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MARKET COMMENTARY

Ashmore

The rational fear of policy mistakes

By Jan Dehn and Romain Bocket

Lengthy and fevered speculation preceded yesterday's "comprehensive reassessment" by the BOJ and the Fed's September decision on interest rates. Yet, in both instances only marginal changes took place. The Fed, for example, is moving at the glacial pace of 25bps per year! This pattern of high speculation leading up to decisions followed by very modest action has been a stable feature of markets since the Developed Market Crisis of 2008/2009. Are markets entirely rational in paying so much attention to the decisions of QE central banks?

On first appearances, markets do indeed appear to be borderline schizophrenic. After all, an overwhelming consensus maintains that the QE central bankers will move rates extremely slowly over a very long period of time, so why fret so much over every little short-term decision? A closer examination of the facts, however, suggests that there may be some method in the market's manic machinations. While there is no reliable evidence that central banks are becoming more prone to making policy mistakes there are strong reasons to believe that the potential cost of policy mistakes have gone up sharply.

The cost of policy mistakes

The cost of policy mistakes has gone up in QE economies for two reasons. First, QE economies today find themselves very delicately poised on a knife-edge between recession and inflation. This means that economic risks are skewed to the downside. Secondly, QE markets have become so addicted to stimulus that even marginal tightening could inflict major damage. It is into this fragile and somewhat twisted reality that policy changes are being introduced and it is the conditions, rather than policy changes per se, that warrant concern.

Another way of saying the same thing is that outcomes from policy decisions are highly conditional upon starting conditions. Even if, say, the odds of a policy mistake remain unchanged the odds of a bad outcome can still be higher simply because conditions are worse. The table below illustrates this point for two set of conditions, a bad one where the conditional odds of a bad outcome are 75% and a good one where the odds are 25%. Under these conditions, the overall odds of bad outcomes are three times as high as the odds of a good outcome, even if the risk of policy mistakes is the same.

Fig 1: **Odds of bad outcomes are conditional**

	Probability of policy mistake leading to bad outcome	Probability of a bad outcome, given policy mistake	Probability of policy mistake
Under 'bad' conditions	0.375	0.75	0.5
Under 'good' conditions	0.125	0.25	0.5

Source: Ashmore.

The dependence of outcomes on pre-existing economic and market conditions strongly suggests that QE central bankers ought to err on the side of less rather than more activism. While their actions have been consistent with this view their rhetoric has been anything but. Indeed, the QE central bankers of the world are by far the most important sources of market risk in the world today.

Knife-edge

The propensity of the QE central bankers repeatedly to upset markets for no obvious reason is worrisome, because there is a lot of vulnerability out there, particularly in the QE part of the world. For one, investors are sitting on large positions in QE markets at stretched valuations. Stock prices are overvalued, which means that negative wealth effects could seriously disrupt consumption and investment in the event of a major correction. Yields are also far too low, so bonds have little protection against capital losses in the event of surprise moves in interest rates. Moreover, QE central bankers are themselves largely to blame for having brought about these market related vulnerabilities.

Many investors in QE markets also appear caught like deer in the headlights when it comes to economic risks. QE economies may have avoided both inflation and recession for many years and growth, inflation and interest rates have been remarkably stable. But the stability is a deception. These economies are not healthy. Many are sliding into outright populism. For years they have relied excessively on stimulus with insufficient attention to reform and debt reduction. Growth rates are depressed and productivity is so poor that even a normal cyclical downturn could easily push whole economies deep into the red. At that point, it would prove difficult to re-emerge from recession due to the diminishing effectiveness of policy.

Hence, QE economies are, in fact, poised on a fine knife-edge between recession and inflation and the view to either side is dizzying. Small policy mistakes could easily push them off the edge.

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The costs of recession or inflation

Suppose that a major QE economy, such as the US, plunged into recession. Policy makers would be extremely poorly placed to respond effectively. Most governments in QE economies have already used up their conventional and 'conventional unconventional' policy tools, such as rate cuts and trillions of Dollars of asset purchases. In addition, they have accumulated debts averaging 30% of GDP due to fiscal stimulus operations following 2008/2009.

These stimulus measures have abjectly failed to spark 'exit velocity'. In fact, average growth rates in developed economies have declined by an astonishing 42% since the Crisis. Looking forward, the picture is even bleaker. The next generation of stimulatory measures, such as Helicopter Money, protectionism and negative interest rates would have serious negative side effects on currencies, trade and banking systems – and ultimately growth.

Inflation cannot be ruled out either and would pose a similar nightmare. Stagflation impales QE central bankers on the horns of a dilemma as they are forced to choose between protecting measly growth or stamping out inflation. It is not possible to do both after years of declining productivity.

Fighting inflation by hiking rates meaningfully would crash stimulus-addicted stock and bond markets and increase debt service costs for over-indebted economies dramatically. Faced with this prospect central banks would likely protect growth, while inflation would rise. Bond markets would immediately object, so bear-steepening of QE yield curves could quickly threaten housing. Regulators and central banks would therefore be forced to step up financial repression significantly to hold down long yields. Japan, of course, has already moved to directly manage of the long-end of its yield curve. Others will follow. Ultimately, QE currencies should decline if yields are forced lower under conditions of rising inflation and domestic savers would face enormous losses in purchasing power terms.

