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The illusion of policy divergence

Dr Robert Gay | Fenwick Advisers | 30 December 2015

> What we anticipate seldom occurs: but what we least expect generally happens.
> – Benjamin Disraeli

By far the most consensual view today is that monetary policies, at least among major central banks, are headed in opposite directions. The US Federal Reserve is tightening while both the ECB and BOJ are trying to double-down on quantitative easing (QE). Even the PBOC is perceived in some circles as a potential candidate for the dubious honor of embracing unconventional policies.

The upshot of this supposed divergence is a disturbingly universal view, constantly repeated in the media, that the US dollar will strengthen further in 2016 – taking dollar-denominated assets along for the ride. Unfortunately, the cozy comfort of this consensus thinking is an illusion that can lead to poor strategic thinking.

A better framework would begin with the mix of policies, both monetary and fiscal settings, which are moving in the direction of convergence rather than divergence. Namely, central banks are gravitating toward a real policy rate of zero and most governments (belatedly) are shifting toward fiscal stimulus.

This broad convergence in economic policies leads to some surprising macro implications, most notably, less currency volatility and more economic growth. Even a weak US dollar is a possibility as is a minor recovery in Europe. In short, do not be distracted by conventional presumptions about the Fed's tightening cycle and interest rates. The ultimate bogeyman of this investment cycle will be credit quality and the warning sign will be when banks tighten lending standards.

THE TENUOUS LINK BETWEEN THE FED AND THE DOLLAR

When central banks are out of sync – especially with the Federal Reserve – currencies do tend to revalue, usually in favor of the country offering higher real interest rates. The reason, of course, is that the differential in interest rates is an irresistible lure for the legions of carry traders, from banks to hedge funds, in the fluid world of globalised capital markets.

There are caveats to this sacred tenet, however. First, the interest rate differential must be sufficiently large to offer outsized returns. Small differentials do not have enough juice, even with the help of leverage. Second, asynchronous policies must be perceived as long-lasting.

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A short horizon doesn't work. So, whatever forces are believed to be causing the divergence in monetary policies must persist even as the favored currency appreciates.[1]

Neither of these conditions fit the Fed's policy in recent years which proved to be stubbornly accommodative. Figure 1 shows a popular measure of the dollar's strength (DXY), a weighted index of the dollar's value versus six other major currencies.[2] The magnitude of the move has been substantial – more than 25% from an index level of about 80 in mid-2014 to 98 today. Throughout this period, the Fed's policy rate was essentially zero and real interest rates were negative. Moreover, fiscal policy was mildly restrictive as economic recovery shored up tax revenues and held down economic growth. Normally, that policy mix would be a classic prescription for a weak currency – namely, a loose monetary policy does not attract capital inflows of hot money and fiscal drag squashes expectations that the central bank would need to tighten monetary policy anytime soon.

Figure 1: DXY – Weighted US dollar index

Source: Bloomberg.

Investors apparently favored US dollar assets for other reasons. For one thing, Europe's problems were legion – no growth, a defective financial architecture, lack of fiscal union, inflexible labor practices, ineffectual bank regulations – and at least one insolvent member in Greece. In comparison with the euro, the US dollar seemed to be an attractive safe haven at any price. The yen also looked like a basket case in the face of a government-sponsored agenda to weaken the currency. Global investors wanted exposure to US dollars, Treasuries and property – all of which looked cheap relative to their overvalued markets at home. Even equity investors who correctly saw value outside the US could have the best of both worlds, as European and Japanese equity ETFs increasingly were hedged into US dollars thanks to the low cost of currency hedging in a world of zero interest rates.

In short, the US dollar defied gravity and traditional policy fundamentals because it was the only game in town. The rest of the world was even worse off with no engine of growth. That

perception was reinforced when commodity prices belatedly collapsed this year, taking the overvalued commodity currencies down as well.

