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MACROCOSM

I Shall Fear No Taper

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If tapering QE made last week's turbulence, then failing to taper only adds to global risk.

The present global correction ends a 71-session rally for US equities -- the second-longest period between corrections (missed it by just three days) since this bull market began in 2009 (please see the chart below). And over the last month or so we've seen the consensus come around to a version of the more optimistic outlook we adopted late last summer (see "A Major Upgrade to our Strategic Outlook" September 12, 2013). So surely this correction was due -- markets were vulnerable.

Perhaps we should leave it at that. But the suddenness, intensity and global scope of it raises important questions about our core thesis: that the era of global contagion is over (see, among many, "2013: The Year of Living Not Dangerously" December 31, 2013). And with the dominant explanatory narrative being that the sell-off was triggered by the Fed's tapering plans, it raises questions about this week's FOMC meeting. It's a

Update to strategic view

EMERGING MARKETS MACRO, EMERGING MARKETS STOCKS, US STOCKS, After a near-record run without even a small correction, markets were due for a rest and a test, so the reaction to emerging markets currency turbulence was severe. That turbulence…

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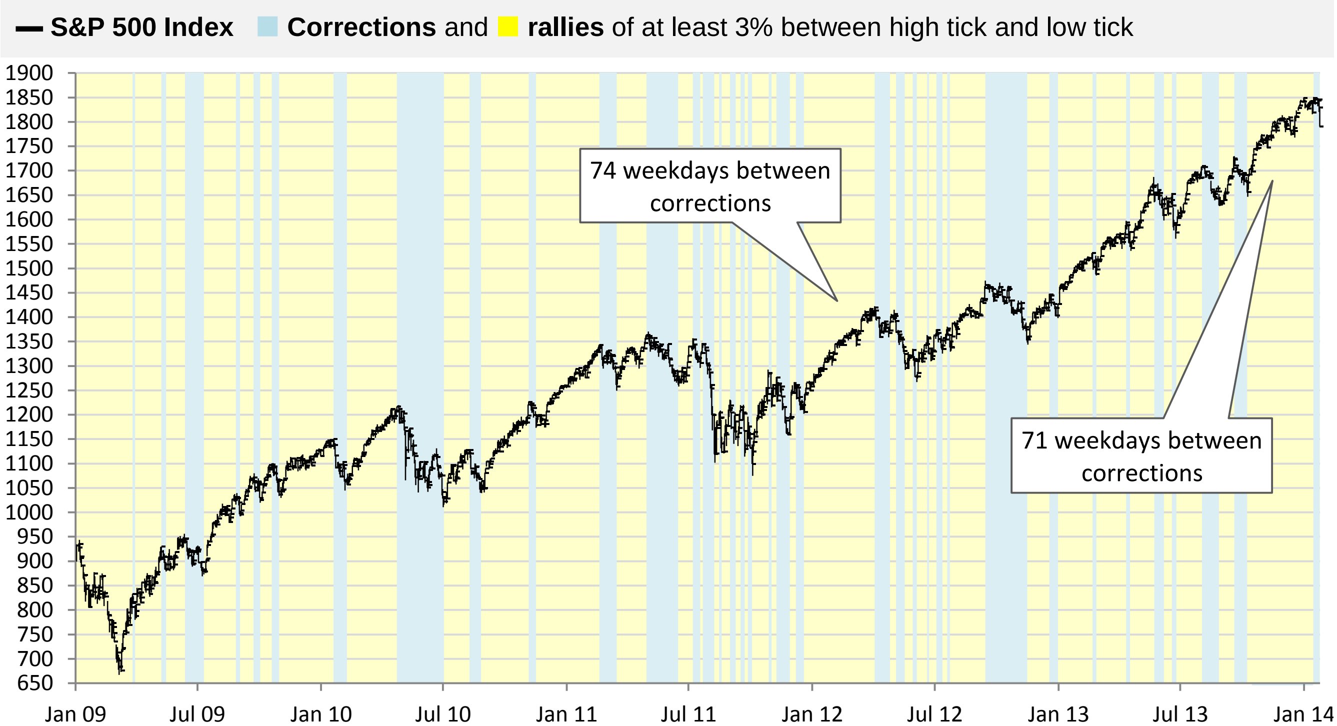

Source: Bloomberg, TrendMacro calculations critical meeting, Bernanke's last (see "Bernanke's Last Big Call" January 21, 2014). So if last week's events influence it -- they'll have an impact well beyond their own reality.

At the epicenter of the sell-off is the emerging markets -- or, more exactly, emerging markets currencies. Something of a speculative panic across EM FX began mid-week when Argentina sharply devalued the peso, and then announced an ambiguous relaxation of currency controls for domestic individuals. *What a surprise: Argentina devalued! And what a perfect event at a perfect time for a speculative over-reaction.*

- Actually, EM currency deterioration has been going on for quite a while, but with less intensity. We highlighted it last summer as the only side-effect of the Fed's announced intentions to taper Large-Scale Asset Purchases that had any credibility as a potential worry (see "A Little Distant Gunfire" August 29, 2013).
- We noted at the same time, and have been telling clients ever since, that emerging markets offer the most attractive equity risk premia (ERP), in a year when valuations have generally tightened up world-wide (see, most recently, this morning's "Data Insights: Global Equity Risk Premia").
- *We said this means that the EMs are both the riskiest markets, and the markets in which you are prospectively being paid the most to take that risk.*
- *But last week demonstrates a critical catch: the ERP is a local-currency phenomenon. It measures the relative value between stocks and bonds priced in a single currency, without regard to the value that currency itself with respect to any other currency.*
- Indeed, in local currency terms, even after last week's bloodshed, most of the hardest-hit markets are above their lows established in the taper panic last summer -- especially Argentina, the locus of the worst volatility last week (please see the chart below).

