Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

Week 29: July 21, 2011

Cheap money wins! Yield-seeking capital flows will return as a driver for EM assets, global corporations with EM exposure, and commodities: *Emerging market central banks and technocrats must be preparing for another wave of speculative capital flows thanks to the Federal Reserve. Emerging Asia will surely benefit the most. New research from the BoE demonstrates that the more policy makers tighten lending restrictions, the more non-banks borrow from foreign lenders! Apparently the seemingly unsustainable can last for quite a while.*

A couple of months ago I wrote that EM assets and commodities would benefit from the end of QEII. Some of my clients were worried about what that might mean for EMs. I argued that there would be a renewed risk appetite for EM exposure through equities and commodities because I believed that the Federal Reserve would continue to keep its interest rates near 0% to support weak growth in the U.S. I still believe that the Fed will keep interest rates near zero, even though headline inflation worries will continue to build in the United States and in emerging markets.

Although political noise in the EU and the U.S. should calm, the economic fundamentals in developed economies are anemic at best. But as long as businesses keep their headcounts and inventories low, and outsource and subcontract when necessary, they will keep their earnings up in spite of low headline growth. This is awesome for equities, but bad news for Main Street. Yet Bernanke’s cheap money is a powerful asset price driver.

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

A new substantial piece of research from Sergi Lanau of the Bank of England has demonstrated econometrically that non-bank foreign borrowing can rise as much as 15–20% in the face of tighter credit conditions and regulations in their home markets. In places like India, China, Brazil, and S. Korea, where foreign banks have not established a significant branch presence, research indicates that corporations will be particularly interested in securing foreign bank loans. Bank of International Settlements GM Jaime Caruana, gave a speech in Sri Lanka a few months ago and raised concerns about this very strong trend in global capital markets. Although the G20, the BIS, the IMF, and the newly empowered FSB are all working on transborder monitoring, I worry that the new regulations will be too little too late from some emerging market credits.

You might argue that this is nothing new, but the near-zero interest rates out of the United States and extremely low growth rates in the developed economies will push very large sums of capital into the EMs. The scale is unprecedented. Perhaps the 1970s (petrodollar and massive lending to Mexico) is a good example of U.S. dollars looking for yield and U.S. banks lending abroad. But now the banks are bigger, the spreads are even higher, and the amount of global liquidity is massive.

Although I do not cover frontier markets, companies in these countries would be especially vulnerable to this trend in private foreign bank lending and potential reversals. But unlike larger EM countries, these frontier market governments do not have the same wealth of forex reserves to protect their financial sectors.

ALISON ADAMS RESEARCH

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

<u>EU stress tests are very nearly useless:</u> *European institutions are almost too weak to be credible and the European Banking Authority (EBA) practically admitted that it met significant resistance from national regulators and banks. In other words, the EBA is tolerated but not obeyed.*

There are a lot reasons why I prefer many emerging market banks to developed market banks. But after reading the press release and watching the EBA conference presentation about stress tests and the conditions and compliance around the tests, I thought that banks in emerging markets looked even more attractive. In spite of higher interest rates and concerns about credit and asset bubbles in emerging markets, the institutions that regulate and monitor the banks are much more substantial and credible. I do not doubt that the Reserve Bank of India has little difficulty in enforcing compliance from Indian banks.

There have been some high-profile arguments in the press that the problem in Europe is political, not economic. Perhaps in academia the intellectual niceties that neatly divide the political from the economic hold water. But in emerging markets—especially in the face of massive bank insolvency—the only backstop, the ultimate guarantor and lender of last resort, is the home government of the banks. In Europe after the 2008, every individual nation within the EU pledged national support of its own banking sector and related branches. The ECB has declared that it will not accept defaulted bonds as collateral, effectively closing off a national banking system from liquidity. There is no separation of the economic from the political. The EU is made

ALISON ADAMS RESEARCH

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

up of individual nations, each with its own national (by explicit guarantee) banking system, and bank regulator.

