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Déjà vu deleveraging

Dr Robert Gay | Fenwick Advisers | 19 December 2015

In the midst of the latest bout of market volatility, it is useful to draw on some previous mid-cycle selloffs that might give some guidance on what to expect in 2015. Consider the following perspective on the collapse in oil and other commodity prices. At $100 per barrel, oil companies and their suppliers were the preferred leveraged equity trade. Similarly, emerging market currencies and US high yield bonds were the preferred carry trades under zero interest rates policies (ZIRP) and quantitative easing (QE) of Federal Reserve – and the US dollar was the preferred funding currency for those positions. With the collapse in oil prices, those leveraged positions are evaporating and are taking down the broader markets along the way. From this perspective, it is much easier to make sense of current market pricing that somehow seems incongruous with the likely stimulus that lower oil prices will bring to the languid global recovery.

In many respects, the current episode brings back memories of the late 1990s when debt and leverage fueled an extraordinary bull market. Until a financial crisis ensued in 1997, many Asian countries had been attracting hot money flows because of their high local interest rates and, in the process, had built up large foreign liabilities relative to their hard currency foreign reserves. The Asian crisis subsequently ensnared Mexico, Brazil and the former Soviet satellite states, all of whom were heavily indebted. Long Term Capital Management (LTCM) was the embodiment of excessive leverage in the equity markets with (at the time of its collapse in 1998) gearing up to 40 times the notional value of the underlying securities. High yield issuance was flourishing, notably on behalf of the dotcom crowd, many of whose companies had yet to earn positive cash flow. An alarming portion of the new debt issuance was used to buy company stock obligations, that is, to retire the stock options of company executives rather than on capital expenditures.

Although the circumstances are quite different today, the patterns are similar enough to ask some probing questions. What are the next shoes to drop, if any? What markets may have overshot in this selloff or still are over-positioned? And perhaps most important, how are policymakers likely to respond to the new reality of lower oil prices and more volatile markets? In retrospect, the Fed's easing of monetary policy in late 1998 was a clear policy blunder that they were forced to retract in subsequent years as the economy overheated and the dotcom bubble ran out of control. As long as policymakers can stay on course and avoid the mid-cycle policy mistakes of the late 1990s, my guess is that the oil price collapse could prove more therapeutic than destructive.