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…isn't a positive development, but we don't think it implies any real threat of resurgent global financial contagion. In local currency, equities in emerging nations have performed surprisingly well. Once this speculative over-reaction has passed, confidence will be enhanced -- an ideal outcome for emerging markets' growth prospects.

US FED: The FOMC on Wednesday is in a bind. If it believes tapering caused last week's sell-off, and that it is systemically threatening, then Bernanke may be obliged to defer further tapering. But that would increase future systemic fragility, especially as it squanders his last opportunity to establish a "measured" pattern of tapering before Yellen takes over. We continue to expect further tapering.

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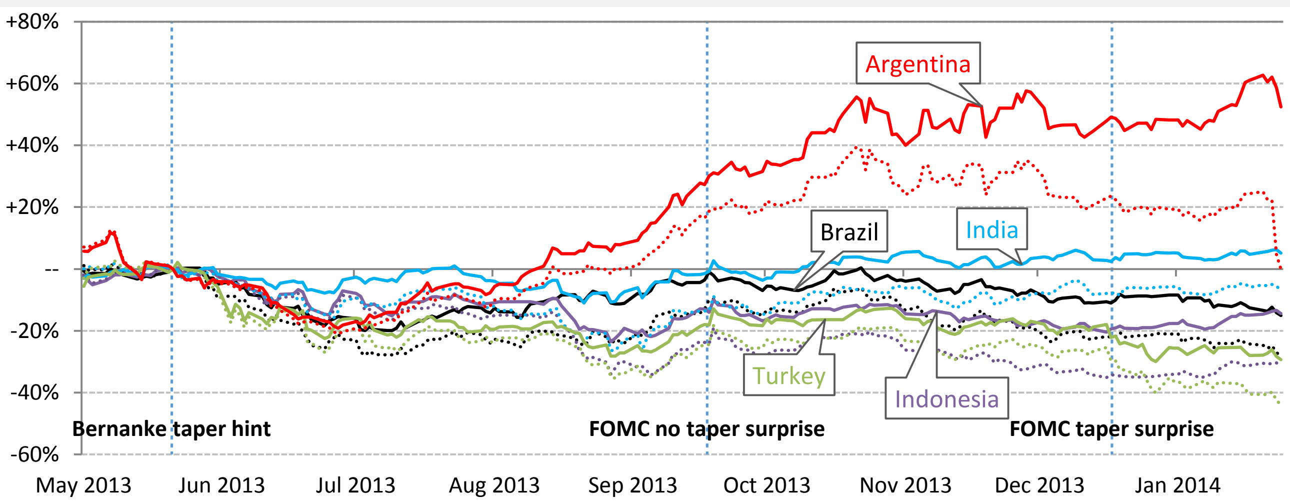
Emerging market equity performance in the taper era — Local currency ··· USD
Cumulative from May 21, 2013, the day prior to Bernanke's first taper hint



Source: Bloomberg, TrendMacro calculations

Which brings us to the critical judgment of whether last week's events imply the re-emergence of global systemic risk.

- At this time we don't think they do.
- *To be clear, we are not brushing these events away as inconsequential. We are not saying they are good things. On the face of it, they are bad things, at least to some extent. But it makes all the difference strategically to correctly draw the distinction between things that are merely bad, and things that are both bad and systemically contagious.*
- The world's economies are intertwined and always have been, so synchronized global market moves like last week's are business as usual. But true systemic risk -- as the markets have experienced it in the Great Recession and its aftermath -- is about financial contagion: that is, cascading fire-sales and defaults that threaten the very existence of fundamental institutions.
- *What, really, is existentially threatened by emerging market currencies weakening?*
- *For goodness sake!* How many times during the euro area crisis of 2010-2012 did we have to hear from influential sources such as Nouriel Roubini how debt-burdened nations like Greece could "quickly restore competitiveness and growth" with "Argentine-style measures" -- that is, leaving the euro and then devaluing a new currency. If "Argentine-style measures" would have been good for Greece then, why should they be a global threat if Argentina itself, or other emerging markets, employ them now?
- The "Asian flu" of 1997 and 1998 swept across all the emerging markets because, at that time, their *economies* shared all the same structural vulnerabilities. Today they are quite diverse.
- For example, Turkey enjoys a fiscal profile that any nation should envy. So for all its present political trouble and currency weakness, it was easily able to get off two major government bond sales last week, one in dollars and one in euros, both over-subscribed, and together taking out half its 2014 financing needs.
- The "Asian flu" was transmitted to markets through homogeneous and highly leveraged speculations, typified -- but by no means limited to -- Long Term Capital Management. After the near-death learning experience of the banking crisis of 2008-2009, we don't think the speculative environment is that fragile now. Even if it were, we know now what we didn't know in 1998 -- that the central banks of the world stand ready to intervene.
- Remember, over the last year we've already been through several tests of global financial fragility. There were shudders, to be sure. But global markets ended up easily enduring last year's Cypriot bank bail-in (see "On the Cypriot Depositor Bail-in" March 17, 2013) and the inversion of the short-term Treasury curve during the US debt default scare (see "Down to the Wire, and Beyond" October 15, 2013). From our perspective those two episodes were far more systemically ominous than another in a long history of Argentine devaluations.
- The tail-event from the emerging markets that has the highest potential to trump all these considerations would be a financial

