Ten Seconds. Are Developed Markets a Threat to Emerging Markets?

Economic growth in the developed markets appears to be in a general if tepid recovery. The US continues to exhibit steady recovery in economic growth supported by a robust housing recovery and manufacturing which has even now widened to a slightly healthier labor market. Tempering this is a falling participation rate, which is troubling since the unemployment is in the younger cohorts, and the increasing proportion of temporary work, which is more likely a consequence of Obamacare, which requires employers to provide health insurance to full time employees.

In Europe, a nascent recovery is underway, a first quarter of positive growth after six negative ones, led by Germany, and featuring, surprisingly, France.

It is perhaps surprising that the weak spots in the world have come to be the emerging markets, although the emerging markets are far from homogenous. China's weakness seems the biggest threat given the size of its economy. India is unnerving with the acute weakness of the INR and the shortage of USD unsettling markets.

The last 5 years have been marked by the importance of policy intervention. Central banks have reduced short term interest rates and multiplied their balance sheets to fund their respective governments in the face of bailout bills and flagging tax receipts, as well as to inflate liquidity in the hope of stimulating demand. Success must imply a rollback of such policies if nothing else than to reset their policy weapons, but more importantly to wean the economy off life support. QE tapering can thus be viewed of evidence of strength and not weakness. Currently only the US Fed is contemplating a moderation of QE. Most other central banks still face weak economies and continue to be dovish. But the US Fed faces another problem, if indeed it can be called that. As the economy recovers, tax revenues have recovered also and the US Treasury will not need to borrow as much. At the same time, despite a housing recovery, securitization has slowed compared to pre crisis levels. This presents a supply problem. If the Fed were to continue to purchase a fixed proportion of new issuance, it would be forced to slow its buying anyway. Perhaps to manage market expectations the Fed has telegraphed its intentions well in advance. No such luxury exists elsewhere in the major economies.

I am comfortable with the nature of the recovery in the US, that it is sustainable in the long run. The volatility in US assets is a consequence of the withdrawal of stimulus which should signal strength. Be that as it may, US asset markets have rallied hard and it is time for a breather. Tactically, buying put protection or outright neutralizing the beta may be a good idea. Longer term, the prospects for US assets remains good. Europe is not out of the woods but could, and I emphasize the could because nothing is certain, be 9 months behind the US in terms of recovery. If so, European assets are a good buy, in particular corporate debt, especially high yield since we appear to have good corporate performance coupled with low growth.

While China had me concerned for a while I am a bit more sanguine on her prospects now. While I still regard the innovation deficit in China to be a serious drag on the economy, and I expect growth to moderate further, valuations are sufficiently low to warrant buying. The one impediment was the health of the financial system, in particular the shadow banking industry. It now appears that the government is serious in facing the issue by measuring the risk and then managing it. In some ways, the Chinese economy, while slowing from a frenetic pace, is, at least in the view of policy makers, sufficiently robust to warrant a restructuring which has certain parallels to QE tapering. This is a good thing.

It is perhaps the strength in developed markets that poses the largest threat to emerging markets.

1. The USD and EUR have been stable to strong with expectations for further strength in the USD.
2. The US economy is expected to extend its recovery and Europe appears to be stabilizing.
3. Developed market corporate balance sheets have been rehabilitated quickly.
4. The Refinancing Wall, a trillion USD and change in Europe, a couple of trillion USD in the Americas, is likely to displace demand away from emerging market debt and perhaps even equities.

So far the nascent sell off in emerging markets has found no trigger, no single factor. However, I would not underestimate the impact of competing sources of capital on EM assets as capital first reallocates and next flees away from emerging markets.