Stress is Growing in EM

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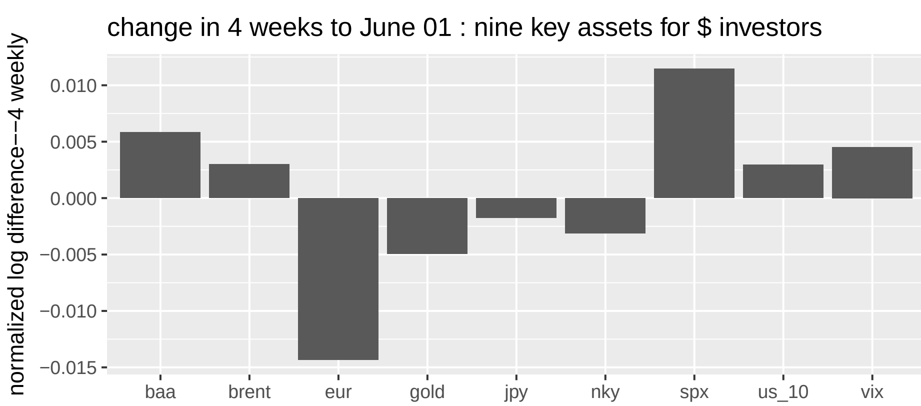
US equities kept moving up as bond yields fell sharply at the end of the month, limiting what had been a big rise. Lower bond yields may have relieved some of the pressure on equity valuations.

The euro fell and Italian bond yields rose, partly because of a populist government in Italy that may not be able to remain in Europe. Partly, too, the risk of tariff damage to exports to the US of the big German car industry is weighing on European sentiment.

Oil prices kept edging up from already high levels, keeping upward pressure on inflation and eroding real incomes in importing countries.



In Europe, sudden illiquidity led to enormous losses on Italian government bonds, which could be at risk if they cannot be rolled over within the monetary union.

In my view, investors saw enough disruption in Italy, and in global trade, to pitch their large, established, and well justified positions short US government bonds. So US government and high grade corporate prices rose and yields fell more sharply than justified by the stronger US business news.

Amid these shifting stresses, EM difficulties roll on. The dollar rose sharply for residents in Turkey, Mexico, and now Brazil.

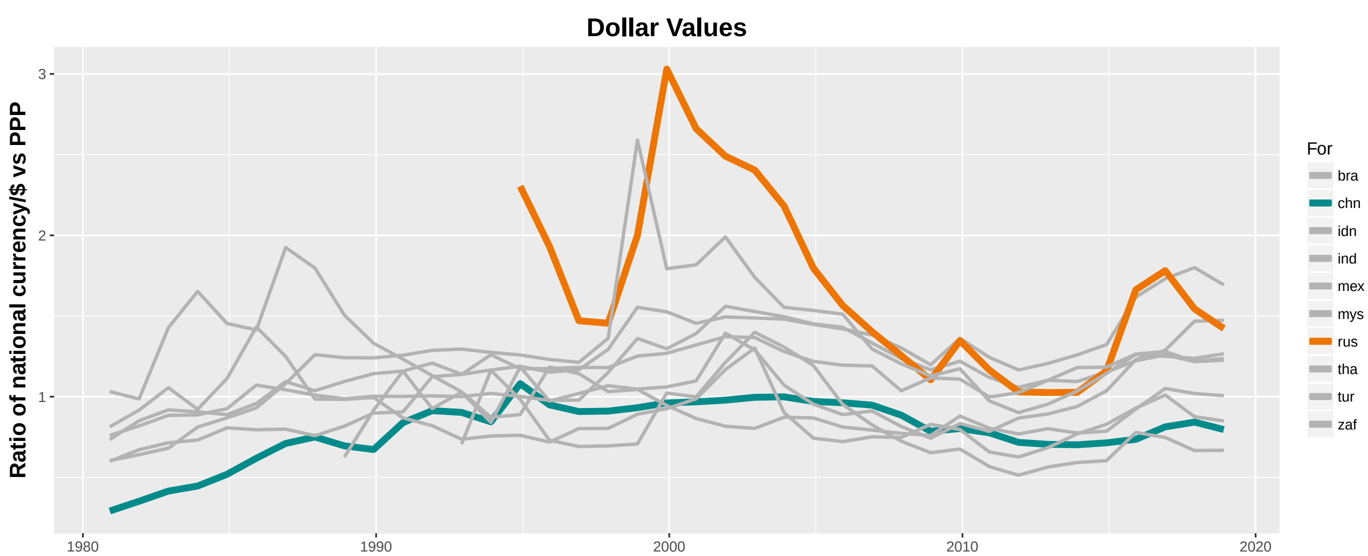
Currency Cycles in EM Emerging markets have been blowing up. Why now? Under the pressure of rising US rates and a probable end to super-easy global conditions, credit for them is tightening. When it does, the local price of dollars goes up. Turkey, Argentina, and Venezuela have just seen massive hikes in the cost of the dollar. Toward month-end Brazil began to look ungovernable as truckers struck to demand a military take over, and the dollar rose suddenly.

