Collision Course Averted?

With the Federal Reserve delaying its lift-off, China and emerging markets have more room to unwind.

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KEY TAKEAWAYS

- For months, market conditions have tightened, given a stronger dollar, widening credit spreads, and falling inflation expectations, while the deflationary shock of "quantitative tightening" (QT) hit the markets over the summer.
- The collision course of these two forces (deflation and tightening) caused this summer's market sell-off, which played a role in the Federal Reserve's (Fed) decision to delay raising interest rates.
- This may be a welcome development because it reduces the lift to a rising dollar, which gives China and emerging markets (EMs) some much-needed breathing room.
- The stock market's technicals have been strong, but ultimately there needs to be a sustained recovery in earnings and liquidity to keep the economic recovery going.

Wave Three

China has been in the news a lot lately, from the significant decline in its local stock market to its surprise currency devaluation in August and subsequent drawdown in currency reserves. But the bigger story in China has been the sharp slowdown in its economy. It appears China's debt-fueled economic growth model may have reached its limits, with more and more debt generating less and less growth.

One way to look at what is happening in China (and EMs by extension) is that it's the third phase of the debt deleveraging supercycle that began in 2007. The first phase was in the U.S. when the subprime mortgage housing bubble burst, bringing a decade-long debt boom for U.S. households to an end. Since the leverage peak in 2007, both households and lending institutions have reduced leverage by significant amounts (but the government and corporate sector not so much).

The second wave of deleveraging began in Europe in 2011. When the euro was launched around 2000, the cost of credit for Europe's weakest links (e.g., Greece and Portugal) fell nearly to the level of Europe's strongest economies (e.g., Germany). This enabled peripheral Europe to basically binge on cheap debt. Greece was the poster child for this. The financial crisis in 2008 brought the debt problems in peripheral Europe to the surface, and those countries have been through their own painful adjustments ever since.

Now it appears to be China's turn. China played a crucial role in lifting the world economy out of its funk in 2009 (along with a coordinated response of zero rates, quantitative easing (QE), and deficit spending). China spent some four trillion renminbi (RMB) on stimulus and, by some estimates, it was more like 10 trillion RMB when considering the bank-

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ing sector's multiplier effect. In any case, the results were swift. Growth in China recovered so much that by 2011 it was actually tightening fiscal and monetary policy to rein in inflation and a property bubble. Despite this tightening, credit growth (as a percentage of GDP) continued to soar as fast as before, driven by the shadow banks (in an analog to the subprime bubble in the U.S.). However, unlike the post-crisis credit boom, this more recent one has failed to keep China's economy going.

In a nutshell, China (and EMs) borrowed a lot, just like everybody else. But what's unique about China is that its currency is closely tied to the dollar, and EM corporates have borrowed heavily in dollars. Now, with Europe and Japan in full QE mode while the U.S. ended its QE over a year ago, the dollar has rallied sharply against most currencies. That means the yuan has become increasingly overvalued because its value is tied to the rising U.S. dollar. Basically, China and EMs are getting squeezed by a rising dollar, which is one reason why China needed to devalue its currency in an attempt to release some pressure. This also is why China is systemic—not so much in the economic sense via the trade channel (exports are only 13% of U.S. GDP, and China's is only a fraction of that), but via the financial and commodity channels.

Collision Course Averted?

Beginning last spring, when market conditions began to tighten (via widening credit spreads, falling TIPS breakevens, and a rising dollar), and especially since August when China devalued, the markets were on a collision course. The devaluation of the yuan was a key development because it compounded an already serious erosion in global currency reserves (known in the markets as "quantitative tightening," or QT). If this loss of liquidity is not offset by monetary or fiscal stimulus elsewhere, or by robust economic growth, a deflationary shock often occurs. That's what happened in August. Not only was QT accelerating on the heels of the yuan devaluation, but it also seemed the Fed was determined to raise rates in September. It was a potential collision course that pushed the dollar ever higher and liquidity conditions tighter. It's what caused the market's volatility in August and September and illustrates the importance of liquidity to the world's risk markets. Earnings growth and liquidity growth are two critical drivers for the stock market, and, at the time the market did not have support from either.

But then the Fed kept rates level at the September Federal Open Market Committee meeting and, while at first the system kept tightening, things have begun to ease up. The dollar is down, credit spreads are down, and risk appetites are up. The collision course has been averted, at least for now. On top of a friendlier Fed, China has been calmer as well. If China can stop the bleeding, we could go back to quieter headlines and less volatility.

Earnings and Liquidity

So where do we go from here? Judging by recent Fed speeches, it is clear that there is less of a consensus now as to whether the Fed will start its rate normalization campaign in December. The futures markets are putting the odds of a December lift-off at 50%, which suggests the Fed may not start lifting rates until 2016. But what might matter more than when the Fed raises rates is what the dollar, inflation expectations, credit spreads, and other market forces are doing. While there has been notable improvement in recent weeks, for the most part the market is still in tightening mode, as evidenced by the Goldman Sachs Financial Conditions Index, which remains in risk-off mode.

What also matters is to what degree the drawdown in currency reserves continues in China and EMs. Fortunately, at least some additional QT should be offset by more monetary easing. The European Central Bank (ECB) remains fully committed to its QE program, and the same is true for Japan, although we can't see quite as far into the future with regard to the Bank of Japan (BoJ). However, it's likely that the Fed will remain determined to raise rates at some point, based on the assumption that the U.S. economy is nearing its inflation threshold. Therefore, the prospect of QE from the Fed remains extremely low. This is important, because if currency reserve drawdowns were to accelerate in the months ahead, and with the ECB and BoJ already "all in," it's possible that only a new QE program from the Fed would keep global liquidity conditions from rolling over.