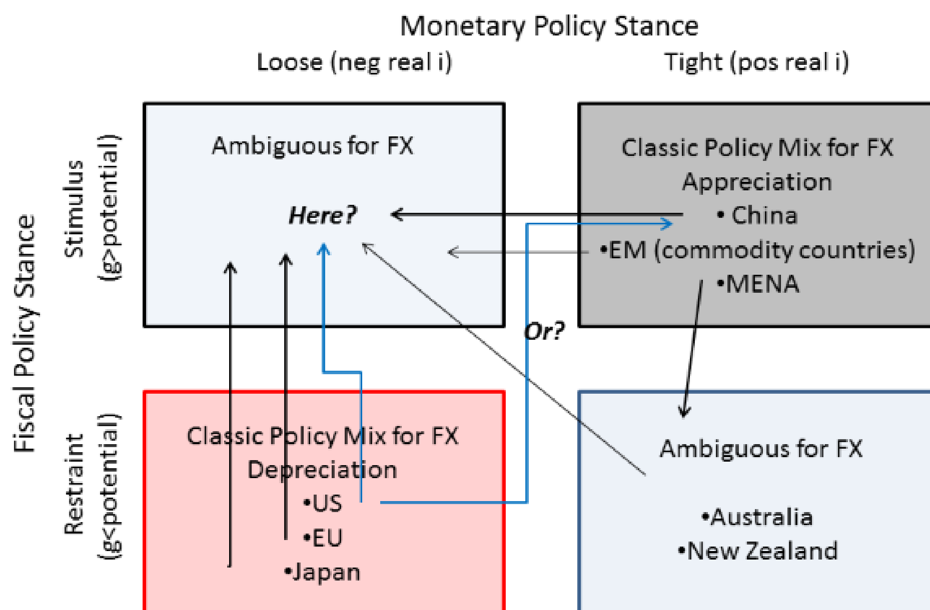
POLICY CONVERGENCE

Figure 2 depicts the four possible combinations of monetary and fiscal policy and characterise their implications for currencies.

The lower left-hand box shaded in red represents the state of most western industrialised economies over the past two years. Monetary policies were exceedingly accommodative and fiscal policies were tight – a classic prescription for a weak currency. Both the euro and yen succumbed to that mix, whereas the US dollar by default became the currency of choice.

The upper right-hand box shaded in black represents tight monetary policies and loose fiscal policies – i.e. high real interest rates an alternative source of stimulus for the economy – which together encourage currency appreciation. China and many commodity producing countries fit that mold until this year. Granted, positive real interest rates at home did not deter these countries from accumulating vast amounts of debt often denominated in US dollars, which only means that central banks were not vigilant enough. And, indeed, the currencies of those countries in general appreciated until their engines of growth dissipated this year.

Figure 2: The Policy Mix (as of Mid -2014)



Source: Fenwick Advisers

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The other two combinations of policies – loose monetary policy accompanied by fiscal stimulus and tight monetary policies counterbalanced by fiscal restraint – tend to ambiguous for the currency, at least in the absence of other compelling drivers. Australia, New Zealand fit this mold until commodity prices collapsed – their currencies had appreciated for other reasons, including the commodity and property booms emanating from China's industrialisation.

Note that no major countries seemed to fit into the upper left-hand box, because few countries maintained fiscal stimulus for long after sovereign debt rose sharply during the Great Financial Crisis. Indeed, what is striking about Figure 2 is concentration of policies at the two extremes with one group fanning the fires of appreciation and the other seemingly making every effort to devalue their currencies. The only inconsistency with this framework was the US whose currency, as the common denominator of the commodity boom, first devalued against most currencies in the early years following the financial crisis as one might expect when the Fed took the lead on monetary stimulus. The dollar's reversal since mid-2014, however, has to do more with the failings and policies of other nations rather than the Fed's recent change in course.

Circumstances are changing in 2016 and the greatest of those changes is the shift to fiscal stimulus by most industrialised nations including the US, EU, Japan and China which collectively account for almost three-fifths of world GDP. The arrows in Figure 2 depict those changes in policies. Note that most countries have moved to a policy mix that is ambiguous for their currencies, with many of them gravitating to the upper left-hand box – in other words, toward policy convergence.

