AN “ECHO BOOM” AHEAD

ANALYTIC INSIGHTS - OCTOBER 2013

Gordon T Long
9/21/2013
AN “ECHO BOOM” AHEAD

The Global Peripheral economies and specifically the Fragile Five (Brazil, India, Indonesia, Turkey and South Africa) have a paper problem! With the shell game of global growth nearing its end, the grandest ‘check kiting’ scheme in history is beginning to come apart in the peripheral nations of the world. It was only a matter of time. Most critically, the resulting "Echo Boom" will ricochet towards the global core in 2014.

A SHELL GAME

We all realize trees don’t grow to the sky because they become unstable when the physics of balance becomes statistically impossible. The proverbial butterfly’s wings can bring it crashing to earth, as likewise a nervous reaction to “TAPER” can become a similarly triggering event to unstable global peripheral economies.

If it hadn't been for three stunning developments occurring immediately following the G20 meeting in St Petersburg, Russia, the economic unwinding in the Emerging Markets, which was well underway and rapidly gaining momentum, would have quickly washed ashore in the developed economies. The urgent selling of currency reserves held in US Treasuries to stabilize Emerging Market currencies was swiftly becoming problematic. The resulting rise in the developed economy interest rates, such as US Treasury rates, was nearing worrying structural levels.

The following choreographed news announcements successfully reworked the global calculus at least temporarily:

1. An abrupt reversal in the US’ immanent attack on Syria by first President Obama’s astonishing deferral to Congress and then just as astoundingly negotiating a diffusion of the escalating crisis.

2. Laurence Summers stunning withdrawal of his name from consideration as the next Chairman of the Federal Reserve. The emerging markets leaped on news of Summers withdrawal. Emerging market stocks hit a three month high and the bonds of developing countries climbed by the most since mid-July. All major currencies climbed against the dollar, with those of emerging markets making the, the Hungarian forint added 0.9 per cent and the Turkish lira – also helped by the easing of tensions over Syria – gained 1.4 per cent.

3. The Federal Reserve’s shocking deferral of the initial stages of “Taper”. A decision which left Fed and market watchers miffed. Global markets exploded higher including the troubled emerging market as Bill Gross of PIMCO heralded the “risk on” trade was back on.

The results of the announcements were dramatic

“If there is a pattern it is that high yield/high current account deficit currencies have rallied the most. Currencies that were hurt the most by fears of liquidity tightening seem to be doing the best.”

Steven Englander, Strategist at Citi
THE PERCEIVED PROBLEM

BRICS elements (Brazil, India and South Africa) hit hard.
The problem is unfortunately quite familiar. It starts with "unsound money" which is initiated through the adoption of 'fiat' based currencies. Without the financial discipline a non-Fiat currency imposes on politicians, it is not long before easy credit and money supply are rapidly expanded. With this quickly and inevitably comes "hot money" looking for mispriced 'carry' risk anywhere it can be found. Just as predictable, as soon as credit slows the Boom turns to a Bust as the Hot Money disappears faster than a thief in the night, leaving behind the pain and destitution which it caused.

Emerging Markets could have prevented the big rush of foreign cash through prudent measures, but they opted not to take any pain, and now they're paying the price for going the easy political route.

This is 'oh so familiar' in an era of fiat currencies and persistent global governance leadership failures!

Richard Koo of Nomura concludes that:

"We're now in for a "tumultuous new era" for emerging markets as QE gets unwound.

... The recent announcements would not have been necessary if these countries had taken advantage of these measures to restrict capital inflows from the US. They did not do so probably because restricting capital inflows is extremely unpopular. In nations attracting foreign capital,

- Asset prices rise,
- People feel richer,
- Companies are able to obtain low-cost funding, and
- Inflation tends to be low with a stronger currency.

Essentially everyone is happy but exporters, which suffer from a stronger currency. It takes a courageous policymaker to spoil that pleasant environment with capital controls, even if it is necessary for stable, longer-term economic growth. Therefore, the authorities typically preserve the status quo, in which "everyone is happy."

![Image of Reserve Changes and Inflation Trends]
As the above charts clearly indicate, the Emerging Markets have been under pressure for some time. The reversal of US Monetary Policy from expansion to a slowing rate of expansion was simply too much to absorb for those peripheral nations with negative current accounts and low net investment levels.

As Zero Hedge reported:

The BIS (following their "party's over" rant 3 months ago) former chief economist now warns, "this looks like to me like 2007 all over again, but even worse." The share of "leveraged loans" or extreme forms of credit risk, used by the poorest corporate borrowers, has soared to an all-time high of 45% - 10 percentage points higher than at the peak of the crisis in 2007.

As The Telegraph reports, ex-BIS Chief Economist William White exclaims, "All the previous imbalances are still there. Total public and private debt levels are 30pc higher as a share of GDP in the advanced economies than they were then, and we have added a whole new problem with bubbles in emerging markets that are ending in a boom-bust cycle."

