What QE cannot do

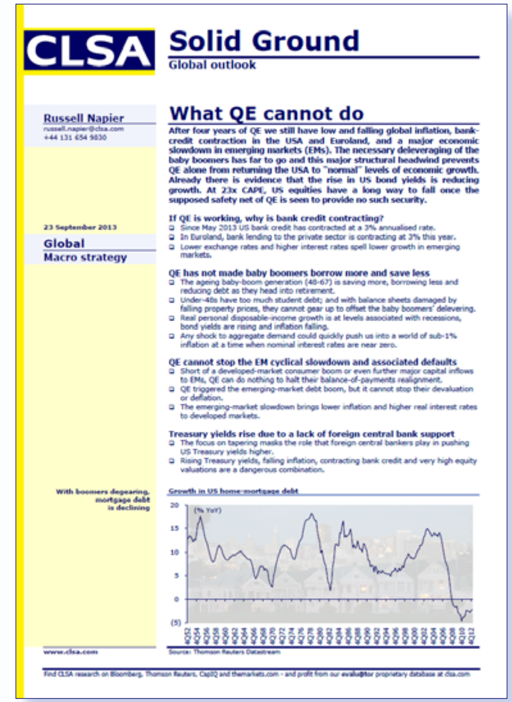
An EM crisis and deflation

Russell Napier

Strategist

23-27 September 2013

CLSA 20th Investors' Forum 2013



Solid Ground

Global outlook

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23 September 2013

Global
Macro strategy

What QE cannot do

After four years of QE we still have low and falling global inflation, bank-credit contraction in the USA and Euroland, and a major economic slowdown in emerging markets (EMs). The necessary deleveraging of the baby boomers has far to go and this major structural headwind prevents QE alone from returning the USA to "normal" levels of economic growth. Already there is evidence that the rise in US bond yields is reducing growth. At 23x CAPE, US equities have a long way to fall once the supposed safety net of QE is seen to provide no such security.

If QE is working, why is bank credit contracting?
- Since May 2013 US bank credit has contracted at a 3% annualised rate.
- In Euroland, bank lending to the private sector is contracting at 3% this year.
- Lower exchange rates and higher interest rates spell lower growth in emerging markets.

QE has not made baby boomers borrow more and save less
- The ageing baby-boom generation (48-67) is saving more, borrowing less and reducing debt as they head into retirement.
- Under-48s have too much student debt; and with balance sheets damaged by falling property prices, they cannot gear up to offset the baby boomers' delevering.
- Real personal disposable-income growth is at levels associated with recessions, bond yields are rising and inflation falling.
- Any shock to aggregate demand could quickly push us into a world of sub-1% inflation at a time when nominal interest rates are near zero.

QE cannot stop the EM cyclical slowdown and associated defaults
- Short of a developed-market consumer boom or even further major capital inflows to EMs, QE can do nothing to halt their balance-of-payments realignment.
- QE triggered the emerging-market debt boom, but it cannot stop their devaluation or deflation.
- The emerging-market slowdown brings lower inflation and higher real interest rates to developed markets.

Treasury yields rise due to a lack of foreign central bank support
- The focus on tapering masks the role that foreign central bankers play in pushing US Treasury yields higher.
- Rising Treasury yields, falling inflation, contracting bank credit and very high equity valuations are a dangerous combination.

With boomers degearing, mortgage debt is declining

Growth in US home-mortgage debt

Source: Thomson Reuters Datastream

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Conclusion

- Global growth is slowing an interest rates rising
- Major debt defaults are likely in Eastern Europe
- Deleveraging baby boomers stop US recovery
- We are near to the trap of which Bernanke warned us
- QE is not a safety net for asset prices
- US equities are very vulnerable at 23X CAPE

QE is not preventing degearing

- US households are degearing and bank credit is contracting
- 66% of US households aged 45-54 have mortgage debt but only 43% of 65-74 year olds
- Consumer credit provided by the government has risen 400% since 2009
- Creating inflation as the baby boomers reduce bank debt will be very difficult
- Monetary policy and fiscal policy will have to combine- forgiveness of student debt?

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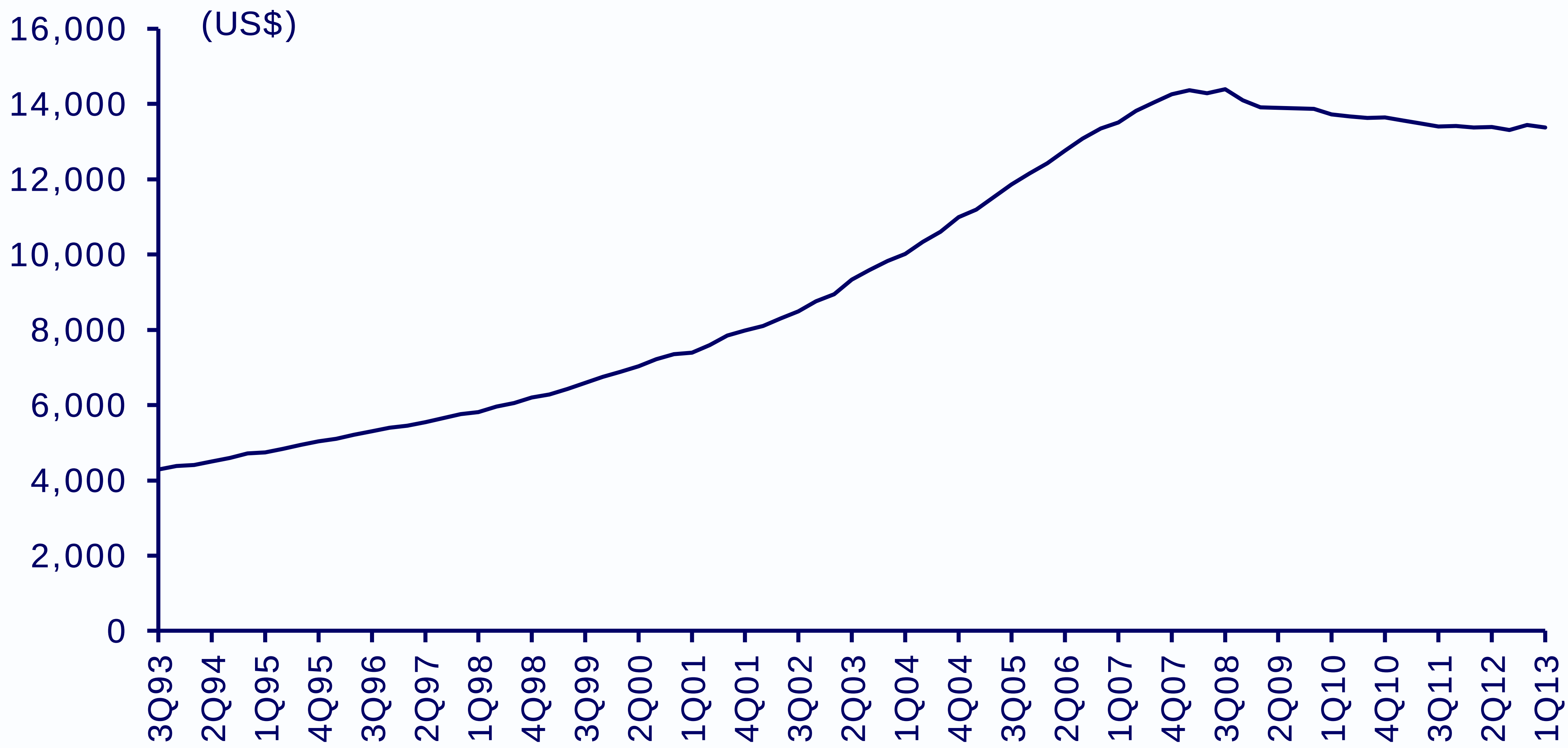
US household financial liabilities