If global growth continues to be sluggish in the years ahead, that policy combination – loose monetary policy and fiscal stimulus – may be the only viable option for most countries. The other possibility will be major structural reforms that are likely to take more time than this investment cycle will allow.

Again, the question is how to characterise the Fed's prospective normalisation of interest rates, as depicted by the two blue arrows. Dollar bulls would argue the arrow should go to the upper right-hand box. I contend that the most we can expect is the upper left-hand box. The debate centers on the Fed's target for the neutral policy rate. Past experience would put that rate at 3.5% to 4%. I argue that current circumstances warrant no more than 2% to 2.5%, or about the same as the target inflation rate. Other countries have other neutral rates but the story is much the same: in a world of plodding progress on growth and huge environmental challenges, all central banks are destined to target a real neutral rate of zero and governments will be forced to cut waste and to redirect resources to efficient uses. Real interest rates of zero do not constitute a 'tight' monetary policy sufficiently compelling to attract massive capital flows.

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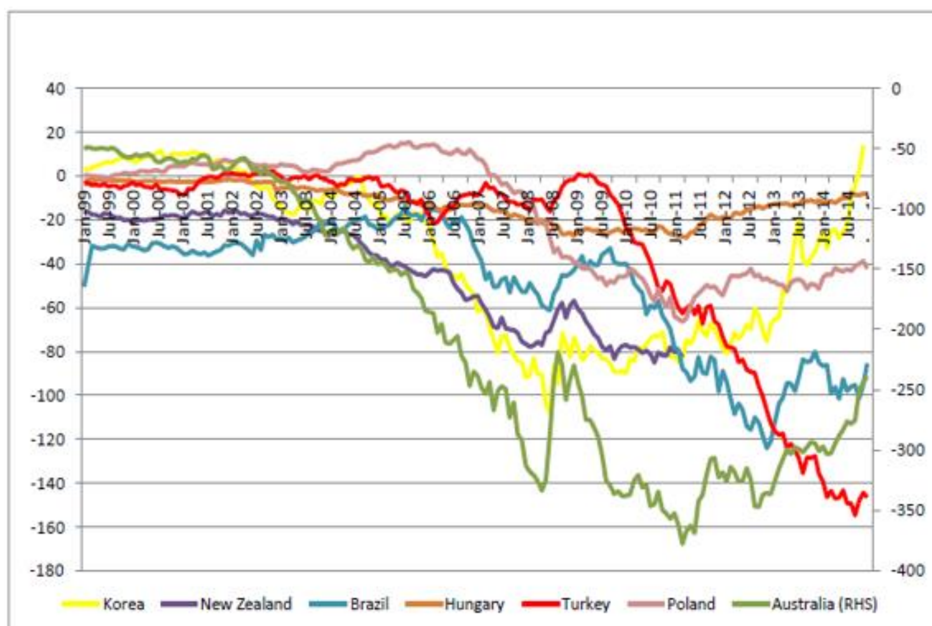
IMPLICATIONS OF POLICY CONVERGENCE

When macro policies diverge for extended periods, asset prices become distorted and entire banking systems often get out of whack. Disparities between local borrowing costs and those abroad become irresistibly large and banks as intermediaries are eager to profit from sourcing low-cost funding abroad.

The consequence can be dangerous, however, especially for debtor countries. Figure 3 shows the net foreign liabilities of domestic banks in seven countries, all of which were popular sources for carry trades over the past decade because of their high real interest rates. As banks, or their customers, borrowed increasing amounts in US dollars, Euros or Yen, their net foreign liabilities rose, sometimes dramatically, leaving a currency mismatch on bank balance sheets. When currencies depreciate suddenly for whatever reason, banks are caught wrong-footed as the cost of liabilities rise and are forced to tap the central bank for hard currency. The three commodity countries – Brazil, New Zealand and Australia – plus Turkey have experienced huge depreciations of 25% to 50% this year since commodity prices have collapsed.

