Damn the Torpedoes - Jay Powell, May 8th 2018
(11/05/18)

Based upon e-mails to your analyst's inbox there is a sudden shift of focus in financial markets. From "Just how synchronised is global growth?", the question now posed is: "Just how unsynchronised is global growth?" In particular can the travails of specific emerging markets become important enough to impact other emerging markets and even global economic growth?

Subscribers seeking answers to these questions can turn to The Solid Ground Report, 4Q 2017 - The New Debt Crisis and What It Means and for those now focused on the impact of a rising USD there is 1Q 2017 - Asset Allocation in a USD Bull Market. For those looking further to the future and the political remedy to a growth scare, or even the recession that must come one day, there is 3Q 2016 - Capital Management in an Age of Repression. For those sceptical that resorting to such works of reference are necessary, it’s time to monitor some very worrying credit metrics and also listen to Jay Powell’s speech in Zurich on May 8th. He thinks that the announced US$380bn shrinkage in the Fed’s balance sheet in the current calendar year and the announced US$600bn for next year will prove ‘manageable’ for emerging markets! He really does.

While the Fortnightly has alerted investors’ attention to many metrics that monitor the slowing of growth in world money supply and the continued slow, but then quick, bankruptcy of Turkey, there are new dynamics at play due to the strength of the USD. Forecasting exchange rates is usually a mug’s game. This is just too big a market with too many players to allow for much accuracy in forecasting. In particular, forecasting is complicated by the fact that an exchange rate has to do just too many things.

While economists may focus on forecasting a purchasing-power parity level for any exchange rate, this ignores the crucial role that capital flows play in determining exchange rates. So if it is so difficult to forecast exchange rates in general, why is your analyst prepared to forecast that the recent rise in the USD is likely to continue? It is because, very occasionally, the chances of forecasting the direction of the USD exchange rate becomes much easier. Those rare occasions are when there is a material credit event somewhere in the world that causes a move to de-gearing and, associated with this, a capital flow away from more risky assets. If the world sought to de-gear tomorrow morning, we would see net buying of USD as it is borrowed in size by debtors without USD cash flows. This scramble to buy USD can be particularly exacerbated if the credit quality issue coincides with a tightening of USD monetary conditions themselves/- as they do today.

In recent months The Solid Ground has focused on the indications that just such a tightening in the USD offshore credit market is underway and credit quality deteriorating. Interestingly, the credit quality deterioration and tightening of the USD offshore credit market preceded the rise of the USD exchange rate. The global debt-to-GDP level is so high that they happened even as the USD declined. Indeed, these credit quality factors may, at the margin, have caused the USD to begin its rise. Now we are in a situation where the rise of the USD causes the greater tightening of liquidity, in USD credit markets but also in local currency credit markets for those who manage their exchange rates relative to the USD. That tightening exacerbates credit quality issues that tend to push the
deleveraging and movement away from riskier credit, which in turn tends to push the USD higher.

That is sometimes called a vicious circle. It is not that vicious, of course, if the US central banker is prepared to do something about it. The Fed blinked when faced with the so-called ‘ taper tantrum’ and, according to some, entered into the so-called ‘Shanghai Accord’ in early 2016 to alleviate credit quality issues for commodity producers and China. Twice then, in recent years, the Fed has pulled back from its indicated monetary policy to alleviate credit deteriorations in emerging markets.

However, in June 2017 the Fed published its addendum to the Policy Normalization Principles and Plans that will see it liquidate US$228bn of Treasury securities and US$152bn of other securities in this calendar year. While investors speculate on an interest rate increase, they choose to ignore a very clear and definite plan for a massive tightening in global liquidity. On May 8th the Fed Chairman told us that this planned liquidation will proceed as its continuation will have only limited impacts upon emerging market economies. The new Fed Chairman, fully cognisant of the solvency issues in Turkey and growing emerging market credit problems elsewhere, has just told us that he will not be blinking:

‘To preview my conclusions, I will argue that, while global factors play an important role in influencing domestic financial conditions, the role of U.S. monetary policy is often exaggerated....