Source: Thomson Reuters Datastream

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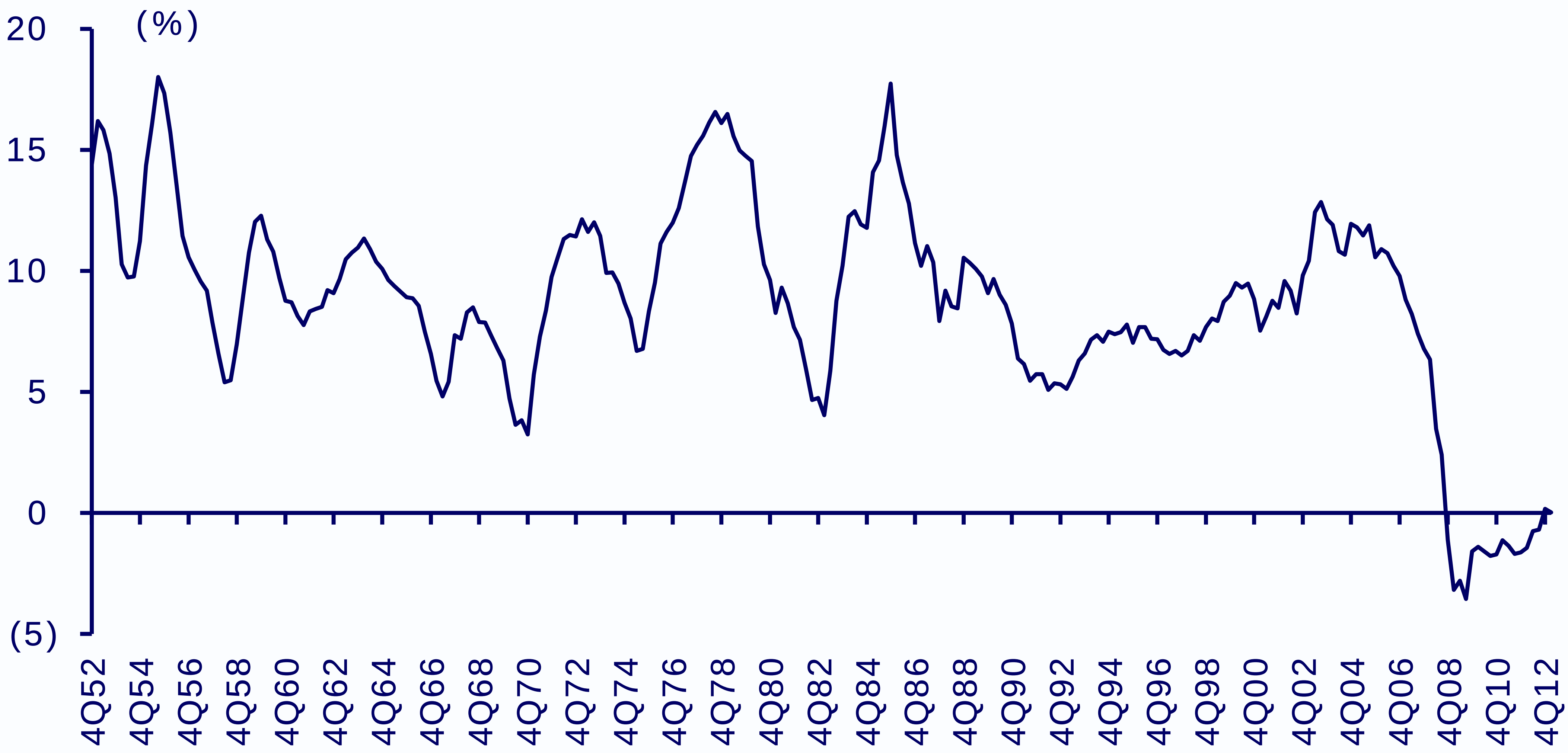
Growth in total US financial liabilities since 1952



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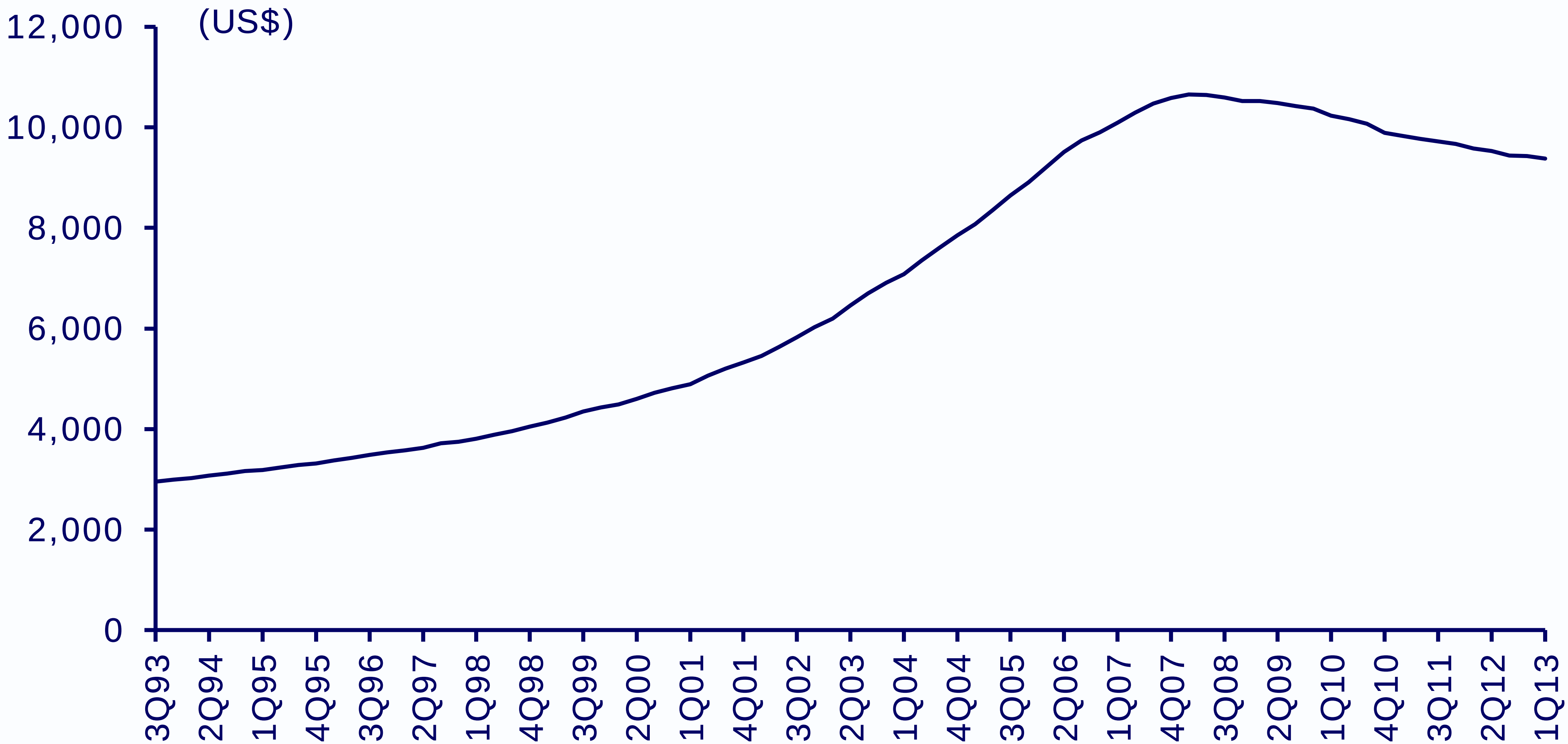
Family holdings of debt, by selected characteristics of families and type of debt, 2007 and 2010 surveys

Family characteristic	Secured by resi property		Instalment loans	Credit-card balances	Credit lines not secured by resi property	Other	Any debt
	Primary residence	Other					
% of families holding debt							
All families	48.7	5.5	46.9	46.1	1.7	6.8	77.0
Percentile of income							
Less than 20	14.9	1.1	27.8	25.7	*	3.9	51.7
20-39.9	29.6	1.9	42.4	39.5	1.8	6.8	70.2
40-59.9	50.5	2.6	53.9	54.8	*	6.4	83.8
60-79.9	69.7	6.9	59.2	62.1	2.1	8.7	90.9
80-89.9	80.8	8.5	57.4	55.8	*	9.6	89.6
90-100	76.4	21.9	45.0	40.6	2.1	7.0	87.6
Age of head (years)							
Less than 35	37.3	3.3	65.2	48.5	2.1	5.9	83.6
35-44	59.5	6.5	56.2	51.7	2.2	7.5	86.2
45-54	65.5	8.0	51.9	53.6	1.9	9.8	86.8
55-64	55.3	7.8	44.6	49.9	1.2	8.7	81.8
65-74	42.9	5.0	26.1	37.0	1.5	4.4	65.5
75 or more	13.9	0.6	7.0	18.8	*	1.3	31.4

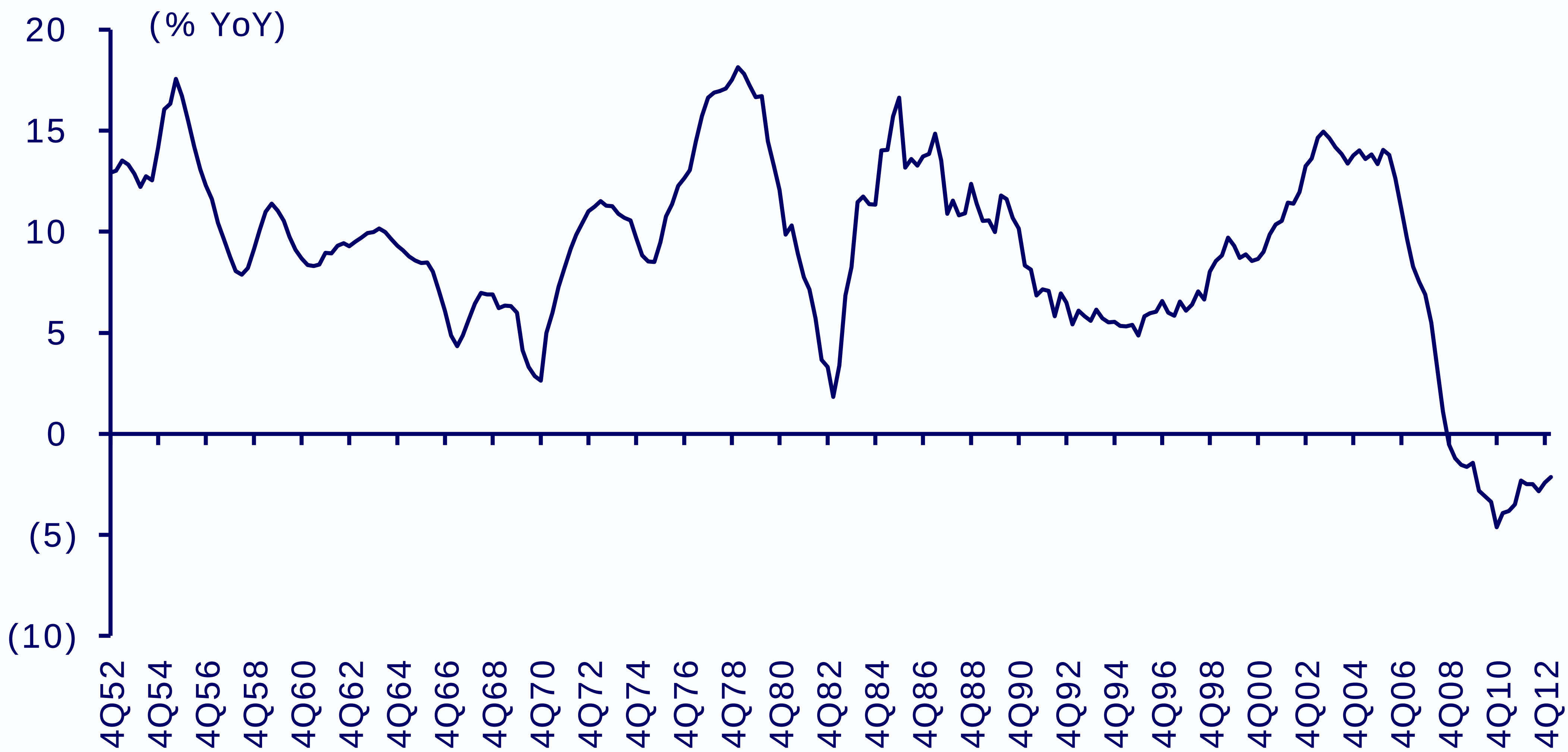
Source: Federal Reserve Survey of Consumer Finances