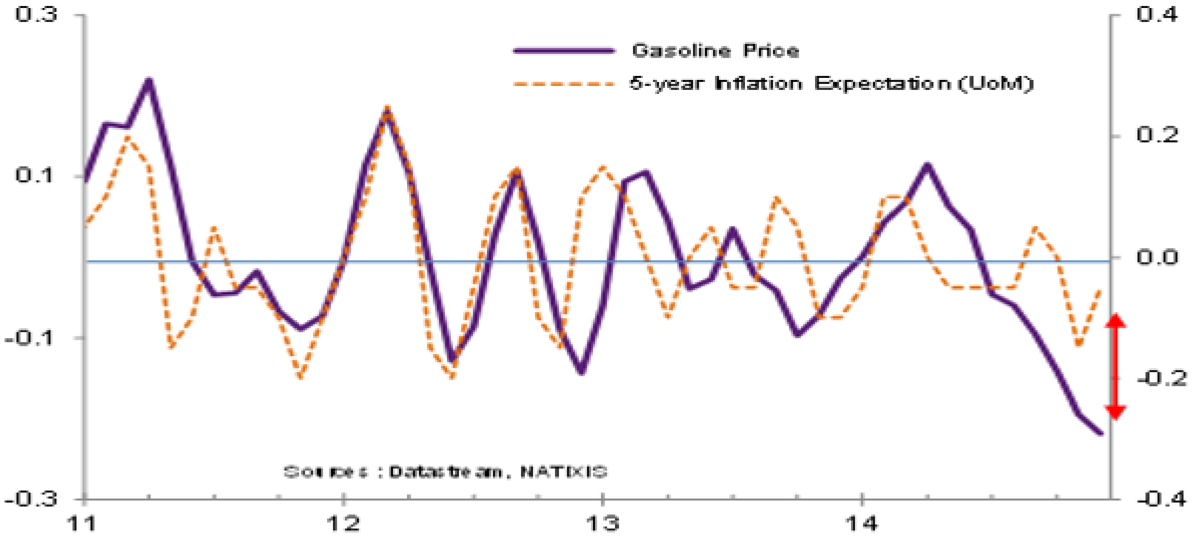
The next shoes to drop

Granted, leverage does not seem to be as great as it was during the late 1990s and surely not anything like the mid-2000s. Nonetheless, rarely does the price of a crucial global commodity such as oil decline by 40% without some backlash. Oil industry suppliers and those who bankrolled high-cost exploration projects are obvious candidates, but I doubt they pose a systemic risk since projects can be mothballed.

More intriguing prospects are those who might suffer collateral damage if capital markets become dysfunctional, which to date they have not. Vulnerable debt issuers include those with unsustainable debt levels and those that are in need of ready cash to meet upcoming bond re-financings or interest payments. Unlike the 1990s, few Asian countries are net debtors anymore. That dubious distinction has shifted to European countries. Italy, Greece, Spain and Portugal owe EUR 1.85 trillion to foreigners, or 18.5% of EU GDP. Nine of the world's 15 largest debtors relative to their GDP are located in the euro zone.

Indeed, the euro zone appears to have a lot of anomalous asset prices. For example, whereas both US high yield and investment grade bonds have sold off in recent months as carry trades were unwound, European corporate debt spreads have held remarkably steady. That decoupling could be rationalised by 1) the imminent divergence of US and European monetary policy in 2015 and 2) the prospect that the ECB will initiate a new QE program with purchases of corporate and government debt. The euro itself also seems to be hugely over-positioned - i.e. everyone is short the euro - on the same rationale. Moreover, European inflation expectations have continued to decline along with oil prices, whereas some measures of US inflation expectations (see Figure 1) have stabilised even as retail gasoline prices have plunged. In short, a lot is riding on the consensual view that the Fed and ECB are headed in different directions.

Figure 1: US inflation expectations
Inflation expectations and gasoline prices (3-month changes)



Sources: Natixis and Datastream

THE CORRECT POLICY RESPONSES

In times of stress, market chatter often turns to why central banks must do something about it. Usually, that is bad advice unless there are clear sign of systemic risks or financial market failure, which are not the case now.

The correct response would be to stay the course, especially in the face of an inevitable boost to global demand. Granted, there will be winners and losers. If crude oil prices eventually stabilise at $60/bbl, for example, that would represent an income transfer of about US$1.5 trillion from oil-producing countries to oil consuming countries, if most of the lower cost is passed along to retail prices. Such a massive redistribution of wealth and income may be fascinating in itself, but it also can distract focus from the bigger picture – namely, that every oil price collapse in recent memory has been a stimulus for the world economy, just as the sudden huge price hikes of the 1970s were contractionary. The reason is that most oil-producing states also have high saving rates, whereas the energy users tend to have low saving rates, and energy consumption is relatively insensitive to sudden price changes. Thus, price hikes act like a tax while any windfalls from lower prices are spent.

We already see signs of a mini spending boom in the US where retail gasoline prices have fallen quickly. The net effect on domestic demand is significant – an extra 0.75% to 1.0% for the US and Japan and perhaps half that much for Europe. Few monetary or fiscal initiatives of late could claim that much potency with so few apparent side-effects. The big differences today are:

1. China has become one of the world's largest users of energy and also has the highest

saving rate, which may mute the boost to global demand; and,
2. the most heavily-indebted region - the euro zone - already is preciously close to deflation, which could make their debts more burdensome. Lower oil prices, even if permanent, will not relieve the world from secular stagnation but neither will QE and ZIRP, both of which have grave limitations as long-run measures.

