Ten Seconds Into The Future… A Quick Take on Market and Economic Outlook

The world is witnessing renewed economic strength. Generally, fundamentals are strong(er), especially in the developed markets. Policy, however, remains nervous and uncertain and drives financial market volatility. Equities in the performing markets seem fully priced. Credit continues to perform in the face of potentially higher interest rates. What can we make of all this? Let's do this back to front…

Implications:

Slower global growth means less cooperative counterparties. Expect more mercantilism, currency wars, and control of cross border movement of intellectual, financial and human capital. Reward national self sufficiency.

US short term interest rates likely to be pinned at close to zero for multiple years. The longer end will be driven by market expectations. Its reasonable to expect the USD curve to be steeper than EUR and GBP term structures on both growth and inflation expectations.

EM inflation is a problem; sovereign finances may add fuel to the fire. Expect EM term structures to underperform.

In the US, high yield and credit may continue to perform despite the QE taper talk. Growth is self sustaining but weaker than the market expects. Hold with high yield now. If QE taper becomes more probable, a switch to equities may be useful.

In Europe, high yield and credit are likely to continue to perform. Equities look cheap in aggregate but when controlled for quality, equities are fully priced. EUR denominated high yield, even of non Eurozone issuers, is attractive as credit is priced off the EUR curve which is likely to outperform.

Growth:

The global economy will face slower long-term potential growth compared with before 2008. Cyclically, the developed markets of the US, Europe and Japan are experiencing a recovery. Emerging markets are slowing down, albeit from higher rates of growth.

It appears that, overall, the fundamental economy is healthy and on its way to self sustaining growth. Over the longer term, emerging market growth must reasonably be expected to moderate as those economies mature.

Post 2008, a global rebalancing is underway, which is natural after every crisis. Whereas the late 1990’s saw emerging market crises which led them to repair their balance sheets, the most recent crisis was rooted in excessive debt in the developed markets. This has been met by efforts to manage the existing stock of debt, to provide relief to poorly underwritten credit, and to scale back indebtedness. Some of these efforts will be mutually confounding.

For the developed markets the rebalancing will involve a revival of manufacturing, a reorganization and reduction in private debt, a resurgence of exports as a driver of growth, and stricter regulation of the financial system. Emerging markets will have to rebalance their economies away from exports, this will be done for them by the developed markets anyway, towards a more consumption led engine of growth. This will tend to weaken emerging market private and public balance sheets.

Emerging markets, which weathered the 2008 crisis relatively well, now face a more difficult reality. The immediate impact of the credit crisis on emerging markets was a quick reversal in their balance of trade, due to the sudden dearth of trade finance, then due to the competitive devaluation of developed market currencies, re-shoring of manufacturing, and competitive intellectual property strategies. Emerging markets have had to operate equally loose monetary policy to support their export dependent economies. They have felt able to do so due to their generally strong foreign reserves and as falling interest rates have helped to offset weak developed market currencies. At the same time, emerging markets are being rebalanced toward more consumption led growth, almost by default, as developed markets become more export competitive.

Earnings:

In the US, the economic recovery there has probably achieved escape velocity. The innovation and efficiency of US companies is driving a sustainable, secular trend in earnings. The distribution of growth is, however, uneven. Capital remains expensive and debt, while cheap, is not widely available. Small and medium businesses rely on bank credit, which remains impaired. Companies with access to debt capital markets can fund cheaply and profit from the increased demand for yield among investors. For these, a simple balance sheet restructuring in favor of debt financing is accretive to earnings per share.

In a positive but low growth environment, compounded by political uncertainty, (over the debt ceiling for example), financial engineering dominates business expansion, and employment. The dearth of bank capital also limits growth capital for small and medium businesses who tend to be more important for employment growth.

The European experience is similar although Europe is a step or two behind the US on the path to recovery. That said, Europe continues to suffer from over-capacity, as evidenced by its lack of inflation, and could profit handsomely from any uptick in growth as operational leverage remains high. Europe, however, suffers from a more acute form of funding shortage. Its banks are well behind the rest of the world in recapitalizing and SME lending is moribund. Recent signals from the ECB indicate that the problem is being addressed. The Asset Quality Review initiated just now is a good example.

As emerging markets rebalance towards more consumption and less investment and saving, the fortunes of companies will rotate accordingly. Current index heavyweights like banks, resources and exporters will likely see increased risk or weaker earnings.

Prices

Emerging markets are suffering from inflation. Inflation measures are imperfect and anecdotal evidence indicates inflation is running faster than official numbers suggest. Additionally, inflation is higher in non-administrative goods markets. This implies higher potential inflation should these goods or services markets be deregulated. What are the sources of this inflation given that emerging markets are in fact facing slowing growth? One is the inflow of capital as a result of QE in developed markets. This argument is weakened by the fact that inflation in the economies printing the money is muted. Asset prices such as real estate are rising but goods and services inflation is decidedly muted in developed markets. As the world becomes less globalized, and economies less open, the sources of inflation are increasingly domestic. Policy tools such as the exchange rate become ineffective. Interest rates on the other hand are a blunt instrument and ineffective under stagflation. Generally, trade enables price discovery and market clearing and a less globalized world encourages inflation.