US home-mortgage debt



Source: Thomson Reuters Datastream

Growth in US home-mortgage debt



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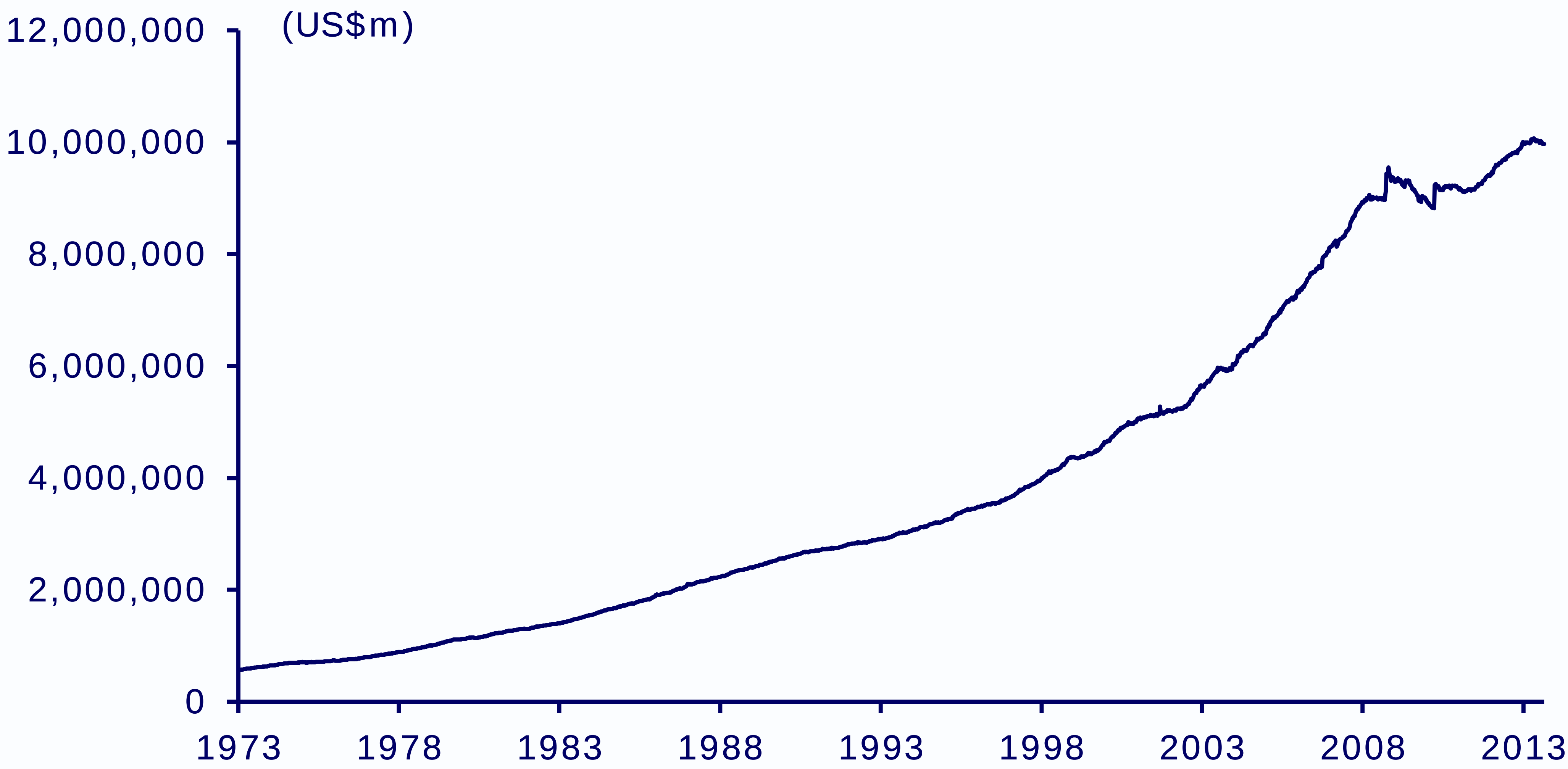
US bank credit

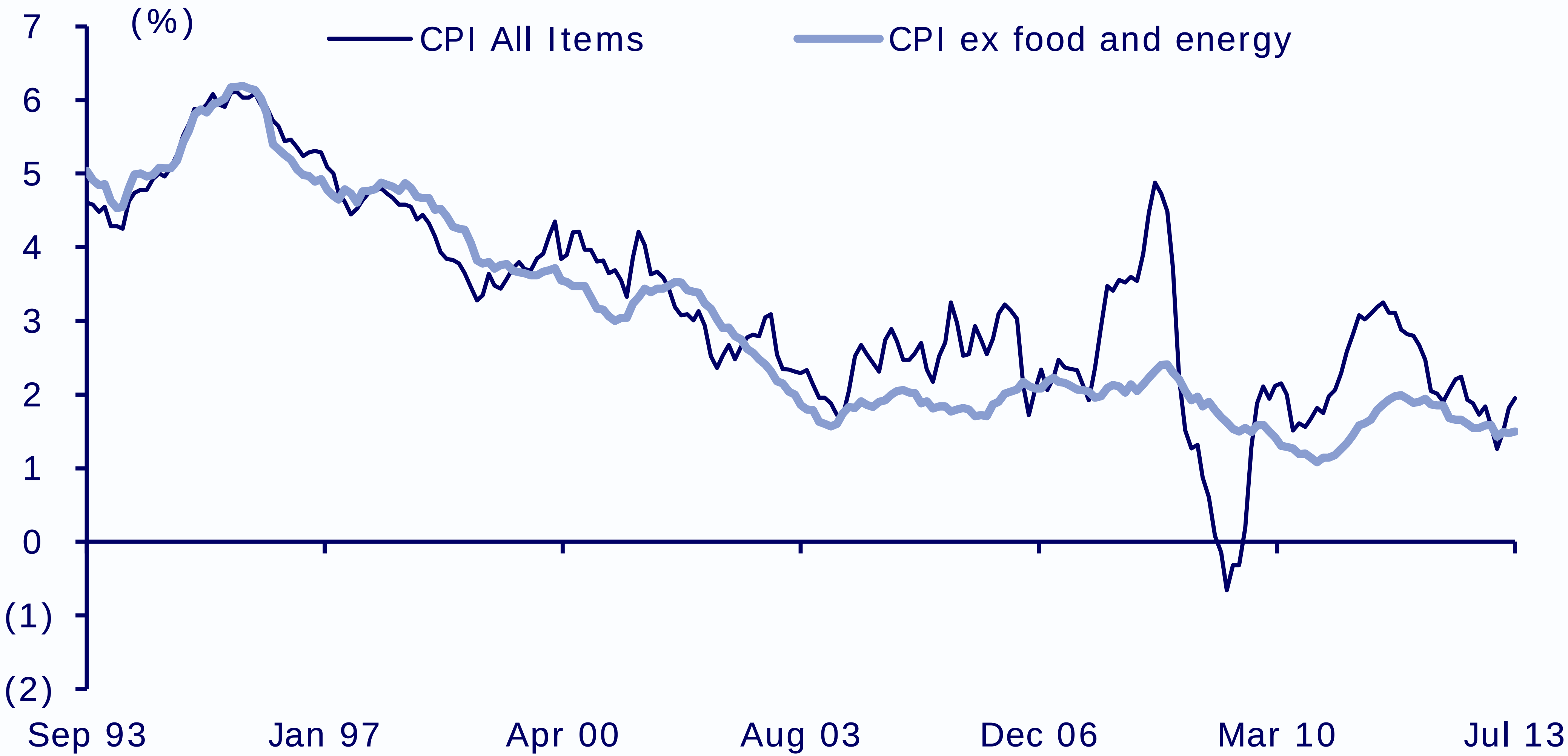


Source: Thomson Reuters Datastream

Is the deflation trap imminent?