Surely looking at national accounts and macroeconomic data is willfully academic. And the fact that the EBA is too weak to mount a credible EU (systemic) stress test only underscores the political *and* economic nature of the crisis.

Below are some takeaways from the report:

1. The EBA admitted that assumed haircuts in the tests have been overtaken by market events so that assumptions on haircuts are not adequate.
2. The EBA Board of Supervisors made clear that market-risk haircuts to the value of sovereign exposures would not apply to exposures held in the banking book.
3. *Cajas* are under "severe strain."
4. Banks "in several cases" did not implement the wholesale funding risks as outlined. This has affected their interest-rate funding assumptions.
5. The stress tests also assumed that there was no currency risk for banks holding debt from their home governments. This may not be true if any member decides to exit the euro.

From a political and policy risk analysis, European banks are more vulnerable than many in emerging markets.

ALISON ADAMS RESEARCH

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

<u>Brazil to reduce ethanol blend to cool inflation:</u> Meanwhile, U.S. policy is subsidizing cheap corn exports to Brazil and the EU: *High sugar prices are pushing up fuel costs in Brazil and President Rousseff is planning a reduction in the ethanol content of fuel to reduce inflation and demand for US corn based ethanol imports.*

The move to reduce the ethanol content in Brazilian gasoline may be temporary, but the cane growers association (UNICA) is concerned that weather will mean a smaller crop and less ethanol. But in an effort to help cool inflation, President Rousseff is considering a reduction in the ethanol content from 25% to 18–20%. Petrobras has said that it will add another refinery to help meet demand. But with higher domestic demand and uncertain weather, ethanol costs could remain high for the rest of the year.

The recent switch from Brazil exporting ethanol to importing ethanol from the United States is perhaps also partly why the government is willing to cut back on the ethanol blend. Many analysts are skeptical about the government's ability to meet its year-end inflation target.

In *Foreign Policy* magazine, Steve LeVine blamed U.S. ethanol policies for high-priced food, animal feed, and ethanol. "In the United States, corn is now officially a fuel crop—the federal government forecasts that this year ethanol markets will for the first time use more corn than poultry and livestock farmers." Is this good news? I would say it's bad news for everyone. Bad weather in the United States is threatening crop yields in wheat, soy, and corn. That has pushed

ALISON ADAMS RESEARCH

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

up grain prices around the world! For emerging markets, this means more inflation, higher interest rates, and less buying power. And tragically, more hunger.

Brazil can help offset its inflation and reduce the "demand" for American corn ethanol by reducing the official blend. But the corn as fuel will have other impacts through substantially higher grain and food prices. The poor don't have cars to drive, but they do need to eat.

Rumors of new bank bankruptcy law in China: *Is the CBRC writing a bank bankruptcy law because of troubles ahead? Imprudent small and regional banks could suffer. But I have no doubt that Beijing will support its national champion banks at any cost.*

Although many governments around the world are currently looking into new rules to establish living wills and bank bankruptcy laws, an article in *Caijing* caught my eye. Rumors are not facts. Unsubstantiated and unnamed sources should be treated with skepticism. But in China, where banks have been allowed to work out bad loans over many years, the rumor of a new national bank bankruptcy law caught my attention. I sincerely doubt that China would allow its big, national champion banks to fail. These banks are still partially owned by the national government and their executives are members of the party.

However, I do believe that the national bank regulator and the PBoC would welcome rules for handling the liquidation of small, imprudent banks. The law is a positive step in the development of meaningful financial modernization and development in China. Yet, given the building

ALISON ADAMS RESEARCH

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

concerns regarding the asset quality of some banks and the rumored insolvency of local government SIVs, the timing of a new law is interesting to say the least.

