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Is the worst behind us?

Nick Bullman | CheckRisk| 26 January 2014

The current corrective phase appears to be the risk phase we have been warning of since early December 2013. It is in its early stages. This week's Global WRAP considers the current levels of overconfidence in major equity markets around the world and looks at whether logic supports the current level of optimism. In addition, we have an update on some interesting topics from Davos. The recent turbulence in emerging market (EM) currencies and markets is not a fresh source of instability or risk, it is entirely expected and explained by Breaking of Unconventional Monetary Policy (B.U.M.P.).

Many observers feel that the worst of the financial risk, emanating from the credit crisis, is now fully absorbed by markets. Tail risks have been reduced, the US and UK economies are recovering, inflation is picking up in Japan and Europe has held together. Some brokers are talking of a new secular bull market in the USA and why valuations are not expensive.

An alternative view might be that QE has distorted financial markets beyond recognition and is currently masking both systemic and network risks to the extent that any unmasking could lead to a serious correction. Our readership will know and understand that is why B.U.M.P. is such a critical factor in determining what happens next. B.U.M.P. is a catalyst to a whole host of risks because it is the antithesis of QE. Its withdrawal, even its gradual withdrawal, signals a change to the markets and implies a new phase where the market must stand alone and on its own two feet.

There has been an astounding level of overconfidence emanating from Davos this week. Risk has an uncanny knack of emerging at times just like this, so the unfolding of an emerging market currency crisis has served to inject some reality into the proceedings.

B.U.M.P. is not an asymmetric outcome – it is more like 50 shades of grey, whips included. Government and central bankers are well aware of how to play the game and will turn the liquidity tap on and off as they deem appropriate. The market has, so far, accorded these central powers with the right to control markets but trying to manoeuvre the economy is a much more complex endeavour than the provision of liquidity. It is more akin to turning a super tanker that has lost its rudder. Every push from a tug has the ability to be too little, too much or just right; the weather can change, or the tide and light conditions. Central bankers are like tugs, they do not know the full impact of their actions until much later and they must anticipate and hope. The point is that B.U.M.P. is going to be a very difficult set of manoeuvres that will have multiple effects. For investors, this means a buy and hold strategy is unlikely to work out. A more deliberate focus on asset allocation is required.

For example, with interest rates at current levels in the USA, UK, and Europe at current levels,

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it is fair to say that the next major move in bond prices will be sideways or down. Volatility in bonds is likely to rise and the worst hit duration will be between three and ten years; precisely where most investors are invested. This may well all happen at a time when broker inventories are at record lows and thus the lack of liquidity will exacerbate the bond price movements.

In contrast, as the supply of excess liquidity diminishes, it is inevitable, as we explained last week, that investors will notice that the velocity of money is increasing. This will lead to consideration of the impact of inflation. Inflation-protected assets are trading off multi year lows and are therefore, on a risk-adjusted basis very cheap and likely to rise in value. There may well be another deflationary round yet to come but that appears discounted in the price already.

Equity markets, by the same token, look expensive as a whole. The S&P is trading off high cyclically adjusted P/E ratios and the outlook for corporate earnings is deteriorating for the moment. The US economy is below escape velocity and we do not believe will achieve in excess of 3.5% growth rate this year it is much more likely to be at 2.5% which remains anaemic.

Last week we wrote "the short term outlook is one of high risk; however, any correction should be modest unless caused by a shock." By modest, CheckRisk means a 5% to 10% correction and we understand that a correction of that nature may or may not be considered modest by investors. The slump is being caused directly by B.U.M.P. and its effect on emerging market currencies. There is a chance that this correction deepens into something more meaningful. A deeper correction depends on the development of the crisis in EM's which we will now examine. And now is not the time to be brave.

Readers will remember that the fourth node in our B.U.M.P. diagram represents currency wars (Figure 1). These are generally considered to be competitive devaluations of a currency in order to gain an advantage while exporting goods. The effects of currency wars and manipulation are broader though and include currency volatility, exchange controls, devaluations and debt defaults.