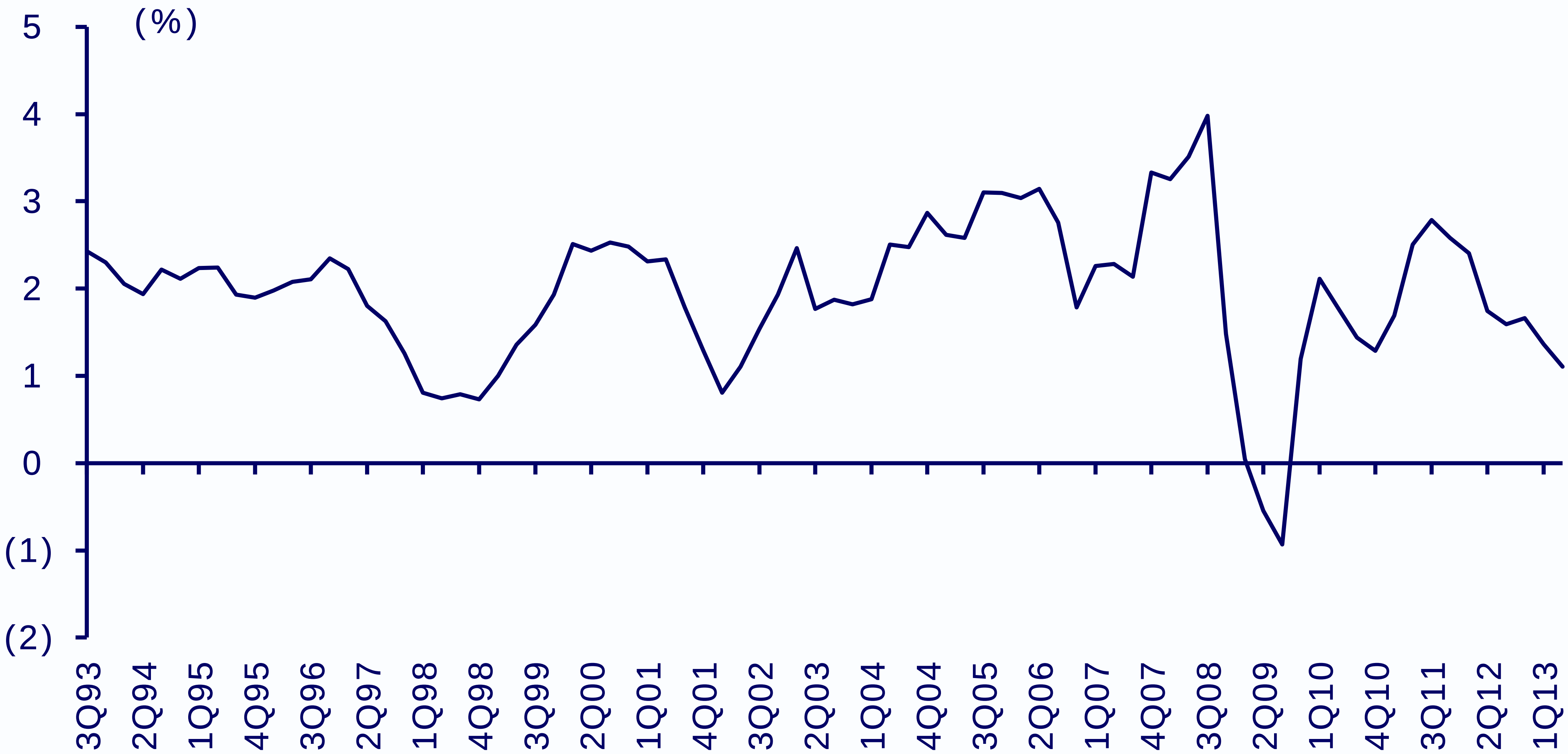
- Bernanke warned that the US must never get to inflation below 1% combined with interest rates near zero
- US bank credit -3% at an annual rate since May
- Feds chosen inflation measure is at 1.1%
- Personal disposable income growth is at levels only previously associated with recesssions
- A shock to global aggregate demand is coming from EM
- At 23X CAPE are equities pricing in the risks of deflation?

OECD CPI and OECD CPI ex food and energy



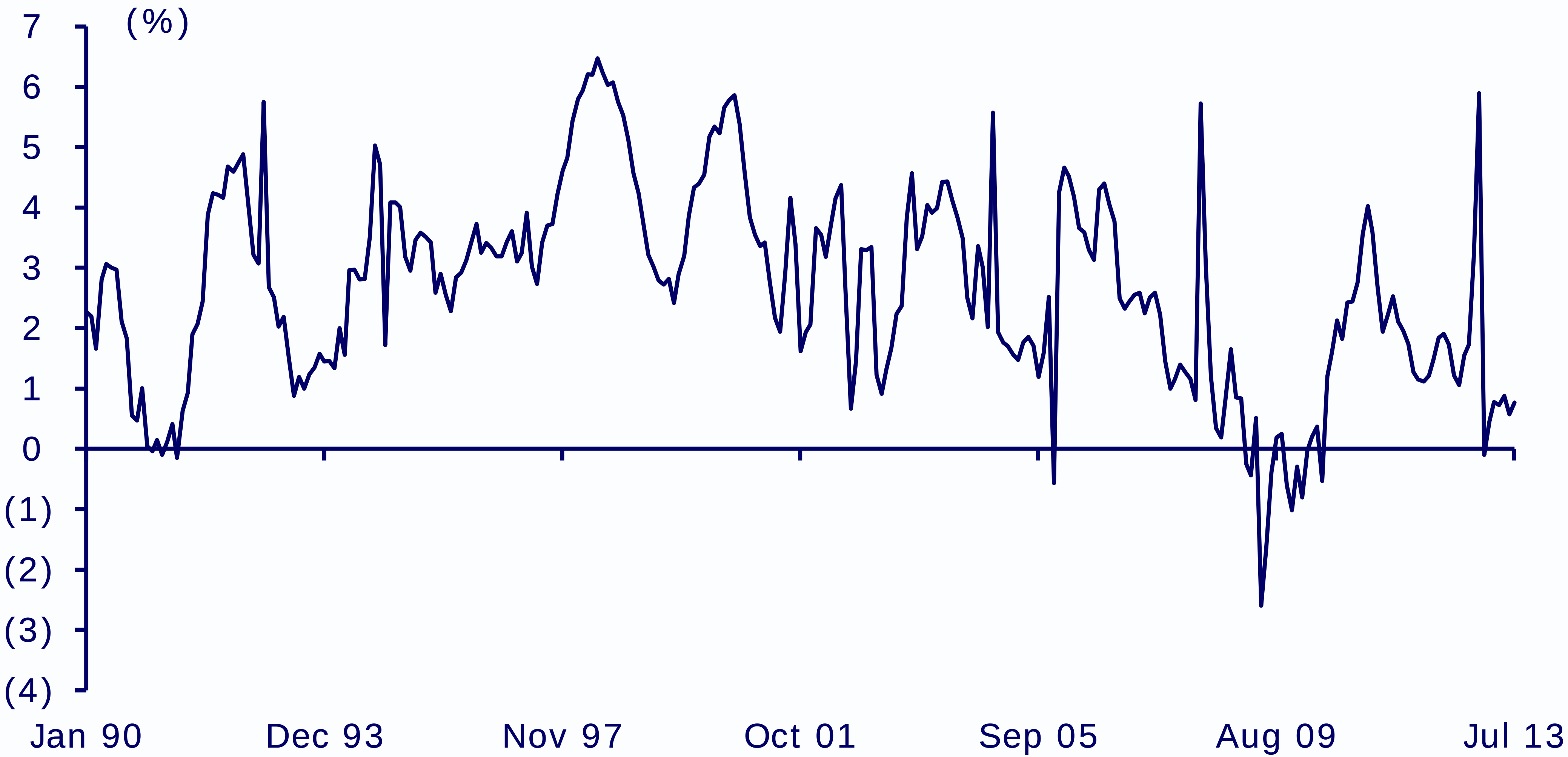
Source: Thomson Reuters Datastream

US personal consumption indicator price index



Source: Thomson Reuters Datastream

Annual personal disposable-income growth



Source: Thomson Reuters Datastream

Emerging market credit crisis has begun

- The EM balance sheet cycle is different from DM
- External debt to GDP ratios are at levels only previously associated with defaults
- Most EMs are above the 30% trigger level for defaults
- Eastern Europe and Turkey are the most vulnerable
- Short term pressure is on those where foreigners hols large stakes in liquid domestic asset markets
- Europe’s commercial banking system is very vulnerable

EM gross external debt

	US$bn	as a % of GDP
Greece	522	210
Hungary	196	155
Latvia	40	143
Slovenia	52	116
Croatia	58	104
Estonia	21	100
Bulgaria	49	94
Georgia	13	87
Moldova	6	86
Romania	130	77
Ukraine	136	77
Slovakia	70	76
Lithuania	31	74
Poland	357	73
Kazakhstan	140	69
Belarus	34	55
Czech Republic	98	50
Turkey	350	44
Chile	119	44
Thailand	140	38
Korea	410	36
South Africa	136	35
Russian Federation	691	34
Malaysia	100	33
Mexico	368	31
Indonesia	253	29
Peru	53	27
Philippines	59	24
India	390	21
Colombia	82	22
Brazil	466	21
Ecuador	17	20
Egypt	38	15

Source: Thomson Reuters Datastream

EM external-debt maturity profile

	Debt securities as % external debt	% of external debt maturing within 1Y
Greece	13	32
Hungary	25	12
Latvia	10	38
Slovenia	27	52
Croatia	19	10
Estonia	7	45
Bulgaria	3	27
Georgia	15	15
Moldova	0	33
Romania	13	12
Ukraine	18	25
Slovakia	32	29
Lithuania	41	19
Poland	36	12
Kazakhstan	13	6
Belarus	6	34
Czech Republic	37	27
Turkey	18	33
Chile	28	15
Thailand	25	41
Korea	53	30
South Africa	49	18
Russian Federation	10	13
Malaysia	3	48
Mexico	73	20
Indonesia	32	18
Peru	21	15
Philippines	36	17
India	11	25
Colombia	38	15
Brazil	25	8
Ecuador	36	0
Egypt	7	18

