Global Connections

Itaú BBA

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The Big Fear

Nine months into the year and 2015 has already been a wild ride. As foreshadowed in the 2015 Outlook piece, it's been a year of tough choices, and that remains the case as the fourth quarter looms (see "2015 Outlook – Tough Choices Ahead," published on December 2, 2014). Today the choice is whether or not to believe in the Big Fear, which suggests that investors are losing faith in policymakers' ability to influence the world's two largest economies: China and the US. And we all know what we do when we lose faith.

3 Big Challenges

First the backdrop, which consists of three big challenges markets have had to contemplate over the past few months. Two are stamped "made in China": a growth scare and a governance scare. The third resides in the US: Fed-led uncertainty.

The equity market response has been clear – sell and stay away, resulting in what increasingly looks like a buyers' strike. Given that none of these challenges has been overcome and that in fact one can argue all three remain in place, such a strike makes a lot of sense. In the very near term, sentiment and positioning suggest equity markets can bounce, but the backdrop implies only a bounce.

China's growth path is still on a downward trajectory, one that is unlikely to reverse for years to come. As a result, China's leaders are pressing policy buttons left and right: a rate cut here, monetary expansion there… stimulus package over here and currency devaluation over there. The key takeaway is this: China does not have the capacity to make a big move on any of these fronts; one should expect a series of small efforts designed to keep that downward trajectory from morphing into a sudden stop.

These small steps included intervening in the financial markets, which led to a governance scare as investors reassessed the always overblown idea that China could do no wrong when it comes to economic policy. Well, like policymakers everywhere, they can do plenty wrong; the realization that 2010's huge policy stimulus was a mistake is one reason why China is highly unlikely to make a big move. Another is that debt levels have become too high, a factor that often brings such unbalanced growth to a halt (see "China – Don't Drop the Ball," published on May 2, 2014).

Today's main concern is that China's rebalancing effort (from production to consumption) is progressing too slowly. As a result, as China's growth rate slows, its trade surplus continues to grow. This in turn means that China is absorbing global demand rather than contributing to it.

That consumption needs to grow faster is becoming visible even in such hot sectors as the tech and e-commerce space, where China's national champions are battling it out to the detriment of profit margins and share prices (US tech investors please note). China has made strides to rebalance: higher wages, a stronger currency and higher interest rates all spur consumption, but the production excess cannot be absorbed domestically or shut down and consequently is now spilling out into the rest of the world.

China's economic transition will take years. Three points to keep in mind: one, China will not rescue the world economy; two, China's adjustment is likely to be evolutionary rather than revolutionary or sudden-stop in nature; and third, this adjustment process entails China shifting from the world's customer to a competitor with ramifications for corporates, investors and national policymakers the world over.

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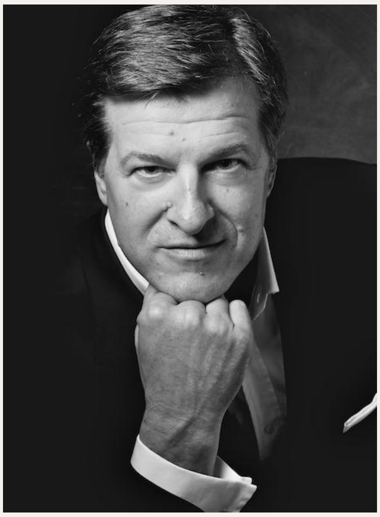

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The Fed

What about the third challenge, Fed-led uncertainty? The Fed, like the PBOC, is increasingly cognizant that it is one with the world, and so what happens in China influences the rest of Asia (The Asian Iron Triangle), and what happens in the US influences China, etc. For example, a Fed rate hike would likely increase the value of the USD and in turn China's yuan, which remains effectively pegged to the USD.

The Fed is beset by internal and external pressures. Asian and EM disinflation coupled with Europe's weak recovery means the US economy cannot rely on external demand to offset stagnant domestic demand. Internally, industrial production and housing starts have been weak of late. Domestic financial conditions have tightened, and according to the Chicago Fed are now tighter than at any point since the GFC, as rates back up, leverage declines and credit starts to tighten. In essence, the market has done the Fed's job for it.

Housing and auto production, two leading lights of the US recovery, are both at risk in light of tighter money (the robust auto-production cycle has been fueled by an explosion in subprime auto loans – subprime didn't disappear, it just went mobile). Had the Fed raised rates, it might have brought a recession home to roost. Post-Fed, the worry is that a weak US economy facing tighter financial conditions at home and disinflation from abroad might also go into recession if investors embrace the Big Fear and sell, creating a reverse wealth effect.

