Tough times, good opportunities

As the global recovery falters as a result of mushrooming public debt in the developed world, emerging economies are in a prime position to benefit, says ***George Tchetvertakov***

2008 was undoubtedly the year of the financial crisis; 2009 was about stabilisation and recovery but 2010 is set to be a year of both. Solid recovery expectations have been dented by the realisation that much of the private sector debt that caused the 2008 quasi-collapse has been transferred to the public sector in almost every major economy. Examples include the US, Japan, UK and most recently Europe, as authorities secured a €750bn safety net underneath the most fiscally embattled EU nations.

Five central banks have increased interest rates since March 2009 – Israel, Australia, Norway, India and Malaysia. Up until May of this year, consensus amongst market participants was that 5-10 more central banks around the world would follow suit. However, fresh market turbulence has delayed tighter monetary policy across the globe. Market expectations have shifted substantially towards lower rates for longer, mainly because of European default risk and lower projected growth rates across Europe. Looking ahead, if recovery expectations resurface as they have been on previous occasions since the start of the recovery, cyclical currencies, emerging market equities and commodities could all be excellent investments at better levels given their sharp retracements in May.

During 2009, developed economies were showing broad recoveries in multiple sectors leading to a broad recovery consensus. The net effect was a steady rise in equity markets worldwide – especially the emerging markets which were fertile ground for higher returns. Commodities rallied on expectations of higher global demand, led by China and the US. Currencies reflected the newly found confidence with traditional safe havens like the US dollar and the Yen being sold aggressively. Better yielding, cyclical currencies such as the Aussie and Kiwi Dollars were the best performers in G20 FX during the recovery as sidelined investors reallocated portfolios from cash into better performing investments such as emerging market equities, corporate bonds as well as commodities as an inflation hedge.

The displaced timing of support introduction, and in turn, support withdrawal has been one of the key themes in 2009. The level of aid was unprecedented, not only in the monetary amount, but also in terms of how many nations actually adopted supportive measures. Almost every G20 nation drew up measures that would assist their economies. The front-runners were the US and the UK by putting forward the largest amounts of funding as a proportion of their GDP. They were also the first to adopt quantitative easing (QE) whereby newly created money was used to purchase assets directly from financial institutions. Only a select few nations could afford to partake in such policies sustainably and so far it seems this approach has not led to significant inflationary effects. However, with so much additional liquidity flowing through the financial system, investors have become tentative and are actively hedging against inflation. One popular method has been to add significant Gold exposure to their portfolios.

Gold has broken out of its recent $1,060 – $1,150 range, reaching all time highs of $1,258 per troy ounce in mid-May. The fact that Gold is making record highs in this environment suggests that investors are becoming increasingly dissatisfied with fiat currencies which in essence could have little or no value if easing programmes persist. Gold has also increased its negative correlation to the Euro, both on a trade weighted basis and in EUR/USD. This indicates that fear of currency debasement is predominating in the market despite the ECB's sizeable rescue package. Furthermore, sovereign default tension is still bubbling under the surface with investors keenly anticipating the outcome of austerity plans and future EU growth rates. The ECB's/EU's unmoving resistance to substantial easing policies has proven incorrect. The Euro was considered a strong alternative to the dollar as a reserve currency but the debt overhang in many peripheral EU countries has gained traction amongst macro players. The unwinding of US dollar reserves was a huge topic post-crisis as investors pondered the dollar's long-term value – central banks stood ready to diversify into alternatives but the onset of default risk in the Euro-zone has reinvigorated Dollar bulls regardless of the Fed's $2trn balance sheet.

The recently announced European rescue fund backed by the EU and IMF sets no target for asset purchases. This is in complete contrast to the Fed which announced $300bn of Treasury purchases and $1,500bn of mortgage/agency debt purchases. The Bank of England's QE venture was initially set at £75bn but was eventually revised up to £200bn. The ECB has said it will not disclose the amount but if its stated intention is simply to stabilise markets until European governments approve some form of stabilisation mechanism and for the periphery to approve additional fiscal tightening, then the amount of ECB bond purchases will be largely dependent on the speed and strength of European political will.

$1500bn

Amount of mortgage/agency debt purchases announced by the Fed

£200bn

Amount of Bank of Englands QE venture (revised from an initial £75 billion)

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The actual amount of bond purchases could be as small as the €60bn of covered bond purchases done in 2009 but by the same token, the ECB may have to support weaker European economies for longer meaning further capital injections.

Most of the default risk has now dissipated but the root cause of the fiscal problems remains – inadequate fiscal policy. Until investors see austerity measures being implemented and debt/GDP ratios coming down, European bond markets, equities and the Euro are likely to be susceptible to declines. The rescue measures are likely to favour cyclical currencies because of the policy divergence set forth by the ECB. Generally, commodity currencies suffer immensely when affected by global events that shift risk preferences away from risk towards safety. It's likely that if default risk continues to subside and risk-tolerance increases; cyclical currencies will be the beneficiaries.

If the ECB keeps bond purchases to a minimum and publicly withdraws from its stated intention of buying distressed EU debt fairly soon, the effect on EUR/USD should be minimal and the pair should remain comfortably above 1.25. On the other hand, a protracted use of QE and delays on agreeing a common solution would renew investor displeasure with EU authorities and could leave EUR/USD dipping below 1.20 – heading towards 1.1640, the low of 2005. The rescue measures announced by EU/IMF/ECB are thorough and far-reaching – some measures are short-term Euro negative (bond purchases, unlimited term repos, Dollar swap lines) and some positive (stabilisation mechanism, mandatory fiscal convergence). Therefore, depending on which measures predominate will decide how strong support for the Euro is. In the short-term we expect the Euro to stay under pressure but as bond purchases are reduced within a common fiscal framework, we should see confidence in the Euro return. Should default risk resurface and speculative selling of European assets resumes, the saving grace for the Euro-zone could be that only a quarter of the region needs to implement fiscal tightening in the short term – the core drivers of growth in Europe are in comparatively great shape and could lead the European recovery. Although unlikely, there remains the possibility of the EU shedding some of its weaker members for the greater good of the region and its currency.

From a more macro perspective, the fiscal woes facing the developed world are likely to suppress strong recoveries in the US, UK, Europe and Japan. Fiscal austerity will take years to fully implement so it stands to reason that during this time, other nations should come to the fore. Fresh drivers of growth and production will come from areas where spare capacity is high i.e. the emerging markets and BRIC (Brazil, Russia, India & China) nations. Traditional investment destinations like the UK, US, Europe and Japan are likely to stay anaemic because of high public debt, abundant liquidity, high unemployment and most importantly, because investors perceive these countries to have lower returns in most asset classes. Nations which dominated global markets since World War II have, in effect, come to a period of consolidation giving other less developed countries an opportunity to close the income gap. In terms of spare capacity, demographics and being in comparatively early stages of economic development, the emerging markets are able to achieve strong growth rates as disposable incomes rise quickly alongside a strongly burgeoning middle-class. These economies are quietly changing the global landscape as they generate sustained strong growth and terms of trade gains. With their share of global consumption now above 30%, their total share of global demand now exceeds that of US consumers. The financial markets have once again entered into a period of uncertainty and volatility which isn't necessarily a bad thing – as they say – every problem is an opportunity in disguise. Regardless of what's coming next, the FX market will continue to be the best macro indicator of investment trends. ◇

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