Source: Thomson Reuters Datastream

Domestic-currency debt as a percentage of total foreign indebtedness

	(%)
Bulgaria	2
Chile	4
Colombia	7
Croatia	8
Georgia	7
Hungary	29
India	24
Kazakhstan	2
Korea	28
Philippines	3
Romania	12
Slovakia	87
South Africa	60
Thailand	34
Turkey	8
Ukraine	2
Uruguay	30

Source: Thomson Reuters Datastream

Stock-market capitalisation to GDP at end 2012

	(%)
Greece	18
Hungary	17
Latvia	4
Slovenia	14
Croatia	36
Estonia	11
Bulgaria	13
Georgia	6
Romania	9
Ukraine	12
Slovakia	5
Lithuania	9
Poland	36
Kazakhstan	12
Czech Republic	19
Turkey	39
Chile	117
Thailand	105
Korea	104
South Africa	160
Russian Federation	43
Malaysia	157
Mexico	45
Indonesia	45
Peru	49
Philippines	106
India	69
Colombia	71
Brazil	55
Ecuador	7
Egypt	23

Source: World Bank

EM current account deficits

	External debt as % of GDP	Current account as % of GDP
Greece	210	(0.3)
Hungary	155	2.1
Latvia	143	(1.8)
Slovenia	116	2.7
Croatia	104	0.0
Estonia	100	0.0
Bulgaria	94	(1.9)
Georgia	87	(10.0)
Moldova	86	(10.0)
Romania	77	(4.2)
Ukraine	77	(7.9)
Slovakia	76	2.2
Lithuania	74	(1.3)
Poland	73	(3.6)
Kazakhstan	69	4.0
Belarus	55	(5.2)
Czech Republic	50	(2.1)
Turkey	44	(6.8)
Chile	44	(4.0)
Thailand	38	1.0
Korea	36	2.7
South Africa	35	(6.4)
Russian Federation	34	2.5
Malaysia	33	6.0
Mexico	31	(1.0)
Indonesia	29	(3.3)
Peru	27	(3.5)
Philippines	24	2.4
India	21	(4.9)
Colombia	22	(3.4)
Brazil	21	(2.4)
Ecuador	20	(1.3)
Egypt	15	(2.1)

Source: JEDH, IMF World Economic Outlook

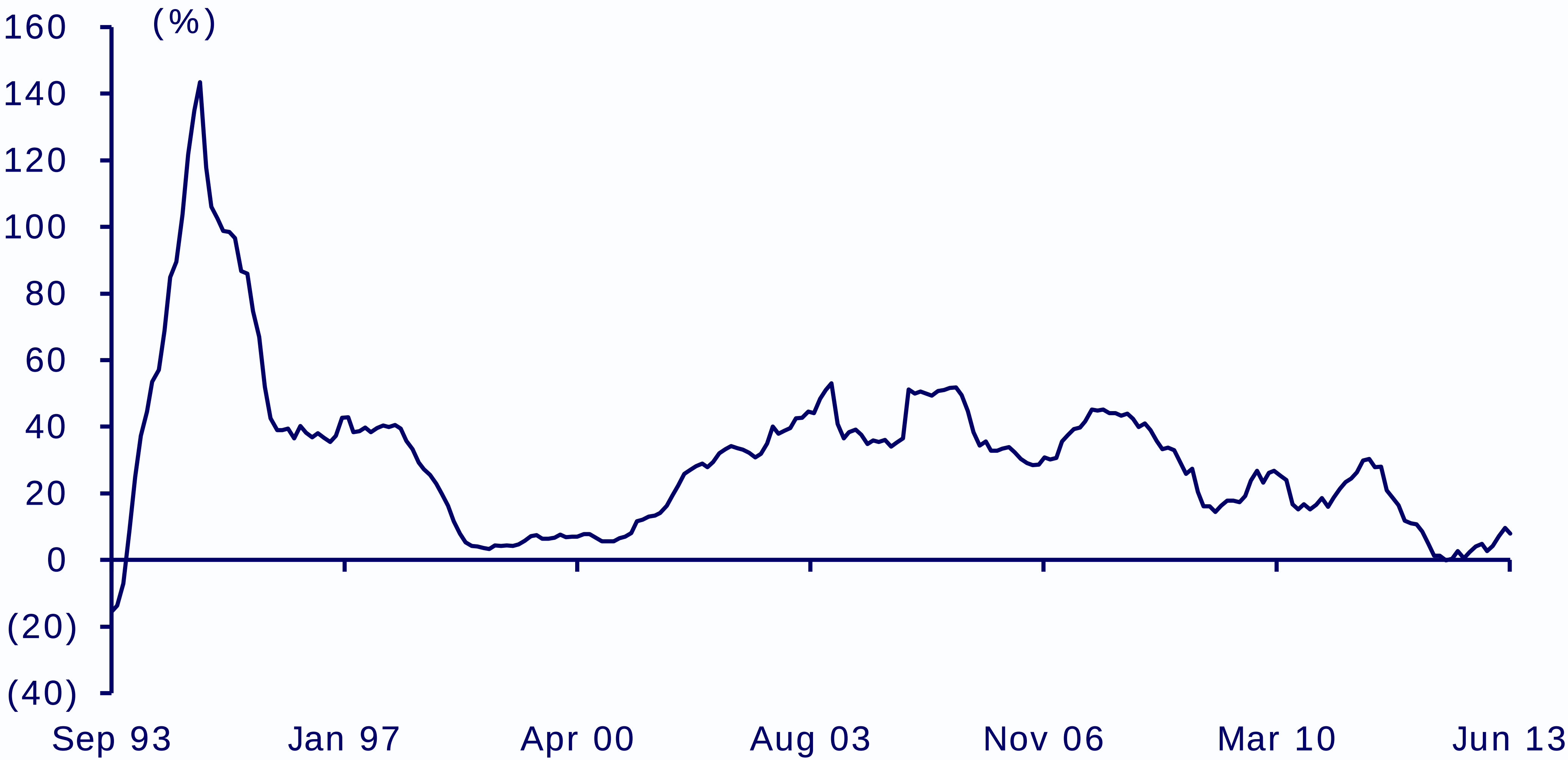
Global implications of the EM crisis

- EMs with external debt above 40% of GDP have borrowed US$1.9trn from foreigners (US$2.4trn with Greece)
- Poland and Turkey alone have borrowed more than Lehman Brothers
- In 1982 and 1998 the Fed came to the rescue but EM was less than 20% of global GDP
- Lagarde thinks capital controls may be the answer to slow the balance sheet realignment in EM
- How can Bernanke's monetary policy fix this?

Treasury yields rising as inflation falls

- It's not just tapering pushing up US Treasury yields
- Foreign central bank ownership of the Treasury market has fallen from 38% to 34%
- Some key EMs have been selling Treasuries to support their exchange rates
- Treasury yields rose 40% in 1987 and have now risen 57% from their 2012 lows
- If this rise in yields does not augur more growth and inflation it is very bad for equities