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crash in China. Indeed, a somewhat weak flash HSBC Purchasing Managers Index announced overnight before the Thursday US trading day closely preceded the intensification of the global sell-off.

- The China crash narrative has been a staple bear case in the nervous aftermath of the 2008-2009 crisis. While all the others have peeled away one by one, this is now the only one we hear frequently from clients. We have respect for it as a possibility, perhaps all the more because news, information and data from China are so opaque. But we see no sufficient reason to think that it is happening right here and right now.
- For example, last week the potential default of a high-yield retail wealth management fund managed by China Credit Trust fueled worries about fragilities in China's so-called shadow banking system. But this morning it seems the fund's investors will be bailed out, with the source and the terms of rescue still unclear.
- *Ruling out that tail-risk, we think last week's events are largely a speculative over-reaction that will burn itself out quickly. This will bolster the global economy's confidence that the era of financial contagion is over, enabling higher levels of risk-taking leading to accelerating global growth -- and you couldn't ask for a better environment for emerging markets than that.*

When the FOMC meets Wednesday, all these issues will be very much front and center. And they put the Fed in a difficult bind.

- We know that the Fed is not unsympathetic to the idea that the tensions in emerging markets are a result of the onset of tapering. The EM/QE nexus was something of a theme at the Kansas City Fed's Jackson Hole conference last summer (see, among others, "Global aspects of unconventional monetary policies" Charles Bean, panel remarks, August 24, 2013).
- And we know that the Bernanke agreed to undertake QE3 initially (see "Rethinking QE3" September 18, 2012) and to defer tapering last autumn (see "On the September FOMC" September 18, 2013) because of perceived systemic threats.
- At the same time, we know that Bernanke has come to believe that LSAPs are themselves becoming a source of systemic risk -- with "drawbacks… including the risk of impairing the functioning of securities markets" as Bernanke puts it -- in exchange for a "pretty small" economic fine-tuning benefit, again as Bernanke puts it.
- *So if the Fed concludes that tapering is responsible for last week's EM currency turbulence -- and further, that this turbulence poses a global systemic threat -- then it will be tempted to defer tapering. But that would be to continue undiminished a program which itself poses a global systemic threat.*
- Bernanke will face this daunting choice knowing that this week's meeting is his last chance to embed a consistent pattern of "measured" tapering moves -- as the December FOMC put it (see "On the December FOMC" December 18, 2013).

- This will hand his successor Janet Yellen -- left to her own, likely to continue LSAPs *ad infinitum* -- with a policy *fait accomplis* (again, see "Bernanke's Last Big Call").
- It's going to be a close call, but we still think the FOMC will decide to taper another $10 billion from monthly LSAPs, divided $5 billion each between Treasuries and MBS.
- We know Bernanke believes and accepts that tapering will move markets -- and that there may be some minor degree of contagion involved. In a November speech, he described the summer's back-up in yields following his first taper hints as reflecting "an unwinding of levered positions…together with some knock-on liquidations of other positions in response to investor losses and the rise in volatility." Emerging markets suffered at the same time, and arguably for the same reason (again, see the chart above).
- But he went on to say that this "may have had the benefit of reducing future risks to financial stability and, in particular, of lowering the probability of an even sharper market correction at some later point."
- *So we think that Bernanke would have to regard last week's EM currency disruption as especially threatening to global financial stability to justify taking the likely greater long-term risk of allowing speculative imbalances to accumulate.*

So when we say in the title of this report that we "fear no taper," we mean it in both senses of the expression.

- *We are not afraid of tapering.*
- *We are afraid of not tapering.*

Bottom line

After a near-record run without even a small correction, markets were due for a rest and a test, so the reaction to emerging markets currency turbulence was severe. That turbulence isn't a positive development, but we don't think it implies any real threat of resurgent global financial contagion. In local currency, equities in emerging nations have performed surprisingly well. Once this speculative over-reaction has passed, confidence will be enhanced -- an ideal outcome for emerging markets' growth prospects. The FOMC on Wednesday is in a bind. If it believes tapering caused last week's sell-off, and that it is systemically threatening, then Bernanke may be obliged to defer further tapering. But that would increase future systemic fragility, especially as it squanders his last opportunity to establish a "measured" pattern of tapering before Yellen takes over. We continue to expect further tapering.