

# Another Rout?

Global equities might have hit another “rough patch,” and the culprit appears to be the same as the previous shakeouts in share prices: increasing investor trepidation over possible Federal Reserve (Fed) rate hikes. Ever since 2013, jitters over tighter Fed policy have been a reoccurring irritant for the marketplace. The question *du jour* is, will the recent bout of price volatility degenerate into another market spasm similar to what happened earlier this year?

## Shakeouts in Perspective

Each shakeout in global risk assets since 2013 has been caused by a unique set of economic and financial circumstances. For instance, the taper tantrum inflicted substantial damage on those emerging markets that had large current-account deficits; while its negative impact on other nations and markets was rather limited.

In hindsight, the taper tantrum provoked fears that—with the Fed tapering its asset purchases—the borrowing costs in global markets would inevitably rise, making it more expensive for net debtors to borrow in the global marketplace. As a result, the currency markets of the so-called “Fragile Five”—India, Indonesia, Brazil, Turkey, and South Africa—collapsed.

With the U.S. economy continuing to show stability into 2015, the Fed intensified its preparation for rate hikes. This period coincided with two significant shakeouts in the S&P 500 of well over 12%. The first shakeout occurred in the summer of 2015 when the Fed warned financial markets that it was ready to raise rates.

However, the combination of a sharp slowdown in the rest of the world economy, collapsing commodity prices, and a meltdown in Chinese stocks culminated into a global financial contagion, threatening global economic growth. The Fed blinked in the summer of 2015 and backed away from a planned rate hike.

The second financial spasm occurred in December of 2015 when the Fed again felt ready to make a move. This time around, the central bank made a move by bumping up rates by 25 basis points but in hindsight, the rate hike was badly timed. It was delivered at a time when the U.S. economy was hitting a soft patch where corporate profits fell, private credit spreads blew out and the rest of the world economy was in a deepening slump. Commodity-producing countries were in recession, China’s nominal growth plunged to 5.6%, and inflation expectations melted. Economic pessimism was running amok.

It is not an exaggeration to say that the Fed rate hike—together with international economic weakness—created a perfect storm towards the end of 2015, causing the S&P 500 to drop over 13% but sending the dollar to new highs.

## Today’s Conditions

Global stocks, commodity prices, and emerging market assets have made substantial advances from their February lows. In hindsight, two key policy developments have brought back the so-called “reflation trade.” The first is the dovish turn by the Fed. The second is China’s aggressive policy shift towards fiscal activism.

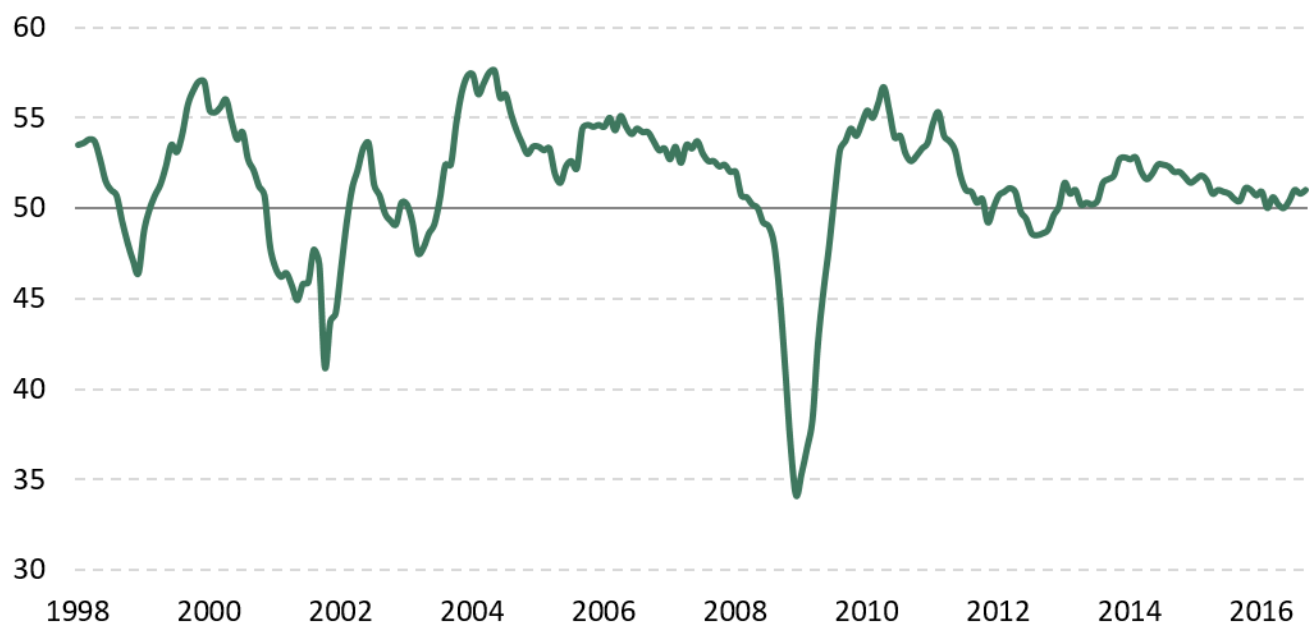
The steep shakeout in U.S. stock prices, collapsing commodities, a soaring dollar and increasing uncertainty over