So, for most central banks, most notably the Fed and the PBOC, the correct response is to stay the course on their current agendas. For the ECB and a few others facing deflation, the path is less clear.

FEDERAL RESERVE: BRING FORWARD THE TIMETABLE FOR LIFT-OFF

Until recent months, most FOMC members including chair Yellen were reluctant to set a timetable for taking the first step toward normalisation of the Fed funds rate until there were clear signs of a more robust recovery that included significant improvement in the labor market. Incoming data since their previous policy meeting, however, satisfy those criterions on most every count. Upward-revised real GDP growth in Q3 at 3.9% far exceeds its potential of 2.25% and data on hours worked through November point to a third consecutive above-par performance. A combination of hefty job gains and higher real incomes has bolstered retail sales which jumped 0.7% in November following a strong 0.5% gain in October. Indeed, the most obvious change in the outlook is that income generation now looks much more robust than at any time during the past several years.

The most dramatic changes in current conditions address the Committee's specific concerns about the labor market - namely, the paucity of new job creation and persistent long-term unemployment. Now that picture looks quite different. Nonfarm payroll employment has risen 250,000 per month over the past six months compared with less than 200,000 on average over the previous two years. Surveys by the NFIB of hiring plans for smaller businesses that generate most of the net new jobs show similar intentions for the months ahead. The outlook for general business conditions reached a six-year high and one-fourth of firms surveyed could not fill a job opening. The flip side of the coin was that firms felt little pressure to raise wages, so there was plenty of time to normalise the policy rate.

That too has changed. The Fed's preferred measure of wages - the comprehensive Employment Cost Index for wages and salaries - has risen 3% over the past four quarters, a distinct uptick from previous readings that were consistently 2% or less throughout this recovery. Clearly the timetable is becoming more pressing as the economy gets closer to full employment.

The collapse in oil prices simply sets in stone a more encouraging outlook for the year ahead as well as an imminent change in the wording of the FOMC directive released at 17-18 December. In my opinion, the FOMC will drop the language on "keeping rates low for a considerable time" and will replace it with a phrase that says the board will be "patient" in normalizing rates. Such seemingly subtle changes to wording carry great significance at the Fed. Specific words are associated with numbers. In this case, "considerable time" means more than six months and possibly a few years. By contrast, "patient" translates into six months or less. Thus, the change in language would be consistent with my view that the first rate hike of 25 basis points will take place at the meeting of 30 April to 1 May.

PBOC: ON TRACK FOR IMF REVIEW OF RESERVE CURRENCY STATUS IN 2015

On 20 November, the PBOC cut its lending rate by 40 bps to 5.6% and the deposit rate by 25 bps to 2.75% to the surprise of many observers. The kneejerk assessment was that the central bank was keen to rejuvenate growth by making credit cheaper and more plentiful. There may have been some thought to lowering the cost of refinancing the country's new pile of debt, especially that of state enterprises that have borrowed heavily over the past few years. A general loosening in credit, however, is not the primary agenda. To the contrary, the PBOC quietly had allowed real interest rates to rise in 2014 as inflation dropped from almost 3% a year ago to 1.6% in October. Real lending rates are still high as inflation is destined to decline further. Besides, it is not clear that throwing more credit at the challenges facing SOEs and manufacturers would help. Their problems with excess capacity, inefficiency and the squeeze on profit margins, none of which can be resolved by an easy money policy or even a weaker currency. Only better productivity and less waste can do that.

Moreover, the reduction in the official deposit rate is somewhat misleading and might be viewed more appropriately in the context of the reform agenda. Deposit rates are no longer restricted to be equal the official rate, but rather can range up to a multiple of this benchmark. The maximum allowable deposit rate has been adjusted to 1.2 times the official rate from 1.1 times. Thus, the maximum deposit rate that can be offered after the "cut" is unchanged at 3.3%. Similarly, lending rates are unregulated, as of over a year ago, so banks are supposed to use the official rate as an indication. Additional operational adjustments and liquidity infusions are likely in the year ahead if inflation falls further.

