Ashmore

Revealed preference

By Jan Dehn

Introduction

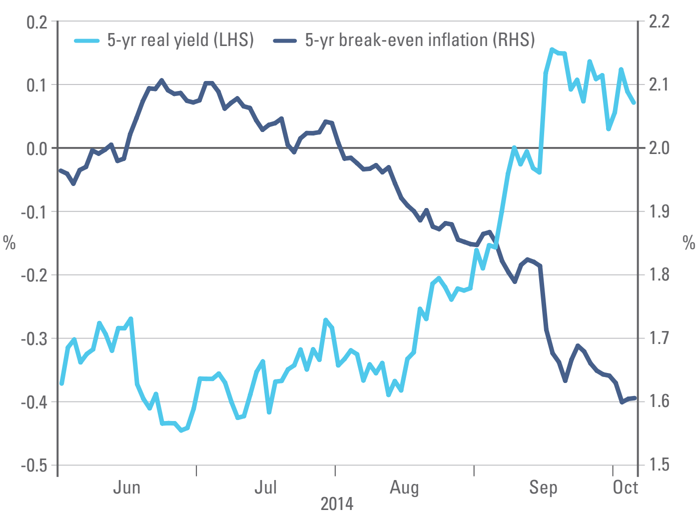
Developed economies are still accumulating debt, making it tougher to tighten monetary policy and to grow. Recently, the market has been pricing in a policy mistake by the Fed – evident in lower breakeven inflation, rising real yields, bigger risks for credit markets, weaker stock markets and a stronger Dollar. We think the true preferences of central banks in developed economies for supporting the recovery are easily revealed by market weakness. Emerging Markets (EM) asset prices and currencies have – as always – been buffeted by the shifting sentiments about the US, Europe and Japan, but fundamentals in EM have hardly changed relative to the heavily indebted developed countries.

In our view this makes current valuations in EM attractive now, especially in local markets. The recovery from the Taper Tantrum last year has only been interrupted, not derailed.

The Fed and the markets are at odds

The recent message coming from US stock, currency and credit markets is starkly at odds with the message coming from the Fed. In its 17 September meeting, the FOMC 'dots' signalled hawkishness. Later the minutes gave a more dovish tilt. The market has taken the view that now is not the right time to hike due to approaching weakness in the underlying economy. As real interest rates on five year TIPS (inflation linked bonds) moved up from -0.4% to +0.1% (now -0.1%), breakeven inflation has fallen from 2.1% in June to 1.6%, which is significantly below the Fed's target. In other words, the market is expecting the Fed to go ahead with its tightening, but saying that this will hurt the economy, and therefore push inflation below target. An economy in pain is bad for credit, bad for equities and bad for risk appetite.

Chart 1: **US breakeven inflation has fallen sharply, pushing up real yields**



Source: BAML, Ashmore.

Markets may force the Fed's hand

The market reaction to the 'dots' has similarities with last year's Fed announcement of tapering in late May. The outcome – another change of heart on the part of the Fed – may also turn out to be similar, in our view.

The problem facing the Fed is that it is very credible when it comes to easing monetary policy, but vulnerable when it comes to tightening.

The vulnerability arises from the US economy's fundamental weaknesses, which is mainly due to the debt, as well as the central role of asset price inflation in the overall strategy for economic recovery. This strategy relies on over-easy monetary policy to maintain confidence via elevated asset prices. If markets sell off too hard and/or Fed tightening exposes serious weaknesses in the underlying economy the entire strategy could collapse.

By selling off, markets could therefore force the Fed either to U-turn on its current path to rate hikes, or at least moderate the trajectory. The greater likelihood, in our opinion, is that the Fed reveals its true preference – i.e. it leans towards protecting the recovery by softening its hawkish stance if US stock and credit markets begin to show serious weakness.

The fact that the Fed can be pushed into reverse should not surprise. Last year this is exactly what happened when, after a relatively modest but rapid weakness in the US treasury market, the Fed U-turned on tapering after a 65% collapse in mortgage applications.

Already the US credit markets have reacted to Fed hawkishness with yields in the US high yield market spiking from 5.1% to 6.4% (a similar spike occurred last year). US equity markets have had their gains from the last quarter entirely wiped out.

Add Dollar pain

The strong Dollar has begun to become a policy problem in the US. A strong currency hurts the economy. US real GDP growth rates could be reduced by between 0.3 and 1.0 percentage points over the next 12 months if the past relationship between growth and the Dollar holds (the estimates vary according to methodology). Trend growth in the US is still no more than 2% so a fall in growth of this magnitude might be too high a price for the Fed to pay.

