Beware of backward looking economic numbers

Last week was a good summary of the policy divergence across the world right now. While the central banks of Japan, the US and the UK announced they were reducing monetary stimulus amid stronger economies, the Reserve Bank of India hiked rates to halt financial outflows and because of higher inflation.

The RBI is the latest in a string of emerging market central banks to take such action even as inflation in these nations is being driven by weakening currencies and higher import prices, rather than an overheating economy.

In fact, there are many signs that the economic trajectory India is embarking on is far from positive. Annualized industrial production growth was 3.2% in May, compared to the recent peak of 8.5% in November. Credit growth has been weak as banks continue to grapple with some of the worst levels of non-performing loans in the world and borrowers balk at rising interest rates.

Inflationary pressure is also subsiding. Brent crude prices have dropped 8.3% since 30th June and the government has reduced the goods and services tax rate. Plus, monsoon rainfall has caught up, suggesting the harvest will be sufficient to keep food prices in check.

Even knowing all that, the RBI increased the repurchase rate by 25 basis points to 6.5%. The reason had less to do with the domestic economy. If the central bank had chosen not to hike, the Indian rupee may have suffered badly as the market had priced an 80% probability of a rate increase ahead of the meeting.

That may sound perverse but it is a sound approach. Increases in oil and food prices feed into inflation mostly through the currency, as they impact India's balance of trade and push the rupee down. By defending the rupee, RBI governor Urjit Patel was executing his mandate to keep inflation in check.

The RBI move did not prompt a strong appreciation of the rupee because it was mostly priced in. A surprise 'rates on hold', however, could have weighed on the Indian currency significantly.

The perfect example of what could have happened had Mr. Patel not chosen the hawkish path is Turkey. The nation's inflation was running at 15.4% in June, but the central bank chose not to increase its repurchase rate from 17.75% in its last meeting in the end of July. Investors had expected a hike and when it did not materialize, they exited Turkish assets in droves prompting a one-day 3% drop in the currency, which is now down 30.6% in the past year.

By delivering two consecutive hikes just as inflation looks to be easing, Mr. Patel has also given himself room to leave rates unchanged for a longer period and even, perhaps, reduce them within the next year as the currency stabilizes.

That tension, however, encompasses all the troubles facing emerging markets at the moment. The central banks of the nations with the most widely – and safest – currencies in the world are prompting a mass exodus from the riskier countries as they roll back a decade of excess money-printing. In the past year, US-focused exchange-traded funds received US$263.2 billion of net new money, while those investing in Japan took US$60.2 billion. That came at the expense of emerging markets.

Direct investment in developing nations dropped to 3.7% of GDP in 2017 against previous forecasts of 4.2%, according to the International Institute of Finance (IIF), which tracks capital flows ranging from money spent on factories and roads to investments in stock and bonds of developing nations. This year, the IIF forecasts foreign direct investment into emerging markets will drop by some US$ 43 billion. This helps explain why the FAB Asset Allocation Committee currently favors stock markets of developed countries over emerging.

"EM weakness may endure as the dollar strengthens and key central banks tighten monetary policy."

In fact, the Federal Reserve showed no sign of slowing down its rate hike schedule in its latest meeting, concluded last Wednesday. The central bank even upgraded the word it used to describe US economic growth to 'strong' from 'solid'.

The Fed's stance found confirmation in the unemployment numbers released on Friday. While the 157,000 new non-farm jobs the US added came in below consensus expectations of 193,000, the Labor Department revised the job creation numbers for June up by 24,000 and by 35,000 for May. The US unemployment rate also dropped below 4%, to 3.9%, only the eighth time that has happened since 1970.

The jobs number compounded with the 4.1% annualized rate at which US GDP expanded in the second quarter to show that the US economy is, indeed, strong – or perhaps 'was' strong.

Both the jobs and GDP reports, though, are backward looking. And there were some particular issues that may have boosted those numbers and beg questions as to how sustainable they may be going forward.

GDP, for instance, was mostly driven by an acceleration of exports. That item could have been boosted by US companies creating global sales orders ahead of expected tariffs that resulted from the trade war and which were first implemented on 6th July. If that is the case, that part of GDP may slow down significantly in the third quarter. Indeed, the Institute for Supply Management new manufacturing export orders index, a preview of future exports, dropped in July after seeing its highest number for June on record.

This is, perhaps, the first indication of what kind of impact the growing trade war may have on the US economy. Export-oriented sectors of the economy are particularly sensitive to further pain as President Donald Trump last week announced he is considering applying 25% tariffs to some US$200 billion more of Chinese goods.

From West to East

Weekly Investment View
5th August, 2018

"As the trade rhetoric heats up, sectors that focus on the US domestic economy could outperform exporters."