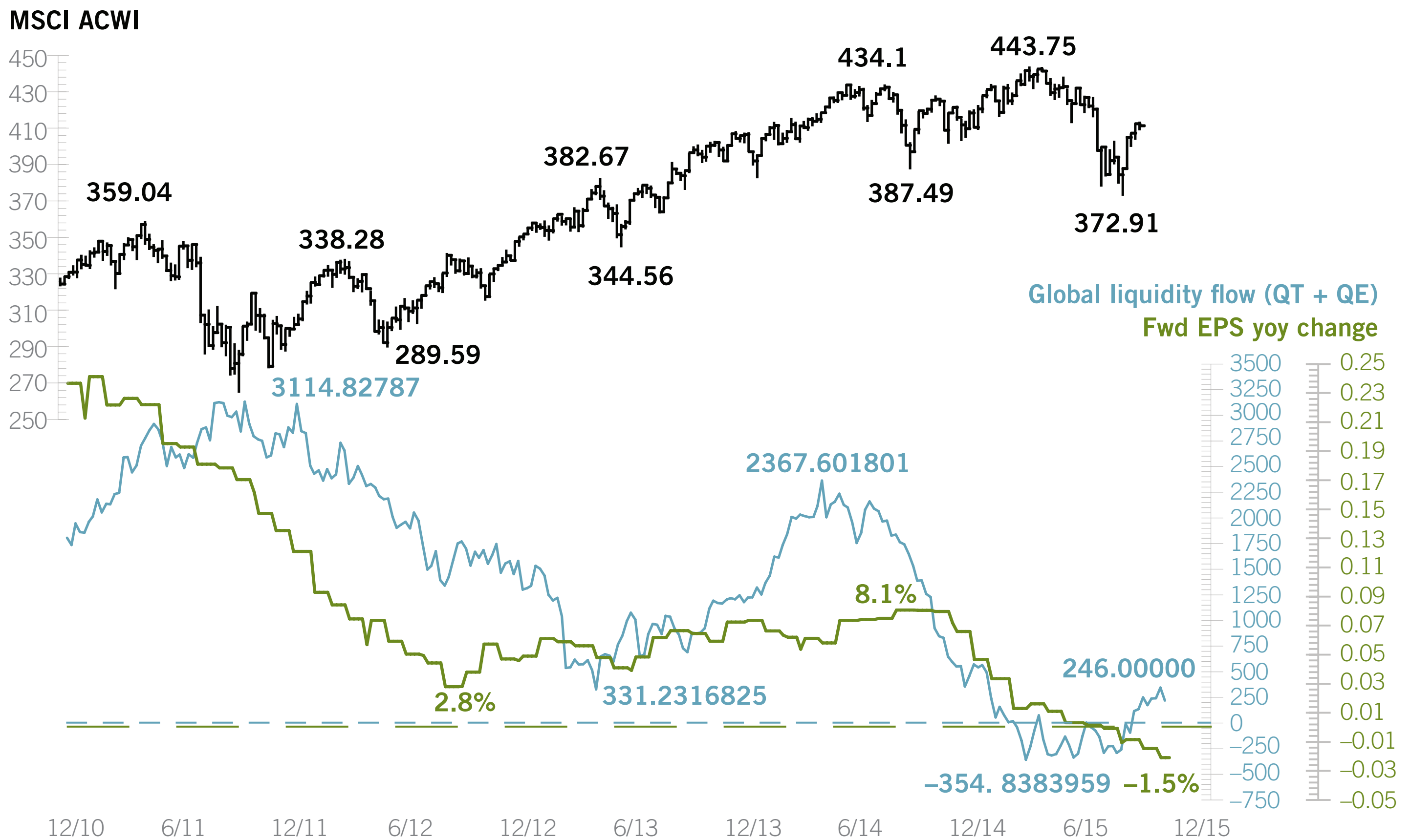
This is shown in Exhibit 1, which takes the sum of QT and QE to arrive at what I call "global liquidity flow." The annual flow

of global liquidity has been declining for months and dipped into negative territory over the summer. The chart also shows the year-over-year change in forward earnings estimates, which have also turned negative after a long deceleration. With earnings and liquidity growth being two critical drivers of stock market performers, the fact that they both dipped into negative territory over the summer is a logical explanation for why the markets struggled in August and September.

Fortunately, liquidity growth is now back in positive territory. If China can contain its currency reserves and capital flight, the flow of liquidity should continue to gain ground, thanks to the pipeline of QE from Europe and Japan and the presumed delay of the Fed's hiking cycle. But we still have to solve for what will happen to earnings growth. This is especially true given the outsized influence of energy sector earnings, which have been especially hard hit by the decline in oil prices. But the growth of liquidity is encouraging in this regard, because if global liquidity is not drying up, it is not a stretch to assume that economic fundamentals and corporate earnings growth may be on the upswing as well.

Exhibit 1 Earnings growth and liquidity growth are key drivers for equities

Global Liquidity Flow Relative to Developed and Emerging Market Equity Performance



EPS: Earnings per share. Source: Bloomberg Finance L.P., MSCI, Fidelity Investments, as of Oct. 31, 2015.

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