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What's causing the panic?

Anatole Kaletsky | GaveKal | 04 February 2014

What's causing investors to panic (or return to rationality, depending on your point of view)? There are probably as many explanations as panicking investors (or rational market participants). But, many discussions with clients, other analysts and policy officials in the period since the bullish mood suddenly changed in early January, have suggested a framework for thinking about the current market mayhem. The purpose of this framework is not to identify the "true" causes of the turmoil and dismiss all the others. The objective is simply to suggest a structure for thinking about recent market events that may be helpful in assessing new evidence as it comes along.

Almost everyone agrees that the market turmoil is linked to the collapsing confidence in several emerging economies.

But why this sudden collapse? There seem to be four broad explanations:
1. Economic weakness and a possible credit squeeze in China;
2. Withdrawal of global liquidity as the Federal Reserve tapers its asset purchase program
3. Economic problems and political instability in so many emerging economies that global investors lose confidence in the entire asset class; and,
4. Weak US economic data that undermines expectations of a robustly accelerating global economy and may even point to another recession.

Whether the present volatility turns out to be a major trend-reversal, or just another opportunity to buy on dips, will largely depend on the relative importance of each of these factors and how they play out.

1. THE CHINA SYNDROME

If China's weak PMI has been the main driving cause of the present troubles, as has been widely reported in the press, then this correction should be treated as a buying opportunity for almost all risk assets. This is not because the Chinese slowdown and credit tightening are an illusion - we have been writing about them for months. But markets have long discounted relatively weak Chinese growth (in the range of 6.5% to 7.5%) and tightening credit conditions. If the fear now is of even weaker Chinese activity and even tighter credit, these are likely to be proved wrong. We believe there is little risk of Chinese growth falling much below the recent, fairly modest, growth rate and even less risk of the Chinese authorities continuing to tighten credit to the point where they risk a financial crisis.

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Figure 1: Checking the boxes – Our short take on the latest news

Fact	Consensus belief	GK Research
US ISM manufacturing PMI slowed to 51.3 in Jan, from 56.5	Worse than the expected 56.0, led by biggest drop in new orders index in 4 years	Worrying; but still above 50, and as some respondents said, weather was a factor
Spain mfg PMI rose to 52.2 in Jan, from 50.8; Greece's rose to 51.2, from 49.6	Spain's PMI was better than the expected 51.1; Greece's PMI hit 53 month high	All peripheral EZ countries now expanding; will EM weakness spoil the party?
Indonesia exports jumped +10.3% YoY in Dec, while trade surplus hits $1.5bn	Much better than the expected +1.7% rise in exports and $0.7bn surplus	Good headline in such times; but volatility to be expected given Jan iron ore export ban

Source: GaveKal

2. THE FED TAPERING

The second most popular explanation of the EM turmoil is the reduction of global liquidity due to tapering. Monetary conditions have certainly tightened in most emerging economies, but this cannot be blamed on a *global* liquidity reduction, since global liquidity is still expanding strongly without any clear evidence of decline even in the rate of expansion (the famous second derivative). Not only is the Fed still buying $65bn of bonds monthly, but the Bank of Japan is expanding its balance sheet by an average of $58bn each month, with a high possibility of even more QE from April onwards. Moreover, there is almost no chance of central bank interest rates rising in any of the G7 economies for at least another year. Why, then have liquidity conditions in many emerging economies so obviously been transformed? One possible answer is that liquidity is flowing out in response to market *expectations* of tighter monetary policy in 2015 and beyond. The trouble with this answer is that longer-term interest rates should in principle express market expectations of future tightening; but yield curves, far from steepening to anticipate tighter money, have flattened very significantly in the past month. The observation that capital outflows from EMs have accelerated, while yield curves have flattened, points to two other explanations of the present market turmoil, which seem more plausible, but are less discussed.

3. EMERGING MARKET POLITCO-ECONOMIC DEATH SPIRALS

The fact that capital is rapidly flowing out of so many EMs, even in an environment of still very ample global liquidity, suggests another source of trouble much more worrying than the withdrawal of international "hot money" - domestic capital flight. When domestic investors lose confidence in the safety of their savings, the integrity of their currencies or the stability of their economy, the scale of capital flight can be orders of magnitude bigger than anything attributable to foreign investors. That domestic capital flight has now become a major driver of the EM crises is suggested by the fact that the Russian ruble is falling as sharply as the Turkish lira. If the main risk to many EMs now comes from domestic, rather than international, capital flight, the crisis is likely to become increasingly political, as governments lose the confidence of their own citizens, and especially the relatively prosperous middle and upper classes. This sort of mutually-reinforcing interaction between financial panic and political instability can quickly degenerate into a death spiral triggering revolutions and military coups - a pattern familiar from many EM politico-economic crises. With exactly this kind of vicious circle now apparently spinning in many EM economies, from Turkey and Ukraine to Thailand and Argentina, it is hardly surprising that some investors are losing faith in the entire EM asset class. At the same time, another threat is coming into view - international contagion. This is what happened in Asia in 1997-98, with devastating results.

But, before getting too apocalyptic, we should recall the many instances in history when such EM vicious circles, instead of degenerating into death spirals, have reversed in response to quite modest improvements in domestic policy or international conditions, combined with the competitiveness benefits of devaluation. For example, India was regarded by many analysts as almost beyond salvation six months ago. Now it looks more like an island of stability in the EM tempest. It is quite possible, therefore, that the loss of confidence in EMs could be reversed, as it seemed to be in India last year or in South Africa in 2001, by cheap valuations combined with moderate policy reforms and peaceful government changes. Such benign outcomes are much more likely if global economic conditions are improving - which brings us to the last possible explanation of the negative market dynamics of the past month.

4. IT'S THE US ECONOMY, STUPID

Maybe the main reason for the sudden swing from risk-on to risk-off mode last month was simply the deterioration in US economic data, especially the shockingly weak payroll report published on 10 January. This report was considered by many observers (including myself) as an aberration, caused by statistical noise and exceptionally cold weather. Nevertheless, financial markets responded very badly to the 10 January payroll report and investors have not really recovered their nerve since then. While US equities enjoyed a few brief rallies after 10 January, based on more positive US data such as last week's fairly strong GDP figures, US treasury bond yields and EM assets of all kinds have fallen steadily and rapidly since the

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December payroll debacle.

Even though the January US payrolls were almost certainly misleading, the market reaction they triggered should not be too surprising. It may seem absurd that one erratic and often inaccurate indicator has such power to drive markets, but this has been the clear experience since 2009. As we have repeatedly pointed out, this single data release has more or less determined the direction of financial markets the world over (see Discretion And Valor On Wall Street). It seems that investors are simply not prepared to believe that the global economy is improving unless the US can produce roughly 200,000 monthly payroll growth. It is possible, therefore, that the necessary and sufficient condition for the bullish trend in global financial markets to resume is simply a re-acceleration in US job creation. Only payroll growth seems to be acceptable to investors as a confirmation that the US economy is still improving and that the global economy, including the emerging markets, will eventually follow.

So here is a simplistic theory, which can be tested on Friday this week: If US payrolls come in above 200,000, the US and European equity rallies will resume and even the emerging markets will at least stabilise. If, on the other hand, the US produces another weak payroll figure, say below 150,000, this will unleash panic in risk-assets around the world.

And, another such bout of panic would, in turn, increase the danger of politico-economic death spirals in several emerging economies. The theory that a single erratic and unreliable US data point could make a life-and-death difference to the world economy may seem absurd. But the extreme market reaction to Monday's US purchasing managers' figures suggests that, although this theory is over-simplified, it is not altogether absurd.

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