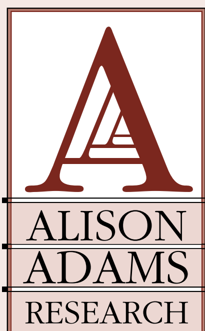

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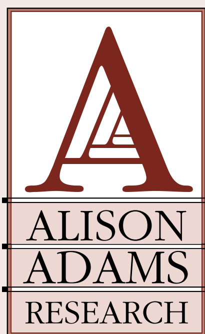
Week 32: August 11, 2011

A second bull run à la 2009 for EMs? Domestic demand stories and government debt should hold up best. But the ability of EMs to successfully decouple from the U.S. and EU would require a substantial route in commodity prices. *Emerging markets have nearly everything to recommend them: strong headline growth, credible central banks, healthy banks, consistent policy, and good demographics. But without a substantial fall in commodity prices the positive and economic fundamentals will not be able to remerge as a fundamental driver for global growth. Brent at $120 will do as much harm to EMs as another Lehman-like event in the U.S.. That said, I still believe that emerging markets are a better bet than the U.S. or the EU. Favor domestic demand, local currency debt, and dollar debt.*

At the launch of AAR in April 2009, I recommended that emerging markets warranted a larger portfolio allocation and said that their strong fundamentals would deliver resurgent global growth. Emerging markets still have those strong fundamentals and credible central banks. Although credit growth has been strong, higher capital ratios and interest rates have been implemented. But energy-importing emerging markets cannot grow with Brent at $120. If markets think that the past few days have been reminiscent of Lehman, the run-up in oil and food prices has been eerily reminiscent of 2008 for emerging markets.



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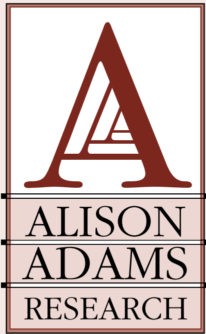
If we see a substantial correction in commodity prices, which has yet to occur, then emerging market central banks (in particular China's PBoC) will be able to cut rates sooner than most models are expecting. But from the perspective of EM companies, a correction in commodity prices would help boost profits and reboot domestic demand. If commodities do not correct, then EM central banks will remain on a tightening bias into 2012. Or even longer depending on the price of oil. Perhaps OPEC will realize that they might like oil above $100, but demand destruction is a risk that may not be worth the short-term gain. I am concerned that the Saudis may not be able to bring Venezuela and Iran to the table and agree to an increase in production. In 2009, when oil fell below $60, EMs grew at full speed. Cheap oil probably did as much to support EM decoupling as government stimulus measures.

It's difficult to pound the table, but there are many good buys out there in emerging markets and their growth outlook is substantially better than those located in the U.S. and the EU. Local government debt performs very well as U.S. cheap money looks for yield. EM dollar government debt will also perform well for much the same reason.

Gold is capital flight by another means, unless the U.S. and EU can deliver substantial policy reform and coordination. *Gold, and possibly other commodity prices, might be driven higher by capital flight and financed by cheap money. This may be a perfect time to set up small local shops that sell foreign currency to Americans in exchange for dollars. When I lived in Latin America before 2004, a good moneychanger was essential to saving money.*



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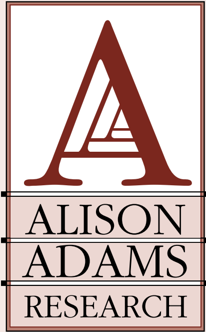
This is what it is like to live in an emerging market country going into an economic crisis. Political leadership cannot calm markets. Technocrats cannot calm markets. Ratings agencies are ignored—either for being too naïve or too gloomy. The banks stop lending and hoard what cash they can and cut lines of credit. And if it were possible to flee the dollar there would be capital flight. If I could go to my local moneychanger—preferably black market, which offers better rates with less paperwork—I would. But I live in America and (for now) I cannot just go and buy other currencies. Though it may be the perfect time to set up such a business. "Can't afford an ounce of gold? I can sell you some Brazilian reis to put under your mattress."