Brexit earlier this year forced Fed Chair Yellen to come out and reassure the world that the projected path of the fed funds rate would be very flat, essentially telling the world that it would be “one and done” from the Fed. This has put a stop on the dollar’s ascension, leading to a return of reflation trade.

Throughout 2015, Chinese President Xi Jinping steadfastly refused to use fiscal policy to support the Chinese economy. Nevertheless, the steep downturn in both nominal and real growth has forced the Chinese government to abandon its supply-side reform. Beijing has instead sought aggressive demand-side stimulation. China’s budget deficit has surged since the second quarter as public sector spending has ramped up.

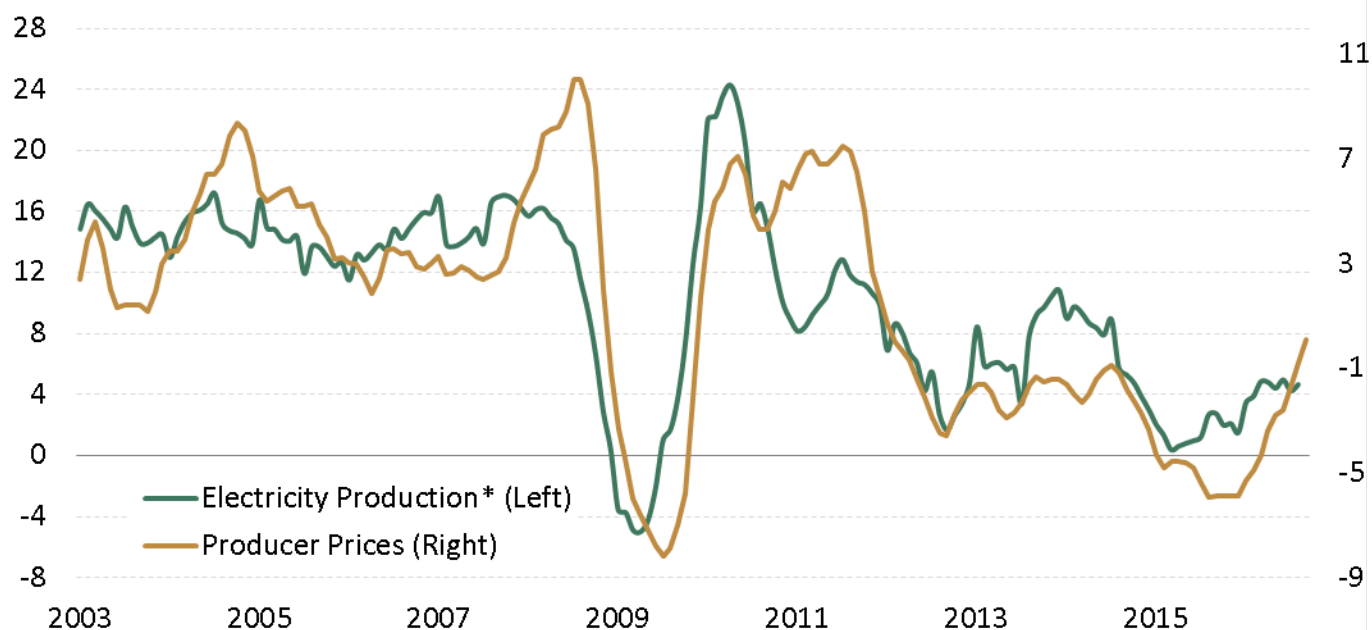
These policy changes have made a difference in the world economy. The decline in the global manufacturing Purchasing Managers Index (PMI) has halted (see [Chart 1](#)) and the Organization for Economic Cooperation and Development (OECD) Leading Economic Indicator has also shown signs of stabilization. China’s Producer Price Index (PPI) deflation has ended and electricity consumption is rebounding (see [Chart 2](#)). In the meantime, the EM Currency Index has rallied by 10% from February lows, while oil has climbed back to \$50/barrel.