Figure 3: Bank Liabilities, Carry Trades and Currency Crises
Bank net foreign liabilities – key recipient countries (US$bn)



Sources: IMF and Pi Economics

Two others – Hungary and Poland – saw their currencies depreciate 25% to 30% in 2014 as 'hot' money sought safer havens. Only South Korea has managed to avoid the currency volatility of recent years, in part because it had weaned its banks from their foreign liabilities by cutting interest rates early (2009) and keeping real rates low (essentially zero) since then.

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It can take years to realign bank balance sheets. South Korea managed to do so in three years thanks to its net creditor status with the rest of the world and an ongoing current account surplus. All the rest are net debtor countries with fewer options.

Volatile exits from carry trades are just one example of distortions to asset prices that occur during extended periods of negative real interest rates. Another prominent example prevalent since mid-2014 had been the widespread currency hedging of equity ETFs. When short-term interest rate differentials are small, as has been the case among the QE Club of central banks, the cost of hedging FX exposure is very low. Purveyors of ETFs recognised this free option and offered hedged (into USD) versions of their European and Japanese products – notably, equities whose valuations were widely seen as much cheaper than those of US companies over the past 18 months. These products were hugely successful and demand for the products still is strong, which means there is a strong demand for the hedge as long as the Fed stays at zero. When the Fed hikes, though, the cost of the hedge will rise and the 'free ride' in hedged ETFs will fade. I believe this creative bit of financial engineering has been a key driver of the strong USD and what we see now is a last flurry of hedging before the game is up. If so, the euro is near a bottom and the USD is nearing a top until something else changes. The same can be said of the yen. Note that both the EU and Japan also have sizeable current account surpluses. Indeed, Europe's surplus at 2.5% of GDP now exceeds that of China. As such, both currencies have the payment flows in their favor.

By contrast, emerging currencies are a mixed bag. Many are oversold, including the Mexican, Chilean and Colombian pesos – all those countries have net foreign liabilities less than 50% of GDP, even though their companies have borrowed heavily in US dollars. On a longer view, currencies of heavily-indebted countries will labor under the weight of debt and weak balance of payments.

The main message, though, of greater policy convergence at least among the major countries is that some semblance of stability will return to currencies, commodity prices and even equity markets in 2016. The danger will come when banks begin to tighten lending standards and the availability of credit dries up. This cycle-ending development will not happen concurrently as the Fed normalise interest rates – indeed, it often occurs with considerable delay and only after banks experience a sharp rise in defaults and late payments. This has yet to happen on a broad scale either in Europe or the US[3] – only energy sector loans are in trouble. When lending standards do tighten as they inevitably will, beware that the next shoes to drop are credit spreads and equities, in that order.

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ENDNOTES

1. Herein lays the scourge of every carry trade – valuations do change and the trades become unsustainable, without exception. The only questions are what will be the catalyst that spells doom for any particular carry trade and how will it manifest itself – with a graceful unwind or a rush to the exit.

2. DXY is an index of the value of the US dollar relative to a basket of foreign currencies of major trading partners: euro (57.6%), yen (13.6%), British pound (11.9%), Canadian dollar (9.1%), Swedish krona (4.2%) and Swiss franc (3.6%).

3. Australia is the only country where banks have reported a broad tightening in lending standards which is not surprising given the heavy concentration of borrowers in commodity industries.

Dr Robert Gay is managing partner of Fenwick Advisers, a financial consultancy serving global investment banks, hedge funds, and other fund managers and financial institutions including fixed income manager, Stratton Street Capital. Prior to forming Fenwick Advisers, Dr Gay served as international economist and global strategist Morgan Stanley, Bankers Trust and Commerzbank AG. He spent eight years as Senior Economist with the Board of Governors of the Federal Reserve System in Washington, DC, primarily during the chairmanship of Paul Volcker.

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