Time to think contrarian

Dr Robert Gay | Fenwick Advisers | 25 August 2015

The latest bout of selling in equities and emerging market (EM) currencies has the feel of capitulation. We should consider the likely probability that commodities, equities and credit spreads will rally over the next several weeks, prior to the FOMC meeting on 16-17 September. Yesterday's price action showed signs of a bottom in a wide range of commodities and the midday recovery in US equities was also a good sign that investors do not believe this correction portends the ultimate downturn in this investment cycle. Neither do I.

Cycles end when banks tighten credit standards - not when the Federal Reserve begins to raise rates - and US banks are still easing credit standards for households and their large corporate borrowers. Granted, I believe that banks are getting more concerned about their loans to shale oil and fracking operations and will begin to tighten up on new loans for some sectors. That would mark the beginning of a classic endgame in which banks try to entice households into greater leverage while cutting back on lending to the corporate sector.

That endgame, though, will take a few more years - so the recent widening of US corporate credit spreads seems premature, as does the correction in equities.

Here are some milestones to watch for if this view is correct:

- Expect commodity prices to stabilise within the next few weeks, especially oil and foodstuffs. Granted, there is still a glut of crude oil, but some slight adjustments to extraction plans can quickly end discounting and dumping.
- EM currencies should soon bottom out. By now, the popular trade of long Asian currencies/ short commodity currencies has been closed out. Indeed, here is where you get a sense of capitulation by those who were not quick to exit after China devalued. Even the news stories, including the one about China's agencies using an exchange of 7 RMB/USD for planning purposes, are what you often see at the end of a sell off, as desperate sellers plant dubious stories.
- Equities should stage a small rally, even in EM. European equities should fare better than US equities while developed market equities should still fare better than EM equities.

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- Many pundits will claim the rally is because the Fed will postpone its first rate hike, thereby providing 'liquidity' to global markets. The implication would be that a risk-on rally would be short-lived. That rationale might fit the stylised facts but, unfortunately, any delay in lifting rates off zero is a policy blunder. Current Fed policy has had nothing to do with the USD's rise and the Fed's normalisation of rates will not be the cause of further USD strength. Negative real interest rates at this point are simply encouraging more leverage in an increasingly diverse array of sketchy investment products. It is that re-leveraging that ultimately will spell doom for equity markets.
- China is faced with some very difficult choices. Party leaders have made the political choice to do whatever it takes to get the RMB into the SDR basket next year. That means the PBOC cannot backtrack on financial liberalisation. Hence, the PBOC must choose between currency stability and monetary control.
- You could see the PBOC is leaning toward easy money rather than currency instability. Both the policy rate and the deposit rate were dropped 25 bps and the PBOC injected funds into the banking system. If the PBOC becomes more desperate to inject funds, it will drop the reserve requirements on deposit reserves, of which it holds several trillion dollars.
- At the heart of China's predicament has been a sharp slowdown in the economy this year. I suspect real GDP growth has dropped to 3%. Consumption spending simply is not taking up the slack quickly enough to compensate for reduced investment. Capital flight probably reflects not only the corruption campaign but also the harsh reality that a lot of marginal manufacturers in industries with excess capacity are trying to cash out before it is too late.
- My advice to China would be to slow down financial liberalisation and plan for SDR status in 2020. A second best option would be a more aggressive monetary easing while cleaning up bad debts before it is too late. Currency devaluation is the least desirable because it would undermine the RMB's role as the anchor for Asian currencies and would be a step backwards in transforming China's unsustainable export-driven economic model. That advice may not meet with a warm reception in China, so the prospect for more volatility and more policy mistakes is ever present.

The bottom line is that we now have the world's three largest central banks all facing policy predicaments and all three seem destined to make the wrong choices in the months ahead. The ECB's QE plan is to big and too ineffectual. The Fed is in danger of following the timid advice of the doomsayers who seem to presume that one rate hike inevitably must lead to many more, which is not the most likely outcome. And now, the PBOC has no choice but to come to grips with the inherent tradeoffs in its evolving monetary framework.

Only steady progress on deleveraging will lengthen this investment cycle which, like its predecessor, has been fueled by debt and rising inequality. It will take a long time to unwind

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those forces and to release the global economy from secular stagnation. Financial markets cannot live off of central bank liquidity indefinitely because QE-style policies are not sustainable. This recent meltdown is a reminder that asset values need a better anchor. The patient is always better off, though, if they take their medicine when the illness is diagnosed rather than procrastinating until they get too sick.

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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