Inflation in the developed markets is more complicated. Whereas central banks like the Fed have been purchasing assets and growing the money base, inflation has been surprisingly low. And yet, the risk of inflation is high. If the money multiplier or the velocity of money were to accelerate, it would multiply through a massive money base to inflate nominal output. If capacity is tight, the risk for a spike in inflation is significant. The US therefore is poised between low inflation and a spike in inflation. This is one reason that the Fed needs to reduce the
size of its balance sheet as soon as practicable. In Europe, the UK excepting, deflation is the greater risk. German influence is likely to keep the ECB tighter than it otherwise would be, even as the ECB maintains its easing stance.

Financing:

Developed market regulators are sending conflicting signals to banks, encouraging to lend more and take less risk. The Basel III capital rules have certainly reduced the amount of credit available per dollar of bank capital. With investors still hurting from the losses of the last crisis, private funding may have rebounded but have yet to fully recover to pre crisis levels. Debt capital markets are a bright spot, however, as low rates and demand from retail investors and mutual funds have driven bond issuance. Structured credit issuance and thus demand for collateral has recovered slightly overall but remains weak outside the US. With less bank capital and still sub capacity shadow banking sources, credit conditions remain constrained. Larger, developed market issuers, not necessarily better credits, will face easier credit conditions through access to bond markets.

For credit to fully recover and grow, the shadow banking industry needs to be further developed. Regulation has so far focused on banks. Some efforts have been made to bring shadow banking under the purview of regulation but the complexity of the system has so far confounded regulators’ efforts.

Policy:

The US treasury will need to continually finance itself despite cash flow insolvency. The US Fed lost its independence the day it stepped in to rescue the markets and the economy and will continue to fund Treasury. It is likely that the Fed will keep rates floored for multiple more years. Attempts by Treasury to extend its funding with low duration issues like FRNs are evidence that rates will be kept low.

QE will be moderated. The question is one of timing. The Fed needs to control its balance sheet soon or risk a spike in inflation. It has tools such as reverse repo to reduce liquidity but these are temporary measures. It is simply not prudent to maintain a balance sheet of this size. The most likely scenario remains that QE moderation will be conducted, but that sufficient noise will surround the incidence to desensitize the market. The goal remains to reduce the size of the balance sheet without steepening the term structure excessively.

Europe is significantly behind the US in terms of policy. The European recovery is still in its early stages and significant tail risks remain, notably in France, whose economy is weaker than its CDS spread suggests. The EUR continues to impede market clearing in the labor market creating chronic unemployment across the region. The ECB will likely continue its LTRO to maintain liquidity in the system while the banking system undergoes its recapitalization exercise.

Slowing growth and rising inflation plague parts of the emerging markets. Countries with sound balance sheets may spend their way out, within limits. Current account deficit an or budget deficit countries will be very constrained in what they can do. Brazil and India are the main examples, and there are more from Asia to Lat Am to Central Europe of countries where currencies are vulnerable, reserves are thin and efforts to support currencies could choke off growth.

China’s efforts at rebalancing its economy are commendable and also a sign of strength. Recent initiatives to reign in credit and to audit the shadow banking industry point to responsible management and imply strength of the financial system. Much will rest on the shoulders of the central government, though, as local governments have been impoverished and the banking system lives on very optimistic appraisals of their balance sheets.

Risks:

If it is written here, it is not a serious risk. The most serious risks are the ones that only become clear once the damage is done. But anyway…

Almost all asset pricing is dependent on some kind of discount rate. Central bank policy dictates interest rates, the most natural discount rate in any asset pricing model. One mistake and all asset prices will be mispriced. We’d better hope that central banks are able to wean the market off interventionist policy in an orderly fashion.

A corollary to the above is that nobody knows the correct price of any asset as long as quantitative easing and other unconventional monetary policies are in force.

Inequality. We have witnessed inequality fall across the globe as poorer nations got richer more quickly than richer nations. Within countries, however, the reverse was true; inequality worsened within each given country. Sufficient in-country inequality can be destabilizing socially, politically and economically.

A small pick up in inflation too soon can be difficult to manage when a central bank’s balance sheet is over inflated.

Long maturity, low interest debt is very long in duration, and very convex.

I reiterate what was said at the start of this article. Slower global growth means less cooperative counterparties. Expect more mercantilism, currency wars, and control of cross border movement of intellectual, financial and human capital. It is not a stretch to extrapolate such competitiveness to armed conflict. All it takes is a little bit of paranoia.