Reading the Markets: Entrenched Growth with Non-Linear Risks
Newsletter for June 2018

Every year we update investors on our learnings from attending various conferences. 2Q of the year is a great time to take stock, meet corporates and thought leaders and get a pulse of activity and business. Over the last few months we have done our fair share of such meetings/ conferences and we have shared our insights from some of these in this newsletter. Our conclusions on the one hand are reassuring on the growth outlook but also make us ponder the ever-morphing nature of asymmetric risk which markets are struggling to price in.

From Synchronized to Solid Growth

As we closed 2017 it seemed as if the world was headed for a period of benign and synchronised growth (RVAM newsletter for November 2018). Moving forward a couple of quarters, growth dynamics seem well entrenched but with stronger trends in US and Asia and softer but healthier growth in Europe. Given the significant stimulus to the US economy so late in the economic cycle by the Trump administration's policies, the current US expansion will most likely end up as the longest in history before it turns down cyclically. Asia is seeing broad based growth with China seeing steady near term numbers, India seeing acceleration and ASEAN governments increasingly focussing on infrastructure, a point succinctly made by Ravi Menon of the Monetary Authority of Singapore at the Nomura Asia conference.

With better and robust growth, the debate is increasingly shifting towards appropriate monetary policy and the path of interest rate moves. The US Federal Reserve seems to be clearly on a path of rate normalization and determined to get ahead of the curve with an eye on the distorting effects of the prolonged loose monetary policy on asset pricing. The big global economic uncertainty at this point seems to be the shape and path of European normalization. Politics, the over-used caveat for economic expectations, was hardly mentioned at the conferences we attended and seemed to be taking a back seat to trade uncertainty. With the recent bout of volatility, a lot of speaker time was spent ruminating on what tighter global financial conditions and rising US interest rates mean for emerging economies and financial assets in these economies. Most commentators drew on past experiences to warn of challenging times ahead for emerging markets, especially those running twin deficits (fiscal and current account), though there was increasing recognition that Asian economies are no longer as vulnerable as in the past.

Asia Getting Delinked from Emerging Markets

For nearly two decades now the economic and financial fortunes of Asian economies and other emerging markets in Latin America and EMEA have been closely linked, initially driven by capital flows from western economies in the late 90's and later driven by the voracious commodity appetite from a rising Chinese investment cycle. The en masse capital exodus out of emerging markets following the taper tantrum just reinforced the linkages. Five years on from the anniversary of that event in May 2013, we have seen market volatility return as investors worry about an encore as the Fed continues on its tightening path. But increasingly observers have noticed the divergence in cycle between the vulnerable economies of Turkey, Argentina, South Africa or Venezuela which are facing challenging economic conditions with rising deficits (in the face of institutional weaknesses) versus economies in Asia which are on a different economic path driven mainly by domestic demand drivers.

The economies in Asia which are vulnerable to reversal of capital flows and oil prices - Indonesia, India and Philippines - all have a better external situation now than five years ago, while their central banks have started moving ahead of the curve as seen from a series of interest rate increases in each of these markets over the last few weeks (for the first time since 2014). More significant is the fact that economic growth in each of these economies over the next few years will be driven by the large number of infrastructure projects which have commenced work and are in various stages of implementation.

On the other hand, the other set of economies in Asia - Korea, Thailand, China, Singapore, Taiwan - are all running significant current account surpluses, making them less vulnerable to capital flight, though the challenge for them in this cycle is the emerging new risk - trade wars. At one of the conferences, we had the opportunity to listen to the central bank governor of Thailand (a country which defined the Asian crisis in 1997 but is running 10% current account surplus now), Dr. Veerathai Santiprabhob, talking of pick up in domestic growth as the multiplier effect kicks in with the government re-starting the long talked about infrastructure projects. China, after stabilizing its economy through property sector stimulus, is increasingly focussed on getting its debt burden under control by incrementally tightening through administrative measures as well as raising rates selectively, all with the intent of deleveraging its economy in a period where trade frictions are growing.

Overall, Asia clearly seems to be at the cusp of a new economic cycle while other emerging markets are battling the age old cyclical problems of hot money flows.

