including EM.

The resulting global misallocation of capital has been disastrous for growth and riskiness in financial markets. Huge amounts of perfectly good money have been thrown after bad in one of the most inefficient and counterproductive policy interventions of all time. Asset bubbles in developed markets have been fully re-inflated and more without kick-starting a sustainable recovery in growth, while the world's only real growth engine, EM, with 57% of global GDP, has been starved of the finances required for investment.

Fortunately, there are ways back from the brink. They involve reversing the direction of capital flows of the last few years – out of the bloated and unfit QE markets and into the leaner and fitter non-QE markets, particularly EM, where the marginal unit of capital can have the largest possible bang for the buck in terms of aggregate demand.

The best and most economically efficient solution for redirecting capital flows back to EM would be to re-align global currencies with a material depreciation of the Dollar[2].

Irrational demand for Dollars is now the main reason for the volatile environment in credit markets. Depreciation of the Dollar would contribute immensely to easing these concerns as global corporations and investors alike would free up capital by reducing hedging transactions and allocating away from US assets again.

Dollar depreciation would be extremely powerful in redirecting capital flows, because currencies have become the main marginal driver of sentiment in all markets due to an unintended consequence of QE. By equalizing returns on bonds and currencies at zero, QE has created a situation where currencies are preferable to bonds (bonds are riskier than currencies, while currencies have no capital costs, no credit risk and greater liquidity).

This is why currencies now determine sentiment at the margin, making FX so powerful in restoring global growth – by shifting stock, bond and credit markets in its wake.

Dollar depreciation would boost growth in four ways. First, it would genuinely ease financial conditions in the US as well as globally and therefore directly help the struggling manufacturing and energy sectors as well as exports.

Secondly, a weaker USD would push money back into EM, where it can finance investment, including infrastructure investment to help EM resume its key role as the world's growth engine while developed markets deleverage and reform.

Thirdly, a lower Dollar would significantly de-risk global financial markets by deflating dangerous asset bubbles in developed markets. Today the only assets in the global financial markets that are not trading at bubble levels are EM assets.

Finally, a weaker USD would reduce deflation risks in the US and ultimately address productivity and debt problems, i.e. a weaker USD would get to the heart of the problem that burst upon the world in 2008/09.

In reality, it is not easy to shift capital from QE markets to the non-QE markets. Many investors and officials still find it difficult to accept the notion that EM is the last remaining safe haven in the global financial system. Risk aversion also encourages flight to liabilities (i.e. even more buying of developed market securities). Regulators continue to apply deeply inappropriate risk weightings to EM assets in pension and insurance portfolios. Finally, EM and developed central banks have not shown much enthusiasm in diversifying FX reserves away from the Dollar.

In the face of these challenges, the only realistic solution may be a new Dollar accord to ensure that the process – which is ultimately inevitable – happens in a timely and orderly fashion.

An accord should centre on EM currencies and the Dollar. Purchases of Chinese RMB would help absorb capital outflows arising from Chinese corporate FX rebalancing. On the other hand, an accord would have to go lightly on JPY and EUR purchases on account of the intractable fundamental problems in Japan and Europe. It is urgent that the process gets underway – the market has recently begun to push the Dollar lower versus EM currencies, anticipating, perhaps, precisely this kind of policy intervention.

2. Another less efficient way would be that central banks, including the Fed, engaged in outright purchase of EM assets. For a discussion, see "How to get global growth back", Market Commentary, October 2015.

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