One sign that the Dollar has overshot is that US policy makers, including most notably William Dudley of the New York Fed, a key FOMC member, have begun to comment openly on the size of the Dollar move. Unsurprisingly, Treasury officials continue to applaud a strong Dollar, because they know that a strong Dollar view is critical to preserving EM central banks among the most important supporters of the Treasury market.

Even versus Europe and Japan the rally in the Dollar seems overdone. Sure, Europe is heading to QE, but its ability to generate inflation is questionable. Equally, Japan had weak growth in Q2, but at least part of that is payback from one-off tax measures. Sure, the US may be up about 4.5% in Q2, but this was after a 2% collapse in Q1 and growth from here will almost certainly slow. And yes, there are individual EM country stories that generate grisly headlines, but the sell-off in EM FX versus the Dollar has been indiscriminate and in many cases entirely unjustified.

The taboo of debt

Why does the Fed get forced into U-turns so early in the tightening cycle? What is it that makes this cycle so different from past cycles?

The answer is that the underlying weaknesses in the economy are so much greater than in any previous recent crisis. And they are not going away anytime soon. The weaknesses include fiscal profligacy, erroneous regulation, financial repression, political persecution of banks and abject failure to reform, but above all the debt (which is largely ignored).

Four eminent economists recently published a Geneva Report titled *"Deleveraging? What deleveraging?",* wherein they point out that the global economy has still not even begun to deleverage, seven years after the Greenspan bubble burst.[1]

They show that the total amount of debt in the world excluding debt issued by financials hit 212% of GDP at the end of 2013 – the highest level since WWII. Developed countries account for the vast majority of the debt with average debt to GDP ratios of 272% of GDP, excluding financial sector debt. When bonds issued by financial firms (i.e. term financing for corporate purposes) are included the average debt to GDP ratio in developed countries rises to a massive 385% of GDP.

The authors also highlight important differences between the UK and the US on one hand and the Eurozone on the other, which have implications for the path of inflation. The UK and the US have pursued policies to reduce household leverage levels, but at the expense of significantly higher public sector imbalances. By contrast, the Eurozone has not achieved much in terms of household deleveraging, but has also not accumulated as much government debt as the UK or the US. Europe has not employed its central bank balance sheet to the same extent and has not recapitalised its banks. This means that the UK and the US may reasonably be expected to generate consumer-led inflation once unemployment gets low enough, negative equity disappears, and household deleveraging reaches completion, while the Eurozone might end up struggling with deflationary pressures, higher real rates and a stronger currency. Japan, of course, is in a category of its own: its total public and private debt stock as a share of GDP is 562% of GDP, raising serious questions about debt sustainability. We agree: a bit of fiscal spending and money printing does not solve this problem.

Where debt matters and why

The enormous (and still growing) amount of the debt in the world is the single most important structural challenge to the global economy today. Debt is limiting growth, limiting the ability to stimulate fiscally, even limiting the ability of central banks to tighten monetary policy. But the vulnerabilities arising from high levels of debt are highly asymmetric across countries.

In particular, developed economies are multiple times more leveraged than EM countries and struggling to grow even with zero interest rates. Developed markets, not EM, should give investors multiple concerns about the possible fall-out from tighter global financial conditions.

What comes first, productivity or inflation?

The main conclusion from the Geneva Report is that deleveraging in developed economies is at best a distant objective. Against this backdrop of continuing heavily debt loads, investors should ask themselves a simple question: what is likely to pick up first in developed economies, inflation or productivity growth?

Inflation and productivity growth are both potential ways out of the debt problem, but they have very different implications for asset prices and currencies: for example, if productivity picks up in developed economies before inflation then hopes will grow that developed economies can grow their way out of their debt problems. Real interest rates would rise moderately as the central banks gently tighten policy amidst low inflation. Developed market currencies would get stronger aided by higher growth as well as higher real rates. On the other hand, stronger currencies would be a headwind for exporters and low inflation would do little to ease real debt stocks. This means that a productivity-led exit from debt would require an extra-ordinarily strong and sustained pick up in productivity in order to succeed.

On the other hand, if inflation was to arrive while productivity is still low central banks would run a serious risk of hurting the economy if they raised real rates meaningfully. They would likely let real rates decline gently as inflation rates drifted higher by keeping nominal bond yields low (aided by financial repression, dovish rhetoric etc).