We know the result of these three big challenges: the bursting of China's equity bubble and significant equity market corrections across the globe, from EM to Japan, Europe and even the US, which has had its first 10% equity correction since 2011. Commodities sold off as well, while bonds provided very limited protection.

While painful the sell-off does imply some beneficial discounting of global recession risk, something discussed in these pages back in July (see "The Global Battle Between Reflation and Recession," published on July 31, 2015). The operative question is how much has been discounted? Hard to tell but the idea of a global recession, considered so ridiculous one was almost laughed out of the room in London this past May, has suddenly become the 2016 base case for various large banks.

Listen to the Market

In times such as these, it often pays to listen to the market. Letting the market tell you what is occurring rather than you telling the market is also a good way to limit losses, maintain sanity and occasionally make some money. Recently, listening to the market provided four indications that some of these challenges were being priced into financial assets.

First, the reaction of Asian EM equity markets to China's continued equity selloff. Whether it was Thailand, Malaysia, South Korea or Taiwan, it looked like these markets were trying to make at least a near-term bottom.

Second, Brazil's reaction to the loss of its Investment Grade rating – while the decision was not a surprise, the timing was, and yet stocks, bonds and the currency all held in pretty well. This makes sense, given the collapse in both stocks and the currency.

Third, oil's response to the suggestion of a major US investment bank that its price could fall to as low as $20 per barrel in 2016. Some of this was the nature of the mood, as the report forecast a higher average 2016 price than the current spot price, but headline writers led with the $20 number. Oil, like our other candidates above, held in quite well.

Fourth and finally, US High Yield's response to the carnage in the S&P, which likewise displayed a pretty solid footing, suggested perhaps that waves of volatility in the HY space over the past year had flushed out many weak hands.

All told, one could argue (and one did) that a risk asset bounce was underway. And yet, and yet…

The Big Fear

Thus, Fed announcement day arrived with most equity markets up 5%-10% off the late August lows, commodity prices higher and rates priced for Fed action. The main concern coming into the Fed meeting was not that the Fed would hike; it seemed quite clear that it would not go against virtually the entire global economic policymaking community and raise rates. No, the concern was that the Fed would stand pat and stocks, rather than rally, would sell off.

Lo and behold, that is exactly what happened, and that is why we need to be very, very concerned about how things move from here. It remains unclear whether the equity market reaction to the Fed decision was (hopefully) just a classic case of buy the rumor (no hike) and sell the news, or something much worse, namely that investors might be starting to price in policymakers' loss of control – The Big Fear.

The Big Fear of policymakers losing control has been lurking underneath the global equity market for years, underpinned as markets have been by central bank support. Think of it this way: there are two global growth drivers: China and the US. Recently, the competence of the policymaking community in both countries has been called into question, suggesting a possible loss of faith in policymakers, which if true is very worrisome, thus the Big Fear concept.

Why is the Big Fear so worrisome? It's simple. If investors lose faith in policymakers and decide that cash or bonds are a better place for their money, then stocks are likely to sell off much further. How much further? One never knows, but maybe asking a few questions might help. First, at what level does the S&P need to be for the Fed to engage in QE 4? Second, what S&P level will be considered cheap (keep in mind 2016 E estimates need to come in sharply)? I don't know the answer to either question, but it seems reasonable to expect that the S&P would need to go much lower than the 1870 level it bottomed at in late August or the 1830 level of a year ago.

The economic implications of such a sell-off would likely be a US and global recession. Such an environment could create a negative feedback loop between financial markets and the real economy, which policymakers would find very difficult to break.

It seems clear that the Fed will not raise rates this year, neither next month when they meet again nor in December, which is the last meeting of the year. Will they raise rates in 2016? From this armchair, the odds are against it, as the forces of recession gather while the forces of reflation stagnate. On this front, one has to question the Fed's 2016 inflation forecast of 1.6%, up from 0.4% this year. The Fed's crystal ball has been mighty cloudy for years, but this forecast takes the cake.