A far more important issue on the agenda, however, is the PBOC's overriding ambition of establishing the renminbi as a reserve currency for international transactions. Indeed, this goal, with its attendant reforms, likely will take precedence over any other policy issues. In late 2015, the IMF will conduct its next review of the basket of currencies that its members can count toward their official reserves under the so-called Special Drawing Rights (SDR) system. Inclusion of the renminbi in the SDR basket has been a primary goal of the PBOC ever since it first applied for that status at the previous review in 2010. China will need to satisfy the IMF's criteria for reserve currency status and get the support of most of the other 187 member countries prior to that review.

To qualify, a currency must be deemed "freely-usable" in international transactions. To meet that standard, a currency must be "widely traded" and "widely used". The renminbi already qualifies as widely-traded. As of September, about 1.7% of international transactions were

settled in renminbi, making it the seventh most traded currency. Meanwhile, the PBOC has made a lot of progress in making the CNY more "widely used", which by necessity requires an opening of China's capital account to foreign inflows as well as domestic outflows. IMF measures of "widely used" include:
i) currency composition of official reserves held by CBs;
ii) currency denomination of international debt securities; and,
iii) share of world exports denominated in a currency.

At least 21 central banks now hold CNY-denominated assets in their reserves and 20% of China's exports are exchanged in CNY. The PBOC also has made enormous progress in making its clearing system one of the best in the world and now has currency swap agreements with almost as many central banks including the BOE and RBA.

So, that leaves the two thorniest challenges - firstly, offering CNY-denominated securities to foreign investors and, secondly, broadening and deepening the local debt markets, both for benchmark sovereign bonds and corporate bonds. On the first count, China clearly has made some progress. The Dim Sum market was the initial overture, but that market has remained small and illiquid. More promising have been the rollout of RQFII quotas for international bond funds and the Shanghai-Hong Kong stock link. Foreign access to the local debt seems to be the only stumbling block because it entails changes to China's capital account restrictions. The only issue is not whether China is headed in that direction but rather whether it can make more headway in the coming months to impress the IMF. The Chinese debt market already is one of the larger ones in the world and the country's sovereign creditworthiness (rated AA- by S&P) appears stronger going forward than that of either the US or Japan.

In my opinion, it is difficult to make a case against inclusion of the CNY as a reserve currency and it would be foolish of the US to exercise is veto vote against inclusion.

IMPLICATIONS

- The Fed has set its course to normalise rates. The word "patient" means it will begin within the next six months, (whereas "considerable time" meant anything longer than six months). Financial markets already reflect the first rate hike and probably even a second one in 2015. Few bonds with maturities less than three years have value. The exception is Chinese sovereign and quasi-sovereign debt, if it becomes available.
- Equities have rotated out of cash-rich oil plays and will shift to value and innovative technology.
- Most EM currencies are oversold in the rush to exit carry trades.
- China's quest for reserve currency status in 2015 will attract considerable attention. Both equities and the CNY will continue to benefit from lower oil prices. The notion that the PBOC might intervene to depreciate the currency to aid manufacturers makes

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no sense in the run-up to the IMF review of candidates for the SDR basket. The appeal of these underweighted assets is enhanced by their improving liquidity, whereas new securities regulations are squeezing liquidity from other securities.

- The least certain outcome centers on what the ECB can do with QE. European debt and the euro itself seem overly reliant and the group-think view that the Fed and ECB are headed on divergent paths for the indefinite future. The Fed should hold up its end of that bargain but the ECB may not.

Dr Robert Gay is managing partner of Fenwick Advisers, a financial consultancy serving global investment banks, hedge funds, and other fund managers and financial institutions including fixed income manager, Stratton Street Capital. Prior to forming Fenwick Advisers, Dr Gay served as international economist and global strategist Morgan Stanley, Bankers Trust and Commerzbank AG. He spent eight years as Senior Economist with the Board of Governors of the Federal Reserve System in Washington, DC, primarily during the chairmanship of Paul Volcker.

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