We think this is what New York Fed Chairman William Dudley had in mind when he said that he wants the economy "a little hot" before hiking rates. The Dollar would weaken in response to falling real rates. The combination of inflation and Dollar weakness help to reduce the debt stock and debt service costs in real terms, while exporters contribute more meaningfully to overall economic growth. Fed credibility suffers and investment remains weak due to the uncertainty created by inflation (and the need eventually to crush it) but the underlying economy eventually heals as inflation erodes away the debt stock.

[1] *'Deleveraging? What Deleveraging?'* The 16th Geneva Report on the World Economy.

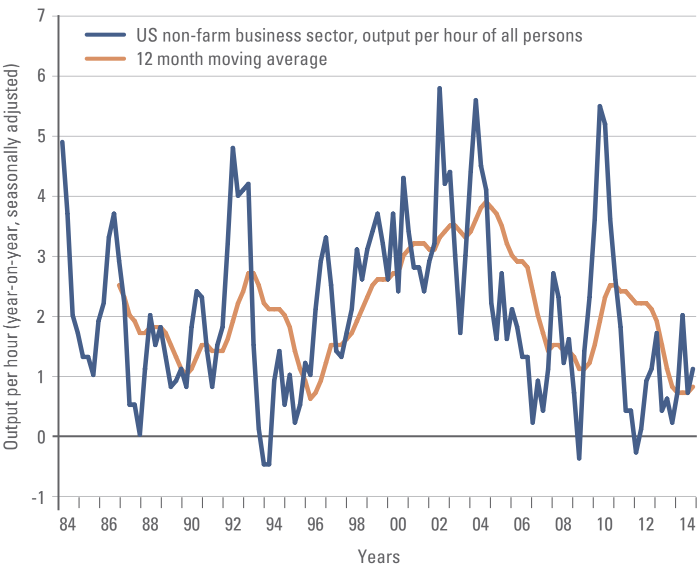
Which path will developed market central banks take?

We expect very little meaningful change in growth, inflation or economic policy between now and late 2016. Sure, we will see the first few rates hikes, but growth, inflation and interest rates should stay within relatively narrow ranges. Currency volatility will continue, but it will be more herd-driven in response to changes in sentiment and imbalances in positioning rather than due to fundamentals per se.

By late 2016, however, fundamentals will become more manifest. The wonderful thing about deleveraging is that it happens all by itself, you just need to let time pass. By late 2016 US households begin to see meaningful improvements, even if the US economy in aggregate remains heavily leveraged. Labour markets will be significantly tighter, negative home equity much reduced, and household balance sheets will be back to pre-Greenspan Bubble levels. It is reasonable to expect consumption to pick up and therefore inflation expectations to rise.

Unfortunately, the outlook for productivity remains very poor. As the chart below shows, productivity has not improved at all despite the weak economic conditions that have prevailed since 2008/2009. Investment rates have been very low. One recent long-term forecast issued by experts on the subject puts US trend growth at 1.93% compared to 2.33% for the 1990-2010 period.[2] The decline in trend growth is attributable in large part to falling quality of labour input. The Obama administration is a lame duck unable even to get basic infrastructure investment programs past Congress. In the background loom much bigger questions – such as how to deal with the unfunded pension and medical liabilities of an ageing population. Some analyses put the looming liability at several hundred per cent of GDP. Moreover, if inflation begins before productivity recovers – a likely outcome in our view – then productivity will fall further.

Chart 2: **US productivity**



Source: Bloomberg, Ashmore.

From our vantage point, inflation is at least imaginable in the not too distant future, while a significant pickup in productivity looks more remote. The 'early' return of inflation would force the Fed and BOE onto the horns of a dilemma: They would have to choose between accepting inflation to sustain the tepid recovery, or crushing inflation at a significant cost to the still weak economy. After all, there is still too much debt to handle both at the same time.

We think central banks already know they have little choice but to go for inflation, when it shows. In addition to the economic benefits of inflation in heavily indebted economies inflation also works politically, for a time at least, because future generations and foreigners – neither of whom vote in domestic elections – end up paying the bills. Sure, long-term investment is hurt by inflation, but there is no long-term investment to begin with, so who cares?