A look at the global economy helps explain why. Four factors stick out: excess debt, an absence of inflation, insufficient demand and excess supply of raw materials and manufactured goods. None of this is new – what is new is how the various hopes and remedies have fallen short while the problems deepen. The toxic combo of excess debt and disinflation is one powerful reason why the Fed did not move, and excess supply in commodities and manufactured items (look at the PPIs around the world) is another. The global economy needs demand-creation or production shut-ins, and to date both have been lacking.

There are small signs that the commodity complex is starting to finally adjust, with closures, dividend cuts and stock issuance in the mining sector and talks about talks in the world oil market. However, the manufacturing segment of the world economy is quite far behind the commodity segment, suggesting that China's need to shift excess production will ensure manufactured-goods disinflation for the foreseeable future.

One can wish for inflation and for the Fed to be able to hike, but one also needs to be focused on the realities of the current global economy. Where is the demand going to come from? Who is going to shut in production? Let's look at the three main economic regions: Asia, Europe and the Americas. Asia is likely to be a source of manufactured-goods disinflation as it seeks to rebalance itself to a China that is a competitor first, a customer second. Japan's recovery is sputtering; it will continue QE while a fiscal stimulus package seems quite likely in the months ahead. Europe remains quite weak, and with the refugee issue now occupying policymakers, ECB-led QE seems the only game in town.

The Americas is a concern. South America is in a deep funk, whether it is Mexico's subpar growth rate, Brazil's political and economic travails, Andean copper dependency or the impact of weak oil on countries such as Colombia or Venezuela. All this is pretty well known.

The US is most worrisome because of its combination of still-high equity prices and a very bare policy toolbox to confront any economic weakness. How bare? Well, monetary policy is on hold, and the bar to QE4 is likely a much lower S&P. What about US fiscal policy, one might ask? Great question. Here is the only thing one needs to know about the US presidential election process: it takes fiscal policy flexibility away and locks it in the freezer until late 2017, two whole years from now. In other words, at a time when the US economic expansion is close to seven years old, with the Fed on hold, incomes flat, debt levels high, a strong dollar and absolutely no inflation, fiscal policy is locked away for the next two years at least!

By the way, the UK confronts similar issues and could possibly be a canary in the coalmine for US monetary policy – QE for the people on BOTH sides of the Atlantic perhaps? The UK's negative rate discussion is likely to move across the pond over the next quarter or so. One other way of thinking about it is this: which comes first, the end of ECB QE or QE4 in America? I would go with the latter.

How does one vanquish the Big Fear? With aggressive policy action on the demand-and-supply side. What is the likelihood of that? Exactly. Seen in this light, it makes perfect sense for investors to worry that policymakers no longer have their back, and thus they take some money off the table. One analogy is that the US economy is like a ship that has engine trouble, is drifting towards the rocks and is left to hope that the wind shifts and takes it away from the reef…. not exactly a bull-market, high-valuation tableau. Hope is not a strategy.

Portfolio Implications

It is as yet unclear whether we are in a trading range or whether loss of faith in policymakers is about to take the US and global equity markets down much further. How will we be able to tell what is likely to occur?

Listen to the market and observe those segments that are ahead in the discounting process, such as Asian EM equity markets and commodities, such as copper, oil and the like. If they are able to maintain the August lows, then the Big Fear may be averted; if not and they break to new lows, then one needs to have sell tickets in hand. In the interim, make sure you love what you own and have enough cash so you can sleep at night.

Within global equities, Europe and Japan remain favored for any new money or rebalancing that one might desire to do, both with policy flexibility, oversold conditions and attractive valuation. Japan has sold off as much as EM equity, which suggests real opportunity. The problem is that these markets are high beta in downdrafts. US equity rallies should be used to raise cash – US is late-cycle across the board.

USD fixed income is perhaps most attractive, as the Fed on hold means one can search out yield with a more benign backdrop across preferreds, MBS, HY, etc. One might even get a boost from the fast-money crowd: the hedge fund trade into year-end may well be short the S&P and long US Treasuries.

Within EM, the USD fixed income space remains the preferred method for exposure, as one takes on UST risk and is paid roughly 400 bps over UST to do so. This space held in very well during the recent downgrade of Brazil, and other worry spots like Ukraine, Venezuela, etc. are well known and likely discounted. Asian currency adjustment has more to go, and while EM equities have been crushed, 2016 E need to come in dramatically – watch out for value traps.

Here is the question – how much has been discounted by the summer selloffs in global equities, EM, FX and commodities? We are likely to learn the answer in the next few months. The key is to keep the lesson fees down… School is back in session, study hard!

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