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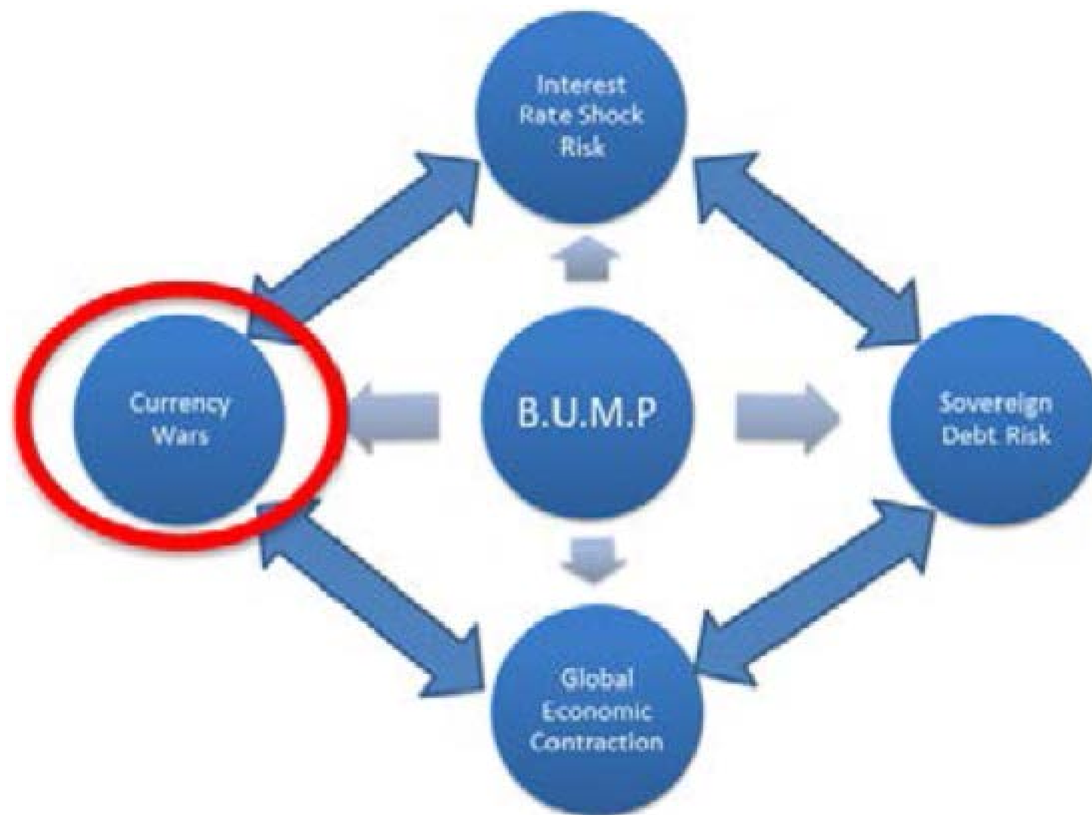
Figure 1: B.U.M.P and currency wars



Source: CheckRisk LLP.

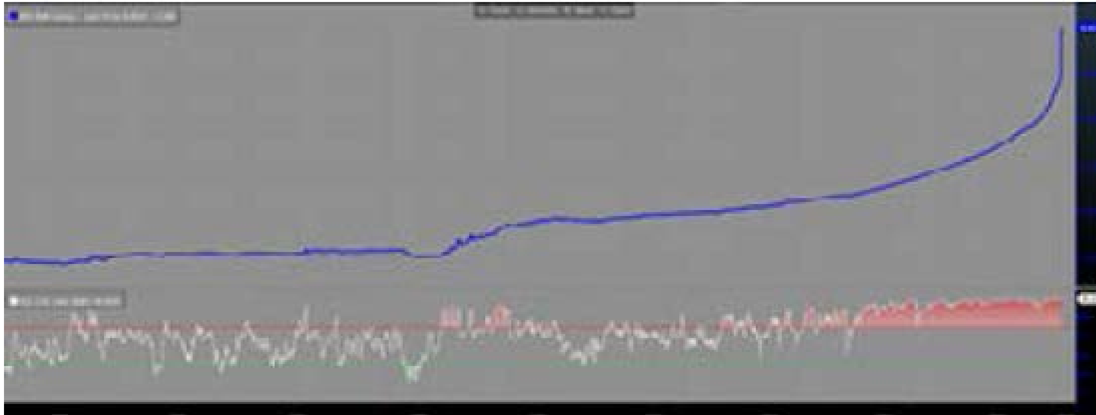
EMERGING MARKET ANGST

Emerging market currencies are having a turbulent time with some having the worst sell-off in five years against the USD. Both the Argentine peso and the Turkish lira hit all-time lows as indicated in Figures 2 and 3 below. Contagion risk between EMs has increased significantly as investors are seeking safety in the USD.