China official reserve growth



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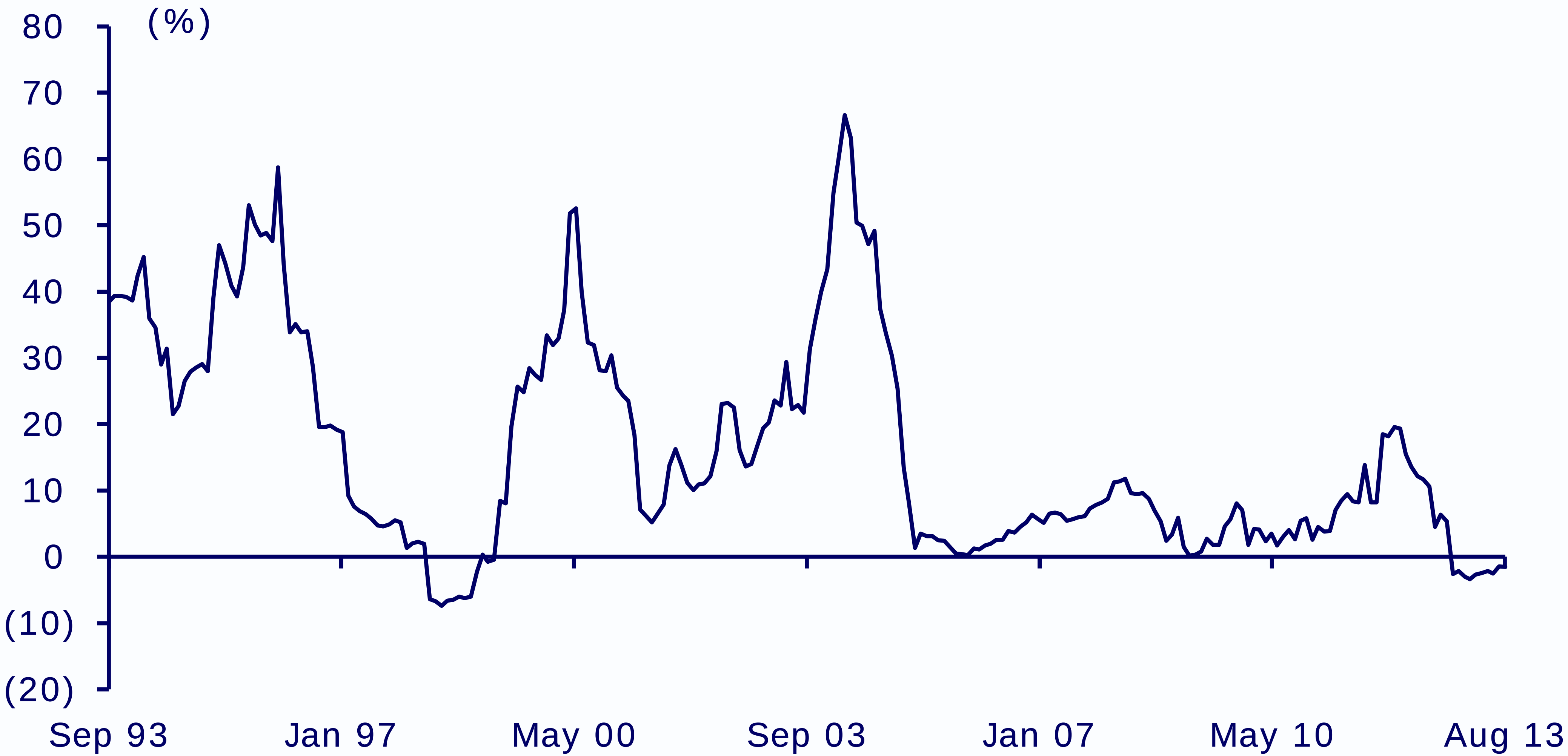
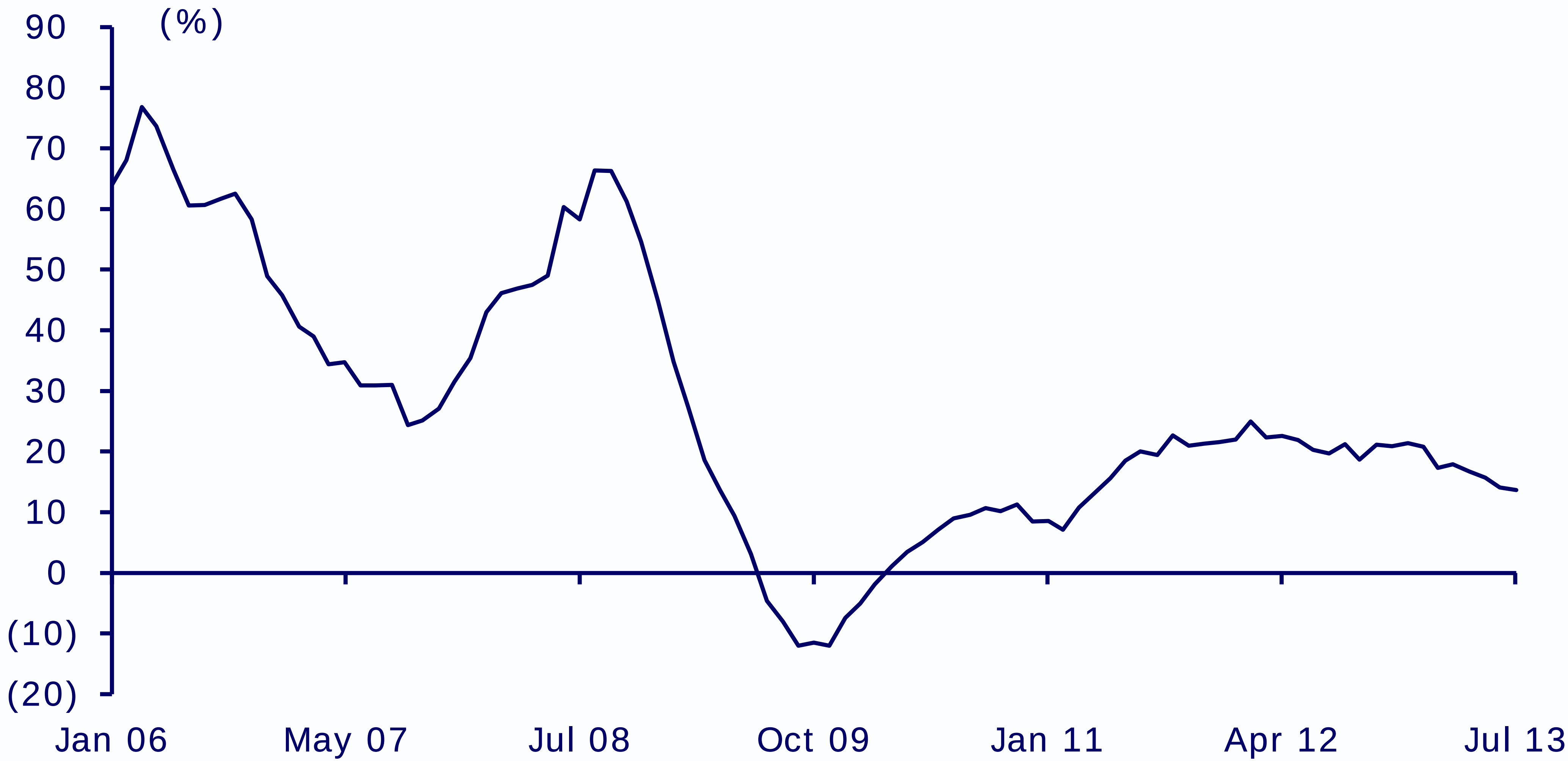
Japan official reserve growth



Source: Thomson Reuters Datastream

Saudi official reserve growth



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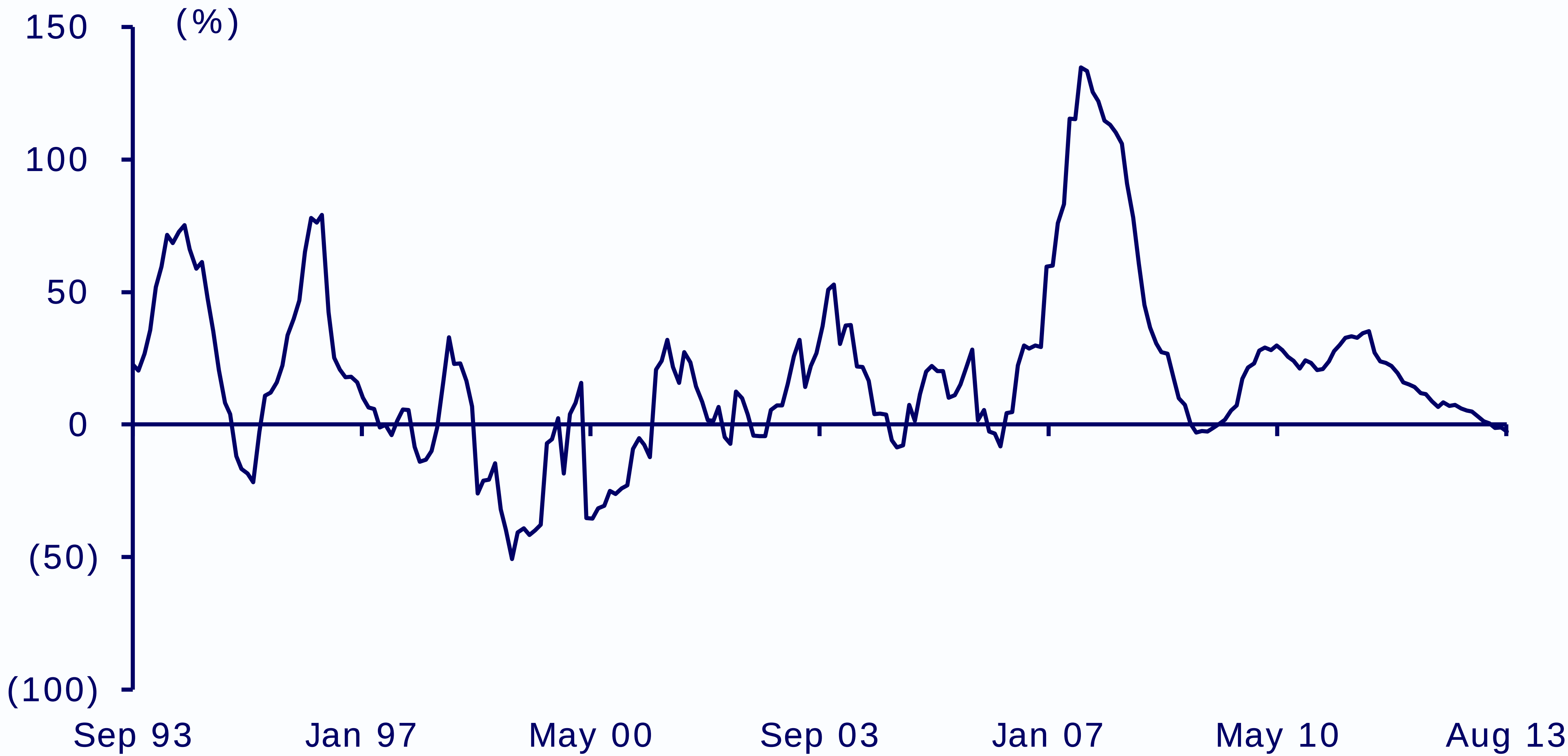
Brazil official reserve growth