EM's Fed sensitivity

There is a profound irony in the fact that the market remains far more preoccupied with the potential effects of QE central bank decisions on EM than on the QE economies themselves. Objectively, EM economies are rapidly becoming the only 'normal' countries left on the planet, in the sense that they have regular business cycles, use conventional policies, have reasonable debt burdens, sensible asset price valuations and so forth.

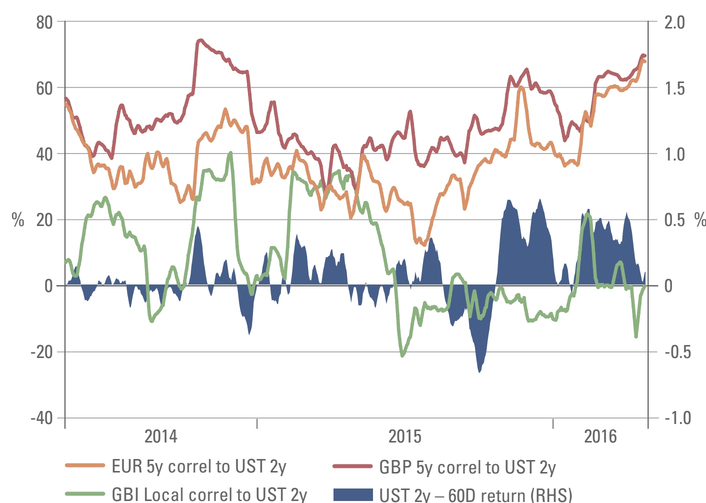
Moreover, EM countries have recently demonstrated considerable resilience. They have just come through a hurricane of headwinds – the start of the Fed hike cycle, the USD rally, the Taper Tantrum and falling commodity prices – without a major pickup in defaults. Indeed, with respect to interest rates, as recently as February of this year the average yield on EM bonds was higher than when the Fed has rates at 5.375% (end of 2006)! EM resilience is rooted in fundamentals that are quite simply much, much stronger than those in developed economies, whether one considers debt levels, FX reserves, growth rates, demographics, the room to ease monetary policies and fiscal room. EM economies are reforming far more than developed economies, especially in the last few years.

In short, the conditions of vulnerability that make Fed policy changes such an important risk in developed economies are simply not present in EM.

EM asset prices have also become far less correlated with Fed fears. The chart below shows returns on 2 year UST bonds (dark blue area) as well as correlations between these returns and the returns on EM local currency bonds (green line) and developed market bonds (red and orange lines). Returns on two year UST bonds respond strongly to market expectations of Fed hikes, so correlations with 2 year UST returns are a meaningful gauge of sensitivity to Fed hike expectations.

The chart below illustrates two basic points: the sensitivity of developed market bonds (UK and EUR bonds) to Fed hikes has been rising steadily and now stands at 70%, while sensitivity of EM bonds to Fed hikes has been declining and now stands at zero. In fact, correlations between EM bonds and 2 year Treasury returns are positive when 2 year UST returns are positive (i.e. when the market prices out Fed hikes) and the correlation is at or below zero when 2 year UST bonds drop (i.e. when the market prices in Fed hikes). By contrast, sensitivity to Fed hikes in developed market bonds is not only higher, but has been growing steadily since last year.

Fig 2: **60 days correlations between UST 2-year returns and 5-year bonds in Europe, Britain and EM local bond markets, compared to 2-year US Treasury 60 days rolling returns**



Source: Ashmore, Bloomberg.

Technicals are good

This relationship alone ought to be a clincher for those, who still struggle with the Fed hike question. But if that is not enough remember that EM bonds also pay 6.26% yield for the same duration that in the US pays just 1.26% and which in Germany pays -0.51%.

Despite its many merits EM bonds remain far from many investors' radar screens. Global asset allocators have shunned non-QE markets for years, particularly EM as they chased risk in developed economies. Flows have barely begun to return. Investors are scared about return prospects in developed economies. Since they still think of EM investments as risk-plays they are reluctant to allocate. Emotions do matter, but today EM is actually the safer play.

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Conclusion

Developed markets are risky. It is not just that valuations have been dangerously stretched; their underlying economies are also vulnerable. It is the combination of vulnerable markets *and* vulnerable economies, which make QE economies especially sensitive to even modest shocks, such as policy actions by their central bankers. Sooner or later a QE central bank will make a mistake. Sooner or later a QE economy will be pushed into inflation or recession or both. The market currently seems to correctly recognise that the decisions of QE central bankers are important, because they can trigger major market or economic convulsions. However, positioning has not yet responded to these risks, so technicals are also poor in the QE markets.

There are very good reasons to believe that EM countries have neither the fundamental nor the market vulnerabilities that characterise developed economies today. Technicals are also strong. For these reasons, it makes sense to allocate out of the QE economies and into EM, the safer alternative.

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