Argentina devalued the peso after the Central Bank stood back from currency interventions in order to try and protect international currency reserves that have fallen to seven year lows – a 31% decline in net reserves to $29.4bn. The peso has collapsed over the past two days falling some 13% with inflation running at a current annualised rate of 28%. The currency has fallen 25% since November.

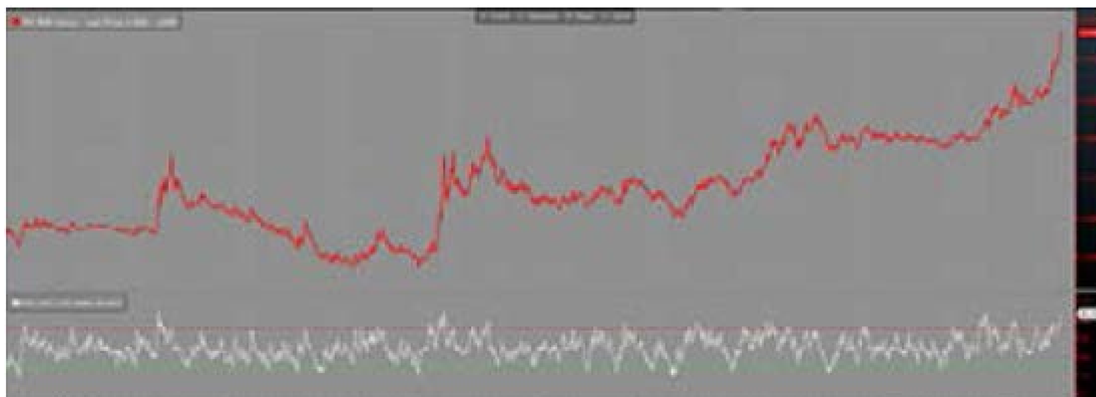
That large developed economies believe that they are immune from a similar crisis is a laughable notion but goes a long way to explain the level of high handed confidence that exists in the Swiss mountain town of Davos, a gloss of overconfidence that may be about to be tested.

Figure 2: Argentine peso vs USD 2005 to YTD 2014



Sources: Bloomberg LLP, CheckRisk LLP

Figure 3: Turkish lira vs USD 2005 to YTS 201



Sources: Bloomberg LLP, CheckRisk LLP

A combination of effects is causing concern for emerging markets. The first is the Fed's clear intent to reduce QE. This has the impact of making the USD more attractive to investors and because the USD currency is so much larger that its counterparts any flow to the USD has a disproportionate effect on EM currencies. The second uncertainty is the slowing growth rates in China, but also India and Russia.

The severity of the corrections so far are highly indicative of a continuance into next week and thus we believe that risk remains elevated in global bond and equity markets. We cover the impact on volatility and investor sentiment in the main body of this report.

The risk of a domino effect amongst EM's is increasing with the South African rand already weakening and a risk that the Brazilian real will follow the Argentine peso. The impact is very similar to that seen when Bernanke first announced the Fed's intention to scale back its monthly QE program. The way that slide was corrected was a U-turn statement of the, "we

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didn't really mean it" variety. That option is no longer available to the Fed as they have already commenced tapering.

What is being exposed is the world's financial dependence on the USD. In an ironic twist of fate the credit crisis in 2008 has reinforced the USD as the world's reserve currency. The Fed acted swiftly to inject trillions of USD into the US economy. As a result, the EM's and other more developed economies like the UK and Europe have become highly dependent on the monetary policies of the US. One of the predictable outcomes is that a blame game will shortly commence. This leads us back to B.U.M.P and currency wars. The EM's and others will blame the US for creating currency instability and impacting their markets. The US will urge EM's to introduce more robust economic policies and central bank actions. In their own way, both sides will be correct. The end result is unlikely to be pretty. It is too early to be increasing exposure to the EM's but on a long term basis there are going to be some good opportunities presented by weak EM prices and cheap stock and bond markets when the dust has settled.

The point is that B.U.M.P. is going to be a very difficult set of manoeuvres that will have multiple effects.

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