All these events are linked, for me, by the pressure of tighter dollar funding after a period of ease and high borrowing. In the past, tighter funding was felt in reserve losses for fixed exchange rate systems, like Mexico and South Africa in the 1980's, Russia in the 1990's, and Indonesia, among others, in 1997. In each case the cost of the dollar finally rose, as measured in terms of the IMF's purchasing power measures, adjusted for each country's per capita income.[1]. Today, these countries all float their currencies, but a more controlled decline of roughly comparable scale seems to emerge periodically all the same.

Russia and China (shown in orange and green) illustrate two extremes of the process. The Chinese never had a collapse of their system, and could hold the value of the dollar in a narrow range. The Russians, during a profound social, political, and economic break-down briefly had a complete currency collapse to valuations completely off this chart, at 10 times or more above normal (not shown) and the ruble has remained extremely volatile ever since.

Looking ahead, not every period of credit tightening in the industrial countries is felt equally across emerging markets. In fact, the big crunches of 1980-82, and then 1998-2000 for emerging markets came during every **other** rate tightening in the core. Recently, the rate squeeze of 2007 and following Great Recession led to only a brief decline in emerging market currencies seen on this long view. But the tightening we are embarked on now has been widely felt on floating currencies since 2015, and continues.

All this finds us today in a position where the values of emerging market currencies are unusually dispersed, with a reasonable probability of some more big declines. Malaysia, Turkey, and Russia already face strikingly high dollar costs. Meanwhile, South Africa, China, and Brazil still face low values for the dollar. Design your own trade to capture the probabilities.



[1] Balassa, B. (1964) The Purchasing-Power Parity Doctrine: A Reappraisal. *Journal of Political Economy, 72(6), 584-596*

A Delayed US Pop. All evidence points to a surge in GDP in 2Q, as inventories pick up and exports improved, pushing up output for the moment. Employment gains have been particularly solid, confirming this picture. But, as we settle down from a series of recent shocks, underlying consumption still looks a little strained in terms of rising credit card defaults and car sales that only stay up on lower quality and longer-term loans. Meanwhile higher prices for oil will sap incomes outside of the oil belt. Consumption growth is at best moderate despite the job gains, illustrating the principle that tax cuts for the rich go mostly to savings not consumption.

The supposed upswing in investment spending following the tax give-away seems to be have lost steam, possibly because the global trading situation grows unstable. With a multitude of possible US trade sanctions pending, companies with a global view may reasonably seek some clarity about the future before committing funds. Less affected by sanctions, the ongoing recovery in new home construction may also be set back if higher mortgage rates stick, increasing the monthly carry on homes by 10%-20%.

Meanwhile, prices keep rising. A slow, low-investment expansion has gradually pulled in workers until competition for labor has finally developed. Selected service prices, including for hotel rooms and for restaurant meals have taken on a more solid feel as as labor costs rise. And, of course, gasoline prices are up substantially. Lastly, important bottleneck pricing is showing up in manufacturer's surveys, particularly in the trucking business.

In its second year, the Trump administration has quickened the pace of its extreme initiatives. I put this down to a growing fear of the pending investigations that lead to Trump's pre-election financial dealings which likely include substantial money-laundering. Trump's favored measures of distraction include a variety of trade and other sanctions, invoked to show headline-grabbing disapproval and hostility. Many may assume that these measures will be soon reversed and their effects ephemeral. But we cannot know that yet.

