Insight beyond information

EXECUTIVE BRIEFINGS
POLITICS AND ECONOMY: GLOBAL EXPANSION

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After seven years of sunshine

A few weeks ago I received a note from a reader based in America, complaining that my cautious position on the world outlook was bordering on needless pessimism. This was ostensibly in response to a piece I wrote in February entitled 'In a sea of crosswinds'. I had argued then, as I will now, that the risks to the global economy remain heavily weighed on the downside.

It is true that in February 2016, financial markets rallied across the world and bond spreads in America, which has risen from 1.6% to 2.2% recovered to 1.56%. Promisingly, emerging market spreads, too, dropped from 5.5% to 3.9%. Commodities, including Brent and iron-ore, made significant gains. Even emerging market currencies such as the Russian Rouble, South African Rand and the Brazilian Real, endorsed recoveries of 15-20%. They had previously crumbled, declining between 30% and 50% over the past year. Be that as it may, what is there to like about South Africa, Russia or indeed Brazil with their withering economies and dysfunctional politics? The reasons for the recovery have nothing to do with any structural shift in the economic outlook, but rather are based on factors that are external, fickle and unreliable.

It all started at the G20 meeting in Shanghai where China pledged to hold the Yuan. Then it clamped down on capital outflows, began a colossal spending programme and sanctioned faster credit growth. A surge in commodities followed on the premise of a construction boom. Commodity-based currencies such as the Rand, Real and Rouble consequently recovered. The second factor that brought cheer to markets was the United States' Federal Reserve receding from its previous commitment to deliver four interest rate hikes, since the first in December 2015. The markets predictably jumped on the continuance of a cheap money policy. The dollar fell against major currencies and emerging market securities attracted sizeable sums of capital, based on their relatively higher yields.

These conditions may yet prevail for a while but not indefinitely. The debt build-up in China is unsustainable at over 250% of GDP, with the bulk of it constituted by private borrowers. Second, the Fed is bound to eventually resume monetary tightening and begin the unwinding of its bond-buying programme. These will lead to capital outflows from emerging markets creating pressures on their currencies and more worryingly, leading to tighter liquidity. The initial stampede actually began in May 2013 with the 'taper tantrum' and those countries that were dependent on foreign capital were the hardest hit. Things are better now as a few emerging market economies, over the years, adjusted their trade imbalances, but only just. As a hedge-fund manager so persuasively put it, 'even the dogs have rallied'. Investors have a tendency to dump stocks at the first signs of panic. Rich Asian economies such as Singapore, Taiwan and South Korea are at greater risk because of their trade linkages with China. Still others such as Malaysia and Thailand are overly exposed to a rapid credit build up and may fall into a trap if their economies slow any further. The better off include Russia (having faced the worst, it can only recover), India (with limited exposure to China and moderation in credit growth) and Indonesia (with falling trade imbalances). If these nations now constitute the high-performers amongst emerging markets, it doesn't say much to induce investment appetite.

The economic expansion cycle in America will be 7 years old in June 2016. Usually 10 years is about as long as expansions have historically lasted. Janet Yellen, the head of the Federal Reserve, recently remarked at a press conference that 'it is a myth that expansions die of old age'. But the fact is expansions do die and the probability of a recession increases with the length of the recovery. Cycles of growth and recession are a part of life and the global economy – led by the US – has been chugging along nicely for one too many years. A nasty mishap anywhere can change this. That aside, with robust labour markets, the Fed will eventually have to hike interest rates. When it does, it will trigger open the floodgates in emerging markets and capital will flow out rapidly with evaporating liquidity and balance of payment problems.

Policy tweaks work with a lag and every tremor cannot be predicted. A nasty one can create a recession before governments and central banks can respond. Moreover, it is unlikely that G20 governments and central banks can work in sync rapidly enough towards an effective response strategy should calamity strike. Notwithstanding the recent cheer, the financial markets are nervous. They should be.

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