Why the global economy needs the G20 (and why the G7 has no credibility). PM Wen is correct to call for global coordination. *Leadership in the EU and the U.S. has lost credibility. A G7 promise is meaningless because the G7 has repeatedly doled out second- and third-best policies. Massive leverage, fueled by super-cheap money, has made U.S. and EU banks and markets vulnerable. Poor growth outlooks are not news. But markets realize that the political leadership is unable to deliver structural and fiscal solutions to the current economic problems. China and other emerging markets will demand more from the G20 and it will take the G20 to solve this.*

Do you believe anything that elected officials say anymore? Who has credibility? Banks in the U.S. and the EU are on fire and London is burning. President Sarkozy has summoned his government back from vacation to deliver even more austerity to preserve the AAA rating. In



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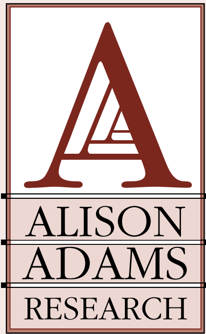
today's *New York Times,* Thomas Friedman fantasized about a grand bargain in the U.S., with the Democrats and the Republicans coming together to save the day. Meanwhile, the violence in the markets seems to indicate that massive leverage and margin calls still have to be unwound. Deleveraging, as in 2008 and 2009, will take markets even lower.

In 2008, it took the G20 meeting for the G7 to realize that the fallout from the Lehman failure had taken a private banking matter into a public global crisis in trade, finance, and confidence. The G20 has had conference calls with the respective representatives. Beijing is calling for coordinated action. It might take emerging markets—through the G20—to force a political solution onto the EU. It might take the G20 to make American politicians realize that they must actually earn investor confidence. I don't expect immediate results, but the pressures from EMs will be substantial. There are those who might think that the U.S still sets global policy. But after Obama's milquetoast comments on Monday and Bernanke on Tuesday, it ought to be clear that America's leadership has lost its credibility.

China's bank regulator (the CRBC) orders banks to lend to affordable housing schemes—including local government SIVs. *The country has 5 million units under construction and another 10 million expected over next year, for a total target of 35 million rental units. This won't be enough to save the global economy. But it should help mitigate the consequences of lower growth and the higher cost of living in China.*



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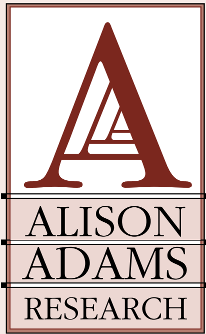
Even as the PBoC is engaged in policy tightening, the bank regulator has given China's banks a direct order: Finance affordable housing projects! The housing projects will provide subsidized rental housing for people who cannot afford to buy their own homes. Local governments have been charged with organizing and implementing the national scheme to provide 35 million units over the next few years. The banks are to provide financing for these projects and even lend to the local government SIVs, which have been subject to much criticism of late. For local governments, the prospect of rental income from these affordable housing units must be attractive. The revenue from land sales is quickly disappearing as available land is in short supply.

Cheap money wins but won't flow where it's needed. *So basically, the Federal Reserve agrees with Standard and Poor's view of sputtering growth in the U.S. The best policy that the U.S. can give is ultra-cheap money for 24 months! But now our banks are bigger than ever before, public coffers are empty, unemployment is higher, housing is still weak, and growth is lower.*

From our note on May 19th:

> **The end of QEII and emerging market assets:** *Although the FOMC demurred about the timing of the end of QEII, cheap money in the U.S. and the interest rate differential will keep flows into emerging markets. The U.S. economy is strong enough to justify the*



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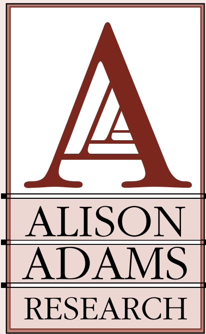
end of QEII, but not nearly strong enough for the banks to start pumping money into the U.S. economy. Emerging market assets will continue to be attractive vis-à-vis the U.S.