European Fears. European business expectations remain weak. A recent Gfk survey of consumer sentiment in Germany revealingly pinpointed concerns over the US unilateral termination of its Iran treaty, the possibility of sanctions on German companies that do not cooperate with the US, sanctions that could threaten the structure of Germany's export-based car industry, and rising levels of violence among foreign forces deployed in Syria. The ECB, meanwhile, tied slowing activity to business concerns over protectionism that can impede investment spending, bad weather, and a particularly disruptive strain of influenza. As well, Europe's export dependent economy was hard hit by a hiccup in the global trade and inventory cycle. Any way you look at it growth in Europe is slowing.

Things will get worse before they get better because the business surveys do not yet reflect the disruptive new Italian populist government. Committed to a program that uses national fiscal policy to deliver goodies to reward national voters, Italy's populist coalition is now bound to policies that largely ignore debt, deficit levels, and European rules. Eager for power, these immature populists may not fully realize the consequences for Italy, and indeed for Europe of following policies that must force Italy out of the monetary union. Or they may cynically expect to deal with Europe only after they get into office. What is certain is that declaring a higher income by legal fiat is always risky, and will always backfire in the end. Here, a collapse in confidence in Italy's banks and government debt is where the backfire will take place, almost instantly, anytime a departure from the euro looks like the end-game.

While all these risks play out, further steps toward a more cohesive Europe seem urgent but unlikely. French incremental plans for a joint bank deposit guarantee fund ahead of full clean up of national bad loans, and a plan to support public spending in nations hit by asymmetrical shocks seem unlikely to go forward. The reason is that Italian populists just illustrated exactly how a national government can abuse its implied European credit to buy local votes. How can any progress be made until a much more basic limit on national fiscal policy is achieved?

China Negotiates with Trump. All the visible indicators of electricity, freight and value added point to a sustained expansion in China. In fact, steel production hit an all time record in April, probably on a pick-up in spending on rail and apartment buildings. Car sales have held up, and imports may be boosted by the reduction in import taxes just announced. Broad consumer taxes were cut as well in a bid to accomodate US trade demands, which should help imports but not local production. Still, business profits and government tax revenue are both solid, suggesting a sustainable recovery is underway.

Deleveraging remains a priority of policy that poses risks to growth. Entrusted credit is falling rapidly as new rules are put in place that limit the way banks comingle high-yield corporate borrowings into investment instruments, bailing out with their own loans any borrowers in trouble. Without that back-up, creditors can become leery and companies that had recourse to these loans can be caught short. As the IMF points out in a recent mission report, defaults are rising, although still in a controlled fashion, and we assume the authorities will be watchful to stop any signs of a credit panic. Meanwhile, we know that M2 growth has slowed sharply even if credit growth is holding up.

President Xi continues to negotiate with Trump. They negotiate both about retaining pressure on North Korea and on the future of Chinese exports to America. US objectives seem dangerously confused to me, since a full description of how North Korea is to proceed without nuclear weapons or missiles but still retaining a savage totalitarian system and co-existing with a democratic South Korea is unclear. Furthermore, US demands to erase all North Koran technical information about bombs and missiles seems infeasible. Similarly, the objective of stopping Chinese technical progress seems equally hopeless. How can either kind of information blockade long succeed in the age of the internet?

Trump's frenzy of diversionary actions has ended up in a spiraling list of tariffs and sanctions that add up to a major, unilateral, and potentially dangerous threat to the global trading system. For the quarter, the US economy seems to be holding up, potentially reinforcing the impression that it is OK for Trump to follow his disruptive instincts.

Any real retreat into defensive, isolated, trading blocks will disrupt existing capital stocks and raise prices. European, Japanese, and Mexican car assembly plants will close and US ones will eventually open up at higher cost. Any exit by Italy from Europe will lead to a sharply lower currency and sudden inflation. Sanctions on Iran and possibly Venezuela can raise world oil prices. With inflation, central bank rate normalization of interest rates is, if anything, more important now than before.

So we have a more complicated picture than last month, but one in which I think the central banks must continue to take steps toward normalization and higher rates. That normalization process, as we mentioned last month and illustrated a little more fully above, adds to the heightened risks for emerging markets, where the signs of stress are erupting every other day.