Monetary stimulus by the Fed and other advanced-economy central banks played a relatively limited role in the surge of capital flows to EMEs in recent years. There is good reason to think that the normalization of monetary policies in advanced economies should continue to prove manageable for EMEs....

Moreover, the linkages among monetary policy, asset prices, and the mood of global financial markets are not fully understood. Some observers have argued that U.S. monetary policy also influences capital flows through its effects on global risk sentiment, with looser policy leading to more positive sentiment in markets and tighter policy depressing sentiment. While those channels may well operate, research at both the Fed and the IMF suggests that actions by major central banks account for only a relatively small fraction of global financial volatility and capital flow movements.'

I do not know whether researchers at the Fed speak to people in financial markets but few, if any, would find themselves agreeing that record low US interest rates have played such a limited role in sending capital pouring into emerging markets; it’s a movement so well known it has its own name - the ‘reach for yield’. Perhaps such research might show that aggregate capital inflows have not been driven by record low USD interest rates, but the composition of inflows in recent years, focused on debt and debt instruments, rather than listed equity or foreign direct investment, surely has. The greatest debt boom in emerging market history is directly related to the interest rate policy of the Federal Reserve, the ECB and the BOJ. It is intellectual sophistry of a sort we are used to in research by academic economists to suggest otherwise.

This analyst doubts very much whether the researchers at the BIS, more steeped in the operation of financial systems than numerical tests to ‘prove’ cause and effect, could come close to agreeing with these conclusions from the Fed and the IMF. The Fed will allow US$380bn of securities to run off its balance sheet this calendar year, forcing savers to take that supply, and the expected near US$900bn in Treasury issuance forecast by the CBO to finance the fiscal deficit. It seems Fed research indicates that the US$1,280bn re-allocation of savings

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1 Jerome H. Powell, Monetary Policy Influences on Global Financial Conditions and International Capital Flows (May 8th 2018)
necessary to mop up these securities will happen somewhere, venue undetermined, other than in emerging market debt! Investors should be rushing to take the other side of that bet with the academics who have placed it.

Anyway, the point is that the man who pulls the trigger is currently taking his advice from the academic economists who believe that Fed monetary policy did not produce:

- the 'reach for yield'
- flows of capital into local currency EM debt markets for the first time in history
- a growth in debt-to-GDP ratios for 10 EM countries that the BIS state is likely to cause a systemic banking crisis, and
- ultimately, the biggest EM debt boom in history.

Believing that none of these was a result of Fed policy means that the Fed Chairman’s speech is the equivalent of the famous pronouncement of David Farragut at The Battle of Mobile Bay: - ‘damn the torpedoes and full steam ahead’.

The evidence that little damage has been inflicted so far seems poor reason to argue that such activities are safe. Jay Powell has sent a very clear message to the markets and there is thus very good reason why the USD is spiking higher and the price of emerging market debt breaking down. The intellectual case has been made as to why the Fed can stop blinking. Only extreme evidence to the contrary is likely to keep the US$380bn monetary torpedo in its tube.

So in monitoring the Fed’s willingness to stay the course, regardless of the collateral damage in emerging markets, what should investors monitor? Most will assume that words are just words and it will not be long before the Powell put is on the shelf for all to see and profit from, as were the Greenspan, Bernanke and Yellen puts. Of course, despite Powell’s speech it can happen but when and how will we know it is coming? Your analyst suggests that currently the best indicator as to whether the Fed will be forced to relinquish the view of ‘research at both the Fed and the IMF’ will be the performance of USD high-yield credit relative to the performance of EM credit. The fact that EM credit is deteriorating more quickly than US high-yield credit indicates that the Fed will maintain a steady course.