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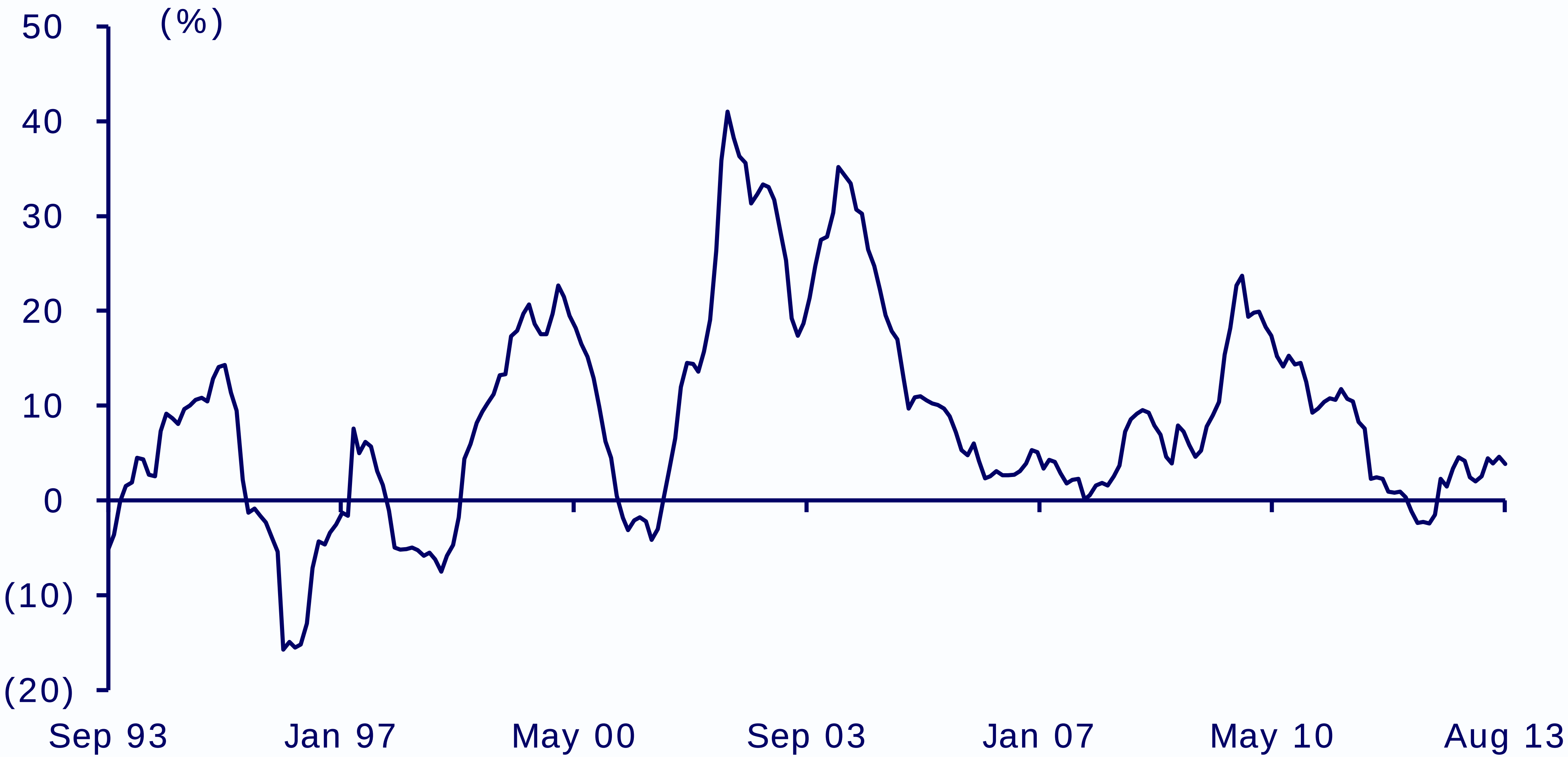
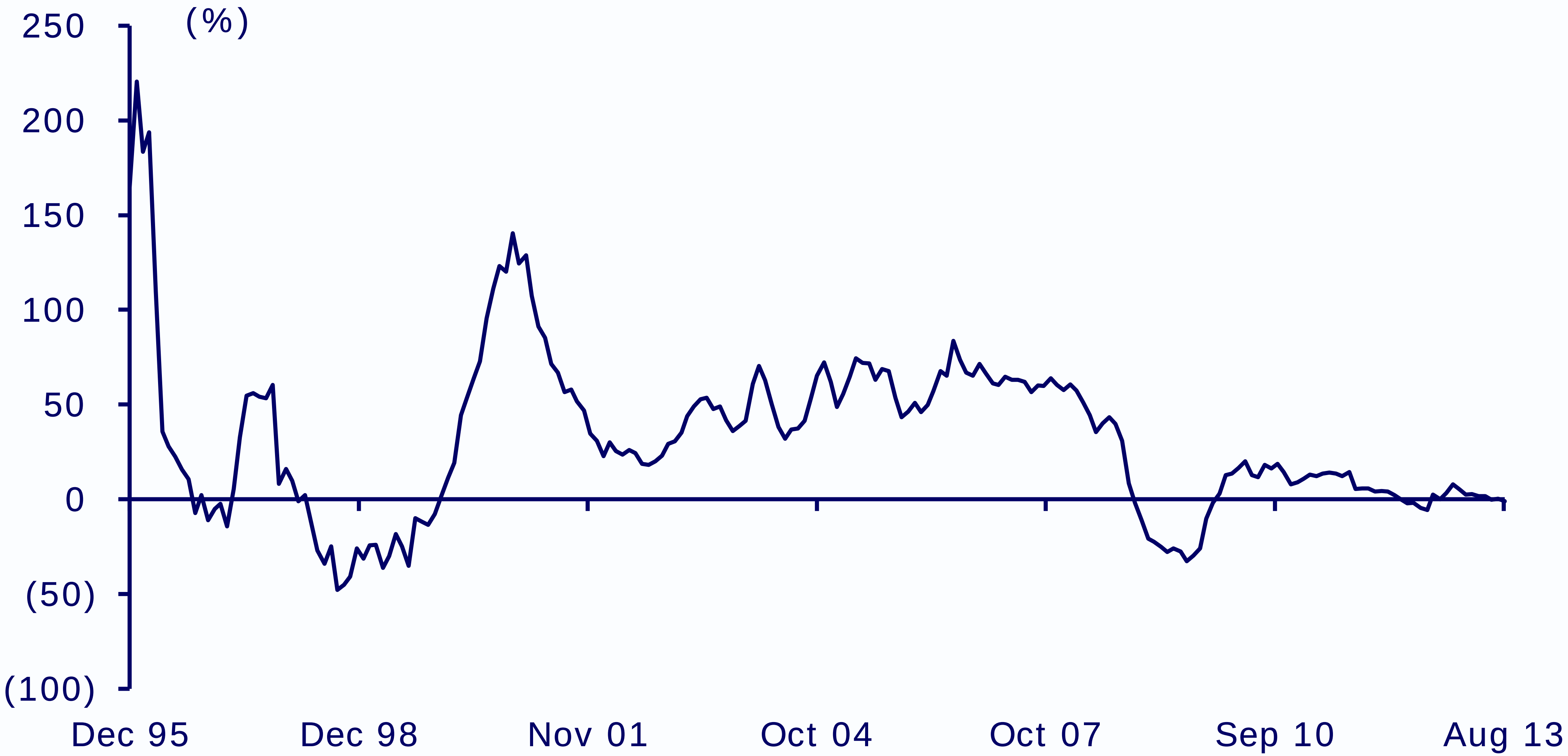
Taiwan official reserve growth