The outlook for productivity remains very poor. Productivity has not improved despite the weak economic conditions that have prevailed since 2008/2009. Investment rates have been very low

The treacherous accumulation of Dollars

Investors should first and foremost be concerned with the purchasing power of their assets – that is, how much 'stuff' their capital will buy at that distant point in the future when it is time to live off accumulated life-time savings. This is not just a function of making the right credit calls (yields versus credit risks), or picking the right stocks (earnings streams versus prices) but, perhaps most importantly for purchasing power purposes in a very monetary world, it is the choice of currencies: Which currencies will preserve your capital the best? QE currencies or the currencies of the big reserve holders of the world? Currency markets are notoriously short-term. The recent episode of 'Dollar exuberance' has very shaky fundamental groundings, in our view. As such, it falls into the same category as the other large currency fads of the last few years, such as the Eurozone break up trade (short EURUSD), the 'Abenomics' trade (long USDJPY), and the Taper Tantrum (long USD-EM). Ultimately, these trades had some fundamental grounding, but they were far more driven by sentiment. The other common denominator in all of these trades was that they involved buying US dollars and selling something else. The technical long position in Dollars has therefore continued to get ever more pregnant.

As we have noted before, the growing long positioning in the Dollar is dangerous.[3] After all, accumulation of Dollars is a precondition for an eventual, fundamentally motivated, depreciation of the Dollar as part of US deleveraging. It will begin once US inflation returns and the market realises that the Fed will still be severely constrained in terms of its ability to tighten meaningfully due to the large overall debt stock and the dependence on asset price inflation to sustain belief in the recovery. The odds of a disorderly unwinding of Dollar longs continues to rise as positions continue to grow; most investors will wait for the herd to move before they do so. Smart investors will get ahead of the crowd.

[2] Jorgensen, Dale W., Ho, Mun S., and Samuels, Jon D. (2014) *"Long-term estimates of US productivity and growth"*, Prepared for Presentation at Third World KLEMS Conference in Tokyo May 19-20, 2014, May 12 2014.
[3] *'The big bad imbalance: EM FX vs. US dollar positioning'*, Market Commentary, 2 April 2014.

What about EM?

The recent loss of confidence in the US growth outlook has triggered the usual knee-jerk selling of EM assets even though this is not an EM event. EM currencies are down 6.7% against the Dollar since May, but spare a thought for the Europeans and the Japanese, whose currencies at one point were down 10.2% and 7.7%, respectively. The Dollar index spot rate was up 9.6% and the US trade weighted currency index up 7.8%. In other words, this has been an indiscriminate lurch into the Dollar just as markets are beginning to show signs of economic weakness that could force a Fed U-turn.

Superficial analysis of EM – as usual

EM countries also have debt. How relevant are the Geneva Report's conclusions for EM? The first point to make is that EM countries are much less indebted than developed economies. The authors' own data shows that EM average government debt to GDP is 48% vs 108% for developed economies. EM countries also already 'live' with yields close to levels one would associate with 'normal' levels; EM countries finance at just below 7% in their local markets, which is roughly consistent with 10-year US treasury yields around 4.5%.

Sadly, the Geneva Report's analysis of the debt situation in Emerging Markets suffers from the usual shortcomings. It only covers 21 EM countries out of a total EM universe of more than 160 countries (even the JP Morgan EMBI index now has more than 60 countries) and covers only the most advanced (and therefore most leveraged) EM countries, whose financial conditions are not very representative of the EM universe.