The Solid Ground has drawn attention to the apparent lack of exposure of US commercial banks to EM credit risk and the contrast with the large exposure run by European banks. Historically, whether in 1982 or 1998, it has been the exposure of the US commercial banking system to EM debt defaults, either directly or indirectly, that has caused the Fed to ease monetary conditions. The evidence from the BIS data is that no such action will be necessary today given the limited exposure, but also the much higher levels of capital now held by US banks. This alone suggests that the Fed’s ability to stay the tightening course is stronger than it has been heretofore in the face of EM credit problems.

Thus, to assess the Fed’s willingness to back down from its pre-determined course of balance sheet reduction, we must first assess to what extent its actions are producing credit distress in the US itself. Of course, these credit markets should be better placed to take their lumps than the naturally highly-gearred banking system. By pushing credit off the banks’ balance sheets and on to the balance sheets of savings institutions and vehicles, the pain of even domestic credit defaults should have less likelihood of undermining bank stability. But still any central banker would at least look to the performance of credit market debt to gauge the impact of their monetary policy on credit availability and ultimately economic growth. If yields from US high-yield debt remain reasonable, there is a greater chance that the Fed will continue to ignore credit pain falling outside the US.

As proxies for the performance of these two key measures of credit, investors need look no further than HYG and EMB, both US-listed ETFs. HYG is the iShares iBoxx $ High Yield Corporate Bond ETF - a vehicle for USD15.3bn of
savings comprised of 1003 bond holdings of almost exclusively US issuers. EMB is the iShares JP Morgan USD Emerging Markets Bond ETF - a vehicle for USD11.2bn comprised of 412 USD denominated bonds issued by EM governments. The price of EMB has fallen 7.4% year to date while HYG has declined just 2.2% over the same period.

We cannot know from day to day whether the relative resilience of US high-yield corporate credit relative to emerging market USD debt issues will continue. However, we can continue to watch it. If the price of EM USD denominated government debt is breaking down this quickly, the decline in EM corporate debt is unlikely to be far behind. Jay Powell’s speech in Zurich on May 8th indicates that he believes the decline in EMB is unrelated to Fed policy and any decline in HYG, that might force him to react due to an over-tightening of US credit conditions, is not yet occurring. The longer this divergence of performance continues, the greater the likelihood that the USD will continue to rise as credit issues force some covering by debtors, while the Fed remains on course with its balance sheet contraction.

It is not the job of The Solid Ground to pass opinion on the desire of the Fed to shrink its balance sheet and to begin the deflation of perhaps the largest credit bubble in history. It is the job of this analyst to point to the investment consequences of such action. The speech by Jay Powell in Zurich and the divergence between US and EM credit suggests that the key consequences are more pain for EMs and an even stronger USD. That is a not so polite way of saying that the researchers at the Fed and the IMF are wrong. Any independent financial advisor could tell them how they have used EM debt instruments to juice up their clients’ portfolio income and that they have been driven to such risk-taking by the low level of US, Eurozone and Japanese interest rates. Indeed they would receive similar evidence from the managers of pension funds and life insurance funds should they care to ask them.

No matter what investors know about the link between low interest rates and capital flows to emerging markets, the academics have convinced themselves that there are none. So once again we are staking the future stability of the global financial system, not on easily measurable real decisions by real people in the real world, but on the assumed causes of financial flows in academics’ economic models.

You should bet against the academic economists and avoid investments in emerging markets and stay long the USD. Jerome Powell will also come to question the validity of research so devoid of real-world mechanisms.

How much damage will have been caused to emerging market credit, exchange rates and growth before this realisation occurs, none of us can know. Your analyst, however, suspects that it will take much longer than investors expect and the Powell put will not be placed up on the shelf until some investors have lost an awful lot of money. In April the markets saw a monetary torpedo of US$20bn, in the form of a Fed balance sheet shrinkage, pass through the emerging market fleet causing just limited damage. In May it will be US$30bn and by August US$40bn and the firing continues with currently no stated limit to the wind down of the Fed’s US$4,325bn securities portfolio. This is a dangerous convoy to sail with.
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