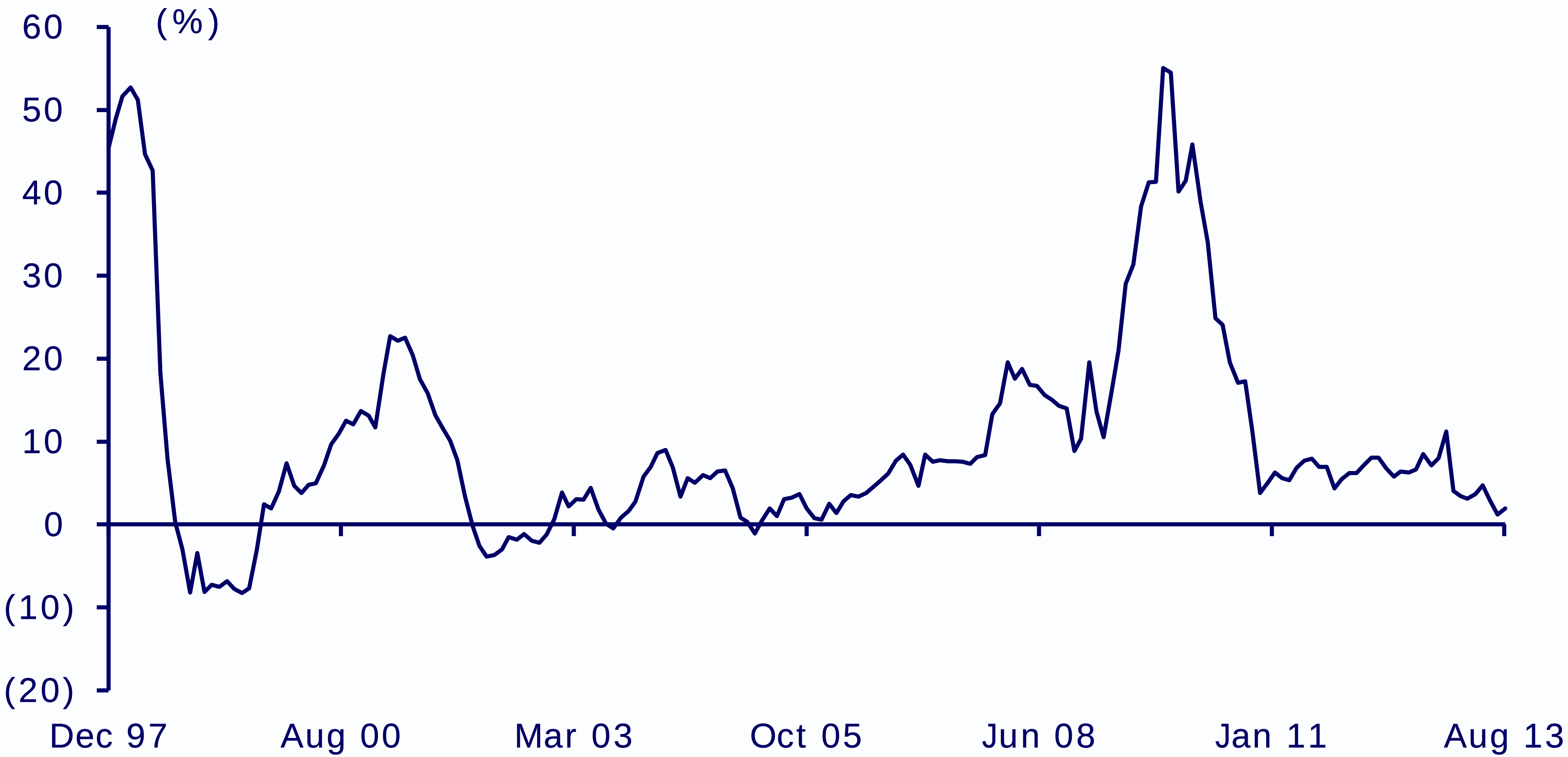
Source: Thomson Reuters Datastream

Russia official reserve growth



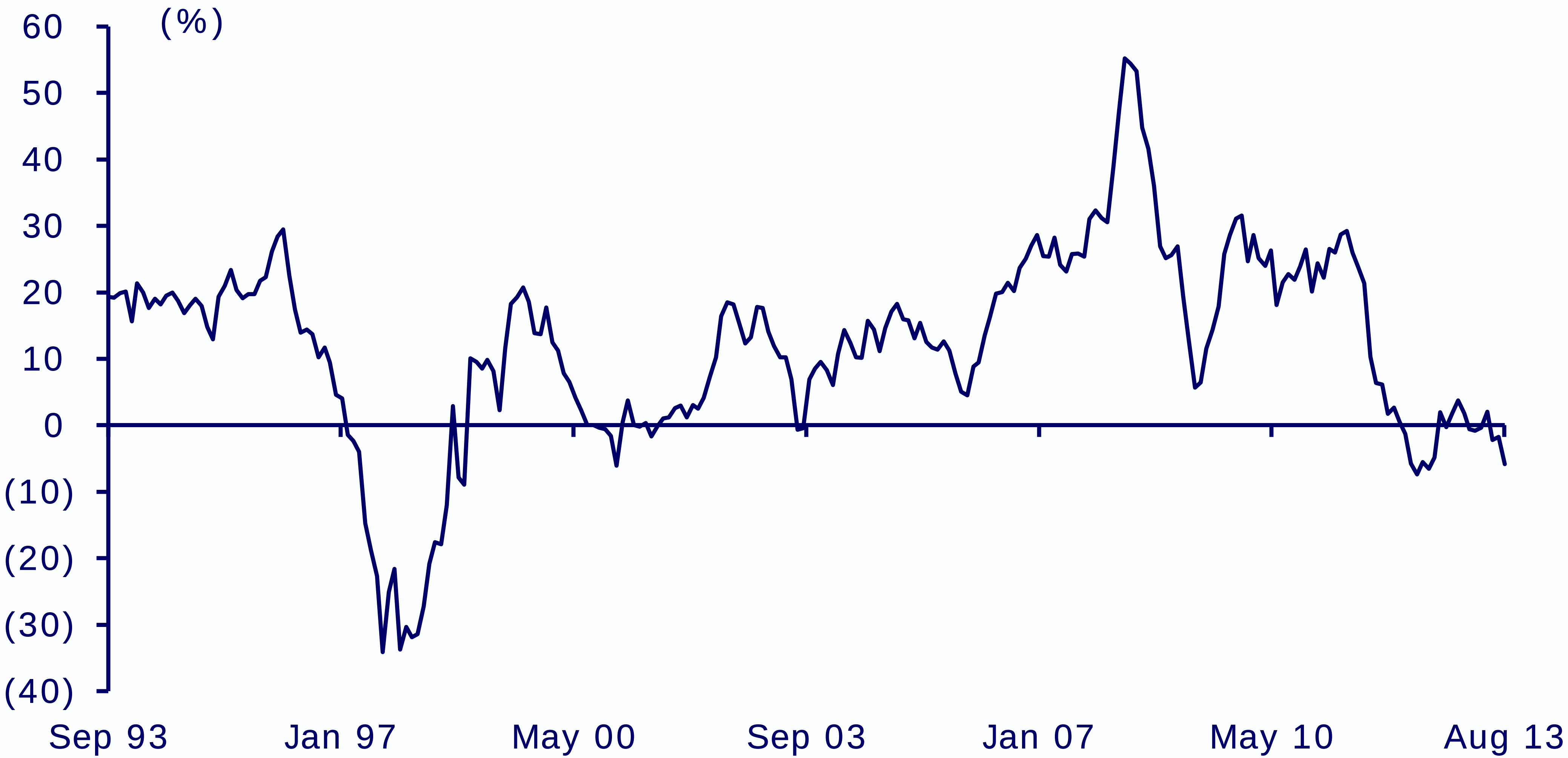
Source: Thomson Reuters Datastream

Hong Kong official reserve growth



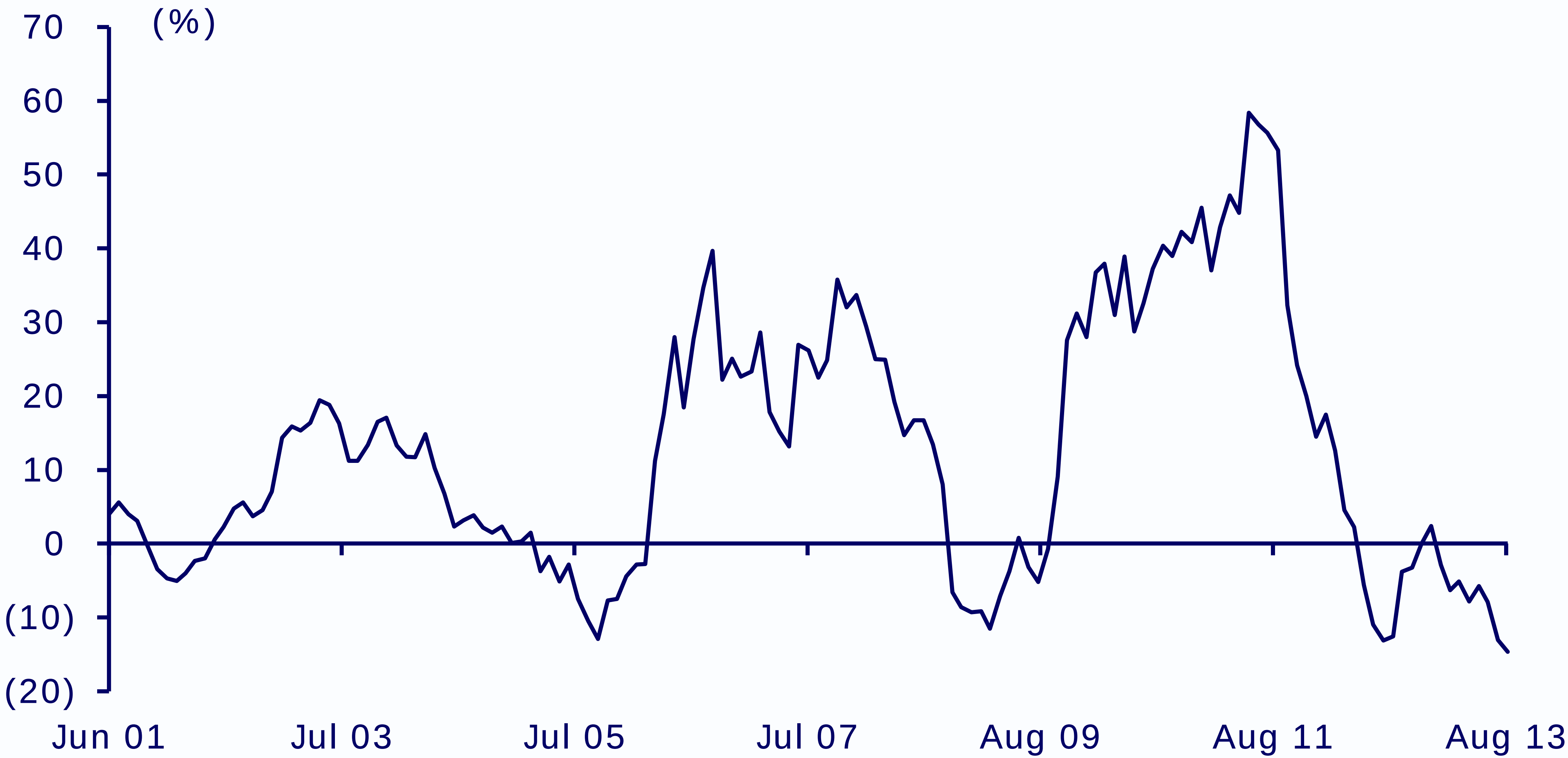
Source: Thomson Reuters Datastream

Thailand official reserve growth