At the risk of being repetitive, I do believe that the outstanding debt revealed by the national audit office is likely to be official debt with some relevant official approval and documentation. Such loans should, under most conditions, be guaranteed by the NDRC and the national government. But the bad news lies in the SIVs and undocumented liabilities of banks and their clients. In other words, I am not worried about the local government debts and liabilities we—or the national auditor—can count. I am worried about what cannot be counted. Those liabilities would not be covered by the state and cannot be estimated.

South Africa and 2012: Strikes, expropriation worries, and inflation: The ANC will continue its conservative path, but political pressure from the left will increase. *President Zuma and the ANC leadership have thwarted demands for more socialism from the Youth League and COSATU. But Zuma may not win ANC endorsement next year because the far left in the ANC seems to be gaining momentum.*

President Jacob Zuma was never a market favorite. Before Zuma became president, the ANC's leftist Youth League (ANCYL) was said to be under his influence. But the ANCYL and the labor union COSATU are doing their best to influence the ANC and bring a new challenger to the national stage. The head of the ANCYL, Julius Malema, make Zuma look like a stodgy central

ALISON ADAMS RESEARCH

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

banker. Malema is a firebrand whose self-aggrandizing tactics (used in the name of the people) are legendary. His repeated calls for the expropriation of mines and farms play well with the particularly militant ANC membership. In his latest scandal, he has been accused of building a massive compound with a bunker. Many of his associates have been involved with corruption and graft. For a time that didn't hurt his support with certain factions, but that has ended and the ANCYL has switched allegiances to the ANC deputy, Motlanthe.

The labor union COSATU has been pushing for more concessions. Although Zuma was able to avert a municipal workers' strike, the workers in the oil and refinery sector are on strike demanding a double-digit wage increase.

The leadership in the ANC will undergo a transition itself. There are few leaders at the top who are from the apartheid era. Surprisingly, that generation has proven to be the most reasonable and disciplined. The unity of the ANC was forged under apartheid, but as the elder generation fades, the younger generation has more ambition, less patience, and less tolerance for political unity. It will be increasingly difficult to contain the more radical elements of the ANC. But between the ANCYL and COSATU, COSATU is the more reasonable.

Rising inflation in South Africa, as in other parts of EMs, is a concern. Food prices continue to increase, even though economic growth is far from the levels enjoyed in other parts of the EM universe. Unemployment is still high. Local governments continue to miss their performance

ALISON ADAMS RESEARCH

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

targets. And the government, in spite of good policies at the top, is struggling to deliver social goods to the poor and unemployed. Higher food costs and low growth will make for a rocky political terrain in the coming year.

Peru, Indonesia, and Brazil: Different plans to capture revenue from commodities.

In Peru, Humala invited Julio Valverde to stay on as central bank president. Valverde accepted and should help boost investor confidence that Humala is open to market-friendly policies. The much vaunted natural resource windfall tax might benefit from his change in tactics, as well. As Valverde pointed out, in trying to capture windfall profits, the government would lose considerably more in FDI and investment and undermine macroeconomic stability. Humala's government is way more likely to look for a market-friendly method to capture revenues. There will be higher taxes on mining companies, but the terms and implementation ought to be more palatable.

In Indonesia, the major commodity companies with partial government ownership have endorsed tentative plans to ban the export of raw commodities. The policy is intended to boost FDI in mills and processing plants and spur employment and economic development. Indonesia's government has a history of manipulating import and export tariffs to manage its economy. This latest law is slated to go into effect in 2014.

Alison Adams, PhD

617-388-9817

research@alisonadamsllc.com

Brazil is in the process of passing a new mineral and natural resource law. Although the law is still being written, there are new rules for royalties and mining and related mining-labor laws. Like Peru and Indonesia, the government is anxious to balance investment needs as well as increase revenues as commodity prices rise. Dow Jones is reporting that the iron ore royalties could double or be capped at 10% of profits.

Alison Adams Research

Mobile: 617-388-9817

Office: 617-475-5295

Email: research@alisonadamsllc.com