From our note 2 weeks ago:

- **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 and commodity speculators will surely benefit the most.*

Last week, I had some questions about the ability of EM governments to address their economic challenges. The more I thought about it, the more depressed I became regarding the feebleness of elected government in the U.S. and the EU. The United States needs a lot more than cheap money and our government could learn a thing or two from Mexico or Brazil, countries whose markets have sold off in a much more moderate manner and with far less loss.

For the most part, emerging market politicians understand what it means to work for their credit rating and access to capital markets. They are capable of delivering policies that can provide fiscal surpluses, even though most of their supporters live on less than $5,000 a year. They can raise the retirement age and get reelected. They can regulate banks and pension funds so that domestic savings are invested in domestic companies. They have balanced budget rules. They



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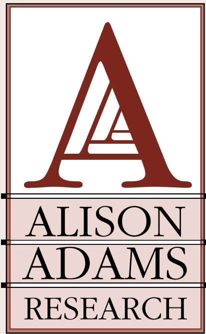
support their national champions. They act to attract foreign investment for more job creation. If emerging market politicians were in charge of the United States, they would be capable of delivering policies that would offer growth and fiscal sustainability. I have often joked that Mexico's central banker could do a much better job than Bernanke. Well after the events of the past month, I would say that Mexico's ruling party the PAN could do a better job than our elected government.

Demand destruction is real and OPEC could cut expected demand further. Can Saudi Arabia save the world again? *In 2009, the Saudis pledged to keep oil supply affordable and plentiful. Their ability to act will be hampered by Venezuela and Iran, which frankly cannot increase production to offset lower prices.*

Affordable energy prices were an import driver for EM outperformance in 2009. Before the crisis in the fall of 2008, most emerging markets (with the notable exception of Brazil) had failed to meet their inflation targets as oil soared above $140 a barrel. If the U.S. and the EU continue under suboptimal growth for the foreseeable future, emerging markets cannot rely on exports to deliver growth. They will need to rely on domestic demand. Brent above $110 a barrel will hurt domestic demand. Consider that in China, there are numerous anecdotal reports of car owners who cannot afford to drive their cars even when the NDRC kept fuel prices lower than its formula would allow. High energy costs, while good for producers, are as dangerous to domestic demand as high food prices in emerging markets.



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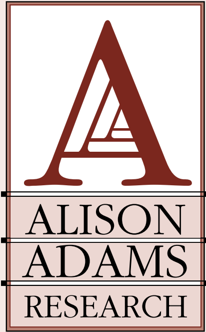
OPEC seems to have a better model for global demand. And it has cut its demand estimates by 150kbpd (though estimates are still above the 2010 number) but OPEC has added that it could cut demand forecasts even further by as much as another 200kbpd on the slowdown in the U.S. and the EU. Demand destruction is a very real threat. This is something the Saudis were very concerned about when they promised to unilaterally raise production earlier this summer. Iran and Venezuela cannot—simply because of gross mismanagement and a lack of political will—increase production. They will fight an increase in quotas from OPEC. *I am concerned that if the financial turmoil in the markets translates into a real economic slowdown around the world, the Saudis will not be able to do much to lower prices by increasing production.*

There will be absolutely no political will to raise margin requirements on commodity futures after the rout this past week. Energy ETFs and spread traders will be let loose on energy markets at nearly no interest.

Uncertainty will impact trade. In 2008, falling exports from Asia was a major vector of contagion. *A sudden stop in global trade served as a major vehicle of contagion from the developed world to emerging markets in 2008. Uncertainty in the U.S. and the EU could hit demand more than we expect. A Bernanke paper from the 1980s that surveyed market uncertainty calculated that prolonged uncertainty could cut as much as .50 percent from the GDP. Weak demand from the U.S. for Asian exports could be even weaker!*



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