Deepening of Asian Credit Markets

As global investors worry about tightening financial conditions, one of the trends worth highlighting is the increasing depth of bond markets in Asia. Most large economies in Asia (China, India, Korea) historically had large domestic fixed income markets but the cross-border hard currency issuances were small when compared to the size of equity markets in the region. That seems to be changing with corporates increasingly venturing out to make large dollar bond issuances. In 2017 nearly US$300bn was raised in Asian credit markets by Asia Pacific ex-Japan issuers, with nearly half of that coming from China. What was interesting for us to learn was that nearly 80% of this issuance was absorbed locally within the region. A decade back the amount raised was a fraction of this, with most of it getting placed in Western markets. Clearly, the local markets have deepened at a time when investor vigilance on capital flow has increased, which is encouraging and gives us increasing confidence that Asia could get delinked from other emerging markets in this cycle. We at River Valley Asset Management have been early participants in this emerging trend and have built up insights and knowledge operating in this segment over the last five years.

Rising Idiosyncratic Risks

At the beginning of the year, in our outlook piece, we highlighted the potential for volatility and risks to rise. Coming close to the mid-point of the year, we have already experienced two bouts of volatility. What is interesting to us is the changing narrative of risk and the market trying to price in an ever-changing risk of the unknown. A comment by the former governor of the Reserve Bank of India, Raghuram Rajan, at the Nomura conference made us ponder - "markets always struggle to price in risk of events which may be known in advance but whose outcome is not clear and is probabilistic". In his keynote speech he went on to elaborate that while the good part of the story is improving global growth conditions, this needs to be tempered by the unknown risks emerging from a changing narrative on trade and deficits, as the rules under which the world was operating for the past decades are now being upended by its very creator, the United States of America under its mercurial president Donald Trump.

Globalization and the Changing Narrative

Since the end of World War II, world economies have broadly operated under a set of rules called the Bretton Woods system with the US acting as the benevolent referee. This has been a period of rising globalization and world trade that has grown exponentially to account for nearly 60% of world GDP now from less than 20% then. While the world in aggregate and emerging economies of Asia in particular have benefitted over this period, it has led the putative losers in Western economies to question the imbalance in distribution of benefits and to elect strongmen as leaders who profess to have a solution. This is visible in election results in Southern Europe or in the Trump phenomenon or numerous similar examples in other countries. As these new leaders try to deliver on their quick fix promises (instead of reforming deeply entrenched inefficiencies and bottlenecks), they are questioning the existing rules which they consider unfair. Markets are struggling to price this kind of probabilistic risk. We saw an example of this in May when, three months after the Italian election, a negotiated coalition government staked its claim to rule and at the same time questioned existing institutional arrangements, leading to panic in the Euro and financial markets.

Elephant in the Room - Trade Wars

In our February 2017 monthly, ruminating about Trump's 100 days in office, we worried about the impact on risk premiums as the President went about questioning the existing order of business. Nearly a year and a half into his term, we are now seeing rhetoric turning into action and neither the market nor seasoned observers can fathom the end result. This could increasingly lead to unexpected outcomes and hence the title of our piece "non-linear risks". As Professor Rajan pointed out in his speech, the US administration does not seem to believe in the existing system of global rules and is happy to unilaterally attempt to change them. This is creating exasperation both for age old allies of the US as well as its perceived adversaries. President Trump seems to be singularly focussed on reducing the US trade deficit (quickly), even if it means tearing up existing agreements.

Economies and markets which have prospered and grown during the win-win decades of global trade under the aegis of the WTO are struggling to grapple with the new reality of a President who nonchalantly tweets, "Trade wars are good and easy to win". In the zero-sum world of Trump where I win if you lose, the risk of a presidential action overnight unravelling years or decades of well laid out business plans focussed on maximizing comparative advantages of global supply chains, is non-trivial. This is a risk which markets will struggle to price as the end outcome is not certain. In the initial days post Trump's election, markets in Asia got roiled (before settling higher) as investors worried about Trump and trade. Eighteen months on, the unlikeliest of countries - the closest allies of the US in the G7 - are getting roiled by Trump's tariff wars. Countries are publicly discussing tit-for-tat tariffs and that is a slippery slope which could unravel years of globalization gains. As Professor Raghuram Rajan stated, the problem with strong men taking extreme positions is that it is difficult to step back if needed and the unintended consequences are difficult to fathom. Markets will struggle to price in the risk from this potential new world of trade tensions.

If we look back, Brexit provides a classic template of how risks impact markets in the new uncertain world. Two years on, nobody knows what Brexit means, leave alone the governments which are negotiating this. Every few months the British pound gets shaken by a new narrative, before it settles down after the markets realize that the new information is no different from the existing confusion.

In conclusion, while we see a robust future in Asian economies with multiple growth drivers, we remain ever vigilant for new narratives on risk which are likely to make markets volatile. A prudent hedging strategy helps us manage the tail risk from non-linear events.

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