**Chart 1: Global Manufacturing PMI** *As of 9/30/2016*



*Source: Thomson Datastream*

**Chart 2: China's Electricity Production & Producer Prices** *Annual % Change, As of 9/30/2016*



*\*Shown as a 6-month moving average.  
Source: Thomson Datastream*

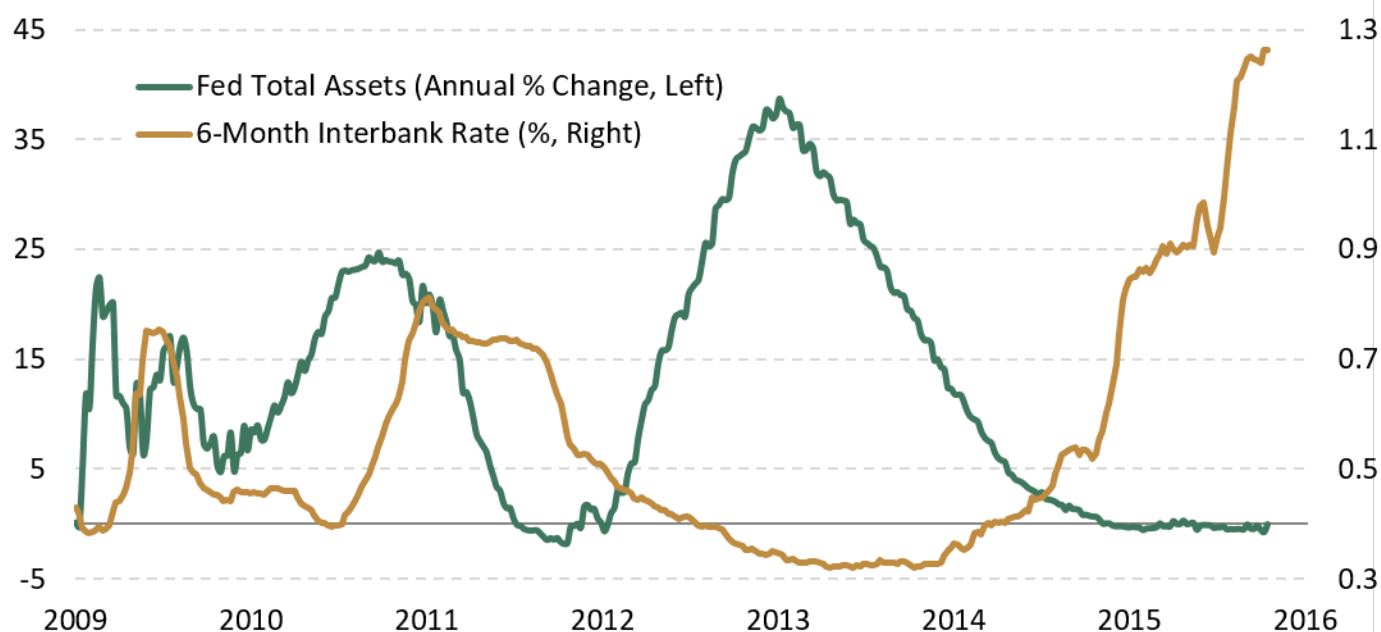
With financial stability seemingly returned, the hawks at the Fed have begun to warn of rate hikes again. Currently, the marketplace assigns a 70% probability that the Fed could lift rates again as early as December. Naturally, this hawkish turn has unnerved the global financial markets, with the S&P 500 having become wobbly again. The dollar also shows some unwanted strength. Are we heading for another turbulent time? A few observations are in order:

First of all, the policy environment seems to be reversing: a hawkish Fed together with a Chinese government showing renewed signs of reluctance to stimulate. Although the world economy is marginally stronger than 2015, the foundation of the growth rebound remains fragile. The sharp contraction in Chinese exports last month is an acute reminder that the world economy is still gliding on a low altitude path. It does not take much to push the system into another growth slump or even contraction.

Second, in all fairness, the U.S. economy is steady, but growth is highly uneven. There are probably as many weak spots as strong ones, but the equilibrium interest rate is likely still around zero. Corporate capital investment is frustratingly weak and economic activity, such as private consumption and business investment growth, remains way below the expansion rates during the pre-crisis years.

Importantly, inadvertent monetary tightening might have already happened. The Fed has tapered its asset purchases, leading to shrinking excess reserves in the banking system. In the meantime, interbank borrowing rates have spiked sharply (see [Chart 3](#)). All of these conditions conjure up the image of a developing scarcity in banking sector liquidity. Could this lead to weakening credit and money growth? Only time will tell.

**Chart 3: Interbank Borrowing Rates Have Spiked Sharply** *As of 10/9/2016*



*Source: Thomson Datastream*

Third, although the Chinese government has been able to stabilize growth via public sector spending, soaring real estate prices have posed some acute and pressing policy dilemmas. Slumping private sector investment and weak manufacturing activity call for more cuts in interest rates and easier credit conditions, but lower rates could further fan the speculative flames in the real estate market, encourage more debt creation, and put downward pressure on the local currency. The government is boxed in. Worse still, Beijing does not seem to have a clear idea how to break the policy logjam.

All of these factors mean the global policy environment remains uncertain and the risk to the world economy is still tilting towards the downside. With the hands of the Chinese government being tied by the impossible trinity dilemma and runaway property price inflation, the Fed must take the leadership role in safeguarding global growth. Fed policy still dictates global monetary conditions—rising rate expectations could unduly curtail the U.S. economic expansion, drive up the dollar, and cause a disruptive fall in asset values.

## So What?

Global stocks, commodities, credit, and emerging markets may come under pressure as long as the Fed hawks are preparing for rate hikes. However, past experience is that the majority of Fed policymakers are not dogmatic, meaning, they always blink when facing a sharp fall in the stock market and/or spreading turmoil in global financial markets. This behavior may not change any time soon, suggesting that risk assets may face short-term pain until the Fed backs away from its hawkish leaning.

The recent steepening of the Treasury yield curve has raised hopes that the world economy is gaining some traction. Nevertheless, any policy mistake by premature tightening could flatten the curve by depressing the long end. In the recent past, a hawkish Fed often—though not always—led to a curve flattening, while a dovish Fed tended to be associated with steepening. Therefore, the behavior of the yield curve will provide us with much insight on whether the U.S. economy can afford higher rates.

Global central bankers continue to face an acute dichotomy between a steady U.S. economy and subpar growth in the rest of the world. This dichotomy means that no central bank in the world could unilaterally raise interest rates without causing disruptive moves in foreign exchange rates. In this vein, the risk of a dollar overshoot on the back of a policy mistake by the Fed cannot be ruled out. This is another reason why the Fed needs to tread

very carefully.

Finally, emerging market assets may experience some short-term pain as investors fret over Fed policy and shun risk assets, but the long-term outlook for emerging market bonds is unambiguously positive in my opinion. In a world of zero/negative interest rates, the pressure on investors to reach out for yields is likely to only grow. In comparison, emerging market assets still offer rich yields, both in nominal and real terms. I believe these yields will provide ultimate support for emerging market currencies, bonds, and stocks over the longer run.

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