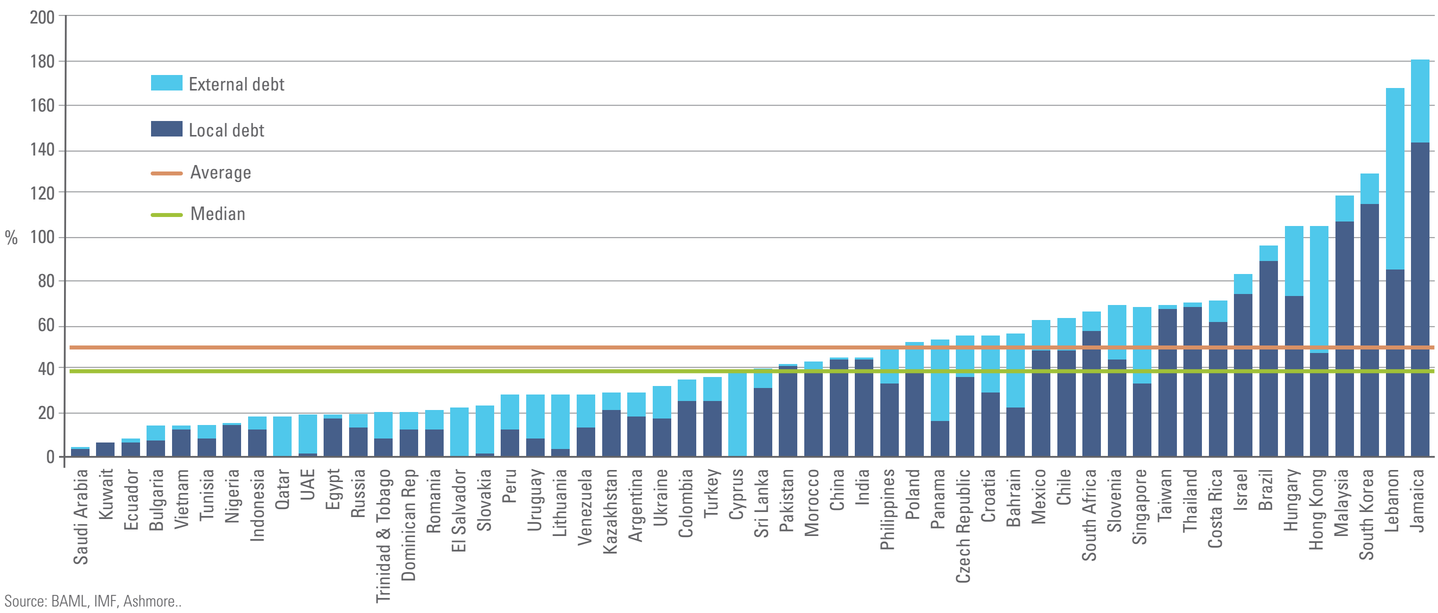
Broadening the scope to cover more EM countries means losing direct comparability. For example, many lower income EM countries have no data on household debt, though in most cases households in lower income EM countries are almost certainly far less indebted than households in higher income countries. Distinctions between tradable and non-tradable debt also fall away as does a comprehensive picture of financial sector debt, though in most cases lower income countries will also have much less of those types of debt than higher income countries. We have data on government and corporate tradeable debt in 58 countries (shown in chart 3 below). The data shows EM government and corporate tradable debt combined averages less than 50% of GDP. Only one third of EM debt is external, which makes a difference when it comes to vulnerability to tightening in US rates because correlations between local yields and US treasury yields drifts towards 0.3 after three months and the long term correlation is zero.

If one broadens the sample to the full universe of EM countries (where there is only public sector data available), the IMF data shows that the average public debt to GDP ratio in EM is just 34% (versus 108% in advanced economies).[4] In other words, while the picture is not directly comparable it is nevertheless clear that the debt situation in EM is hugely stronger than that of developed economies.

The recurring China story

The Geneva Report's conclusions about EM are also heavily influenced by China. But China is in many ways very unrepresentative of EM, or any other country for that matter. There are good reasons to be less concerned about China's debt stock. Combined, the stocks of public and private debt in China measure 217% of GDP. This is high by EM standards, but note that government debt is a modest 49% of GDP. More importantly, China has an extraordinarily high gross national savings rate of 50% of GDP, which means that deposits in the Chinese banking system are at a high level of 160% of GDP. High private lending by Chinese banks reflects this high level of funding via deposits. The leverage in the banking system – a key risk parameter – is actually quite low (217% over 160%). Thus China is far less risky than its overall debt level would imply. Indeed, we think China's onshore government bond market in particular is one of the most interesting bond markets in the world today.[5]

Chart 3: **Total public and private debt to GDP (%) in 58 EM countries**



Source: BAML, IMF, Ashmore..

[4] *IMF WEO Outlook*, April 2014.
[5] *'Probably the best bond market in the world'*, The Emerging View, September 2014.

EM, interrupted

For EM, the Fed's recent hawkish tilt interrupted, but did not reverse the recovery from last year's sell-off. The normal pattern of recovery after an irrational sell-off is for external sovereign debt markets to rally first – this has happened already with external debt up just under 8.5% year to date. The next stage is usually for corporate and local bond markets to outperform, but these markets have been interrupted by the surge in the Dollar and the weakness in US high yield (HY). External debt has also given up some gains from earlier in the year (spreads have widened about 60bps to 299bps, an attractive entry level in our view).

EM corporates have held up well, maintaining their spread above Treasuries close to 500bps despite a significant sell-off in the US HY market.

The relative outperformance of EM HY over US HY is justified, in our view. After all, until recently the US HY market traded at half the spread per turn of leverage of identically rated EM corporates. The US high yield sell-off has mainly had the effect of delaying spread compression in EM corporate space, in our view.

Interestingly, local bond yields have been well-behaved throughout the Dollar rally. EM local currency government bond yields are sitting around 6.7%. This is an attractive yield which has historically been consistent with much higher levels of interest rates in the US. Those investors who liked local bonds before the surge in the Dollar should like the market even more now.

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