Crucially, the BIS warns, nobody knows how far global borrowing costs will rise as the Fed tightens or "how disorderly the process might be... the challenge is to be prepared." This means, in their view, "avoiding the temptation to believe the market will remain liquid under stress - the illusion of liquidity."
GLOBAL SLOWING WELL UNDERWAY

The dynamics are familiar. The Mexican Crisis of 1994-95, the Asian Financial Crisis of 1997 and the Russian Crisis of 1998 were preceded by a turning point in U.S. monetary policy, with the Fed interest rates doubling to 6% in early 1995 from 3% in early 1994. Speculative flows into emerging markets created highly leveraged investment and spending booms that fell apart when the hot money dried up.

The problems are both cyclical and structural, and policy options are limited. The recent stock-market falls and currency routs suggest the coming months will be rough. Singapore’s Straits Times index, Taiwan’s Taeix, Korea’s Kospi, India’s Sensex and Malaysia’s KLCI have either broken or are breaking below important technical supports, with the likelihood of accelerated losses ahead. There may be corrective rebounds in emerging-market currencies and equities over the coming week or two, but these are likely to be pauses rather than reversals. There are no quick fixes to the savings deficits in the economies worst hit by falling currencies, equities and bond prices. The policy dilemma is excruciating. Falling stock markets, selloffs in government bonds, weakening currencies and fund outflows could reinforce each other to form a dangerous negative feedback loop. But some of the policy remedies being pursued could amplify these dangers. For example, while the Indonesian government announced some worthy supply-side reforms last Friday, its plan to juice growth through infrastructure spending could aggravate Jakarta’s current account deficit.

In a similar vein, emerging market policy makers could end up digging themselves into bigger holes selling U.S. Treasuries to defend their currencies. Data shows a notable decline in EM central bank reserves over recent months. Morgan Stanley suggests a decline of $81bn since May. Standard Chartered data speaks of a $71bn decline this year. US Treasury
International Capital System (TIC) data – which tracks foreign flows in and out of US bonds, should eventually bear this out, albeit with a lag. Whatever edge EM central banks gain from buying their own currencies will likely be taken back by the higher Treasury yields they help create. In the process, they squander precious reserves.

It was no coincidence that cracks first appeared in India and Indonesia, both of which run large current account deficits. Indeed, the rupiah started accelerating downward after Indonesia's release of its deficit figure on Friday. At 4.4% of GDP, Jakarta's deficit was larger than the deficit recorded just before the Asian Financial Crisis. India’s deficit is even higher, at around 5% of GDP.

A repeat of that earlier crisis is what Asian policymakers have feared ever since developed economies began their ultra-loose monetary policies. What quantitative easing gave, tapering is now taking back. Whether tapering starts in September or December is probably irrelevant. Tapering will occur, and U.S. Treasury yields will, over time, push higher.

Economies which had developed dependencies on U.S. inflows to fund their consumption and investment now face painful adjustments. And the market knows the dollar risks moving higher in tandem with Treasury yields.

If there’s good news for today’s leaders amid a slew of bad policy options, it is this: despite the 1990s parallels, we are not necessarily headed for another emerging market financial crisis. While there are pockets of weakness, current account positions are generally stronger in the emerging markets today compared to the 1990. External debt to GDP is lower. International reserves are generally higher relative to GDP and number of months of imports, and international banks’ claims are lower relative to the economy.

THE REAL PROBLEM: VALUE ADD & VALUE CREATION

A structural and fundamental problem is that too many of the peripherals economies have limited pricing power.

Most of the peripheral nations that are experiencing problems are low on the value ladder and in the outside rings of value add proposition. They therefore have limited margin and wage leverage. They are dependent on others higher on the ladder. When those higher catch a cold, the peripheral nations come down with pneumonia.
GLOBAL LIQUIDITY TRAP

Last month I explained the basis for a Global Liquidity Trap being underway. I would be highly surprised if the magnitude of the slowdown occurring around the world was not foremost on the recent G20 table.
The possibility of the US Federal Reserve beginning “Taper” was terrifying to all the Emerging markets in attendance, as was the looming potential Geo-Political shock of a US attack on Syria. Clearly the US and President Barrack Obama must have received the strong message at the G20 that the US must refrain from shooting the world’s economy in the foot!

The about turn in Syria and the Federal Reserve’s “Taper” policy may be indications of the degree of worry world leaders have that an expanding problem in the emerging economies would be a catalyst for an “Echo Boom”!

---

Gordon T Long  
Publisher & Editor  
general@GordonTLong.com  

Gordon T Long is not a registered advisor and does not give investment advice. His comments are an expression of opinion only and should not be construed in any manner whatsoever as recommendations to buy or sell a stock, option, future, bond, commodity or any other financial instrument at any time. While he believes his statements to be true, they always depend on the reliability of his own credible sources. Of course, he recommends that you consult with a qualified investment advisor, one licensed by appropriate regulatory agencies in your legal jurisdiction, before making any investment decisions, and barring that you are encouraged to confirm the facts on your own before making important investment commitments.

© Copyright 2013 Gordon T Long. The information herein was obtained from sources which Mr. Long believes reliable, but he does not guarantee its accuracy. None of the information, advertisements, website links, or any opinions expressed constitutes a solicitation of the purchase or sale of any securities or commodities. Please note that Mr. Long may already have invested or may from time to time invest in securities that are recommended or otherwise covered on this website. Mr. Long does not intend to disclose the extent of any current holdings or future transactions with respect to any particular security. You should consider this possibility before investing in any security based upon statements and information contained in any report, post, comment or suggestions you receive from him.