However, even the domestic economy could be slackening a bit. The second quarter GDP report showed that imports increased at a slower pace, usually a sign of slowing demand in the US – although personal consumption accelerated. Forward-looking numbers, so-called leading indicators, are not looking as good as their rearview peers. The ISM report on business new orders, a key gauge of what companies will look to produce in the coming months, dropped 5.2% to 60.2 in July, the steepest fall in 15 months. The Conference Board's consumer confidence index, often seen as the most important measure of future demand in the US, has dropped for four of the past five months. The index was at 101.7 in July, down from 109.2 in February, while CEO confidence fell two percentage points in July. On the jobs front, the Conference Board's Help-Wanted Online index, a measure of expected job creation, dropped in both June and July.

All of this does not mean there is a US recession around the corner, though. Most numbers, particularly unemployment, continue to show a strong economy. However, the leading indicators suggest the current pace is unlikely to hold. And the Fed will be watching for signs that the US is slowing down and by how much. If the bad news compounds by September, when the central bank is expected to hike rates again, the Fed could slacken the pace at which it is normalizing rates.

Such a move could put a floor under the losses being suffered by emerging market currencies and precious metals, which tend to move in the opposite direction to the dollar. It could also cap the rise in US Treasury yields and, by proxy, limit the downside in fixed income generally.

The yield on the 10-year US Treasury, for instance, has not breached 3% consistently even as the US benchmark rate has been increased to 2%. That failure to rise suggests investors may be skeptical about how much higher the Fed can hike.

Buyers of UK assets are expressing similar skepticism. While the Bank of England surprised markets by voting unanimously to hike its benchmark rate to 0.75% last week and signaled that 'normal' rates may be in the 2%-3% ballpark (hence, several hikes away), the British pound ended the week 0.8% weaker. The market seems to be betting that Brexit, and in particular an exit from the European Union without pre-agreed terms, could have a serious impact on the UK economy and that, by this time next year, the benchmark rate may be unchanged or even lower.

As emerging markets fixed income goes, oil-producing nations in the Gulf Cooperation Council are in a special position. While their economies could suffer from rising dollar interest rates – which affect borrowing costs in pegged currencies such as the Kuwaiti dinar or the Saudi riyal – the main source of wealth in these countries, oil, is well-supported.

The Brent crude price fell 1.5% last week to US$73.2/barrel, but remained in the US$72-US$80 range it has held since mid-April. It could remain within that band for a while still, and seems unlikely to breach the US$65-US$90 range the FAB AAC has forecast for the rest of this year. If anything, the risk remains to the upside. The US, Saudi Arabia and Russia are pumping oil at a record rate, and yet, prices have failed to drop significantly. That is a sign demand is strong while there is little room for supply to increase in the short-term.

Meanwhile, US sanctions on Iran begin to be implemented this week, promising not only less Iranian oil but more political uncertainty in the Persian Gulf. On Sunday, Iran's Revolutionary Guards confirmed they had been doing war drills in the Gulf, just as the battle of words between Presidents Hassan Rouhani and Donald Trump escalated. The same Revolutionary Guards called on Mr. Rouhani to stem the depreciation of the Iranian rial, which hit a record low against the dollar last week and prompted a rescue package on the weekend. Additional turmoil in the country could boost oil prices.

The current range is helping countries such as the Sultanate of Oman, where the budget deficit between January and May was almost half that of the same period in 2017. If the trend continues, the country could avoid a downgrade to junk from either Fitch Ratings or Moody's, which have it at the lowest-rung of investment-grade and with a negative outlook.

Similarly, the Kingdom of Bahrain, which has been on the crosshairs of investors, has seen its foreign exchange reserves climb to US$2.2 billion, the highest this year, suggesting less concern about how the country will face a US$750 million bond repayment in November. At the same time, on Friday the government in Manama rejected a parliament proposal to increase allowances to citizens, in a sign that Bahrain is keeping a lid on expenses. That was not enough to stop Moody's from downgrading the Kingdom's debt to B2 on Friday. Again, rating agencies are lagging indicators and the picture is much rosier ahead than it is in the rearview mirror.

The biggest boost to GCC bonds, however, may be yet to come. JP Morgan is currently asking investors whether it should include the region's bonds into its Emerging Markets Bond Index. Given the size of outstanding liabilities, GCC bonds could comprise as much as 12% of the index. Funds following the index could further boost bonds in the region. A decision could come as early as September, when the index provider usually announces the annual rebalancing of the benchmark.

"EMBI inclusion could boost GCC bonds just as oil prices help the region."

INVESTMENT SUMMARY: The S&P 500 ended the week 0.76% higher, its fifth consecutive weekly gain amid excitement over the US economy. The NASDAQ 100 index reversed losses from the previous two weeks, finishing 1.35% higher boosted by better-than-expected numbers from Apple, which became the first US company to achieve a US$1 trillion market cap.

On the other side of the world, the Chinese yuan continued its slide, ending the week at 6.8270/US$, pushing the CSI 300 Chinese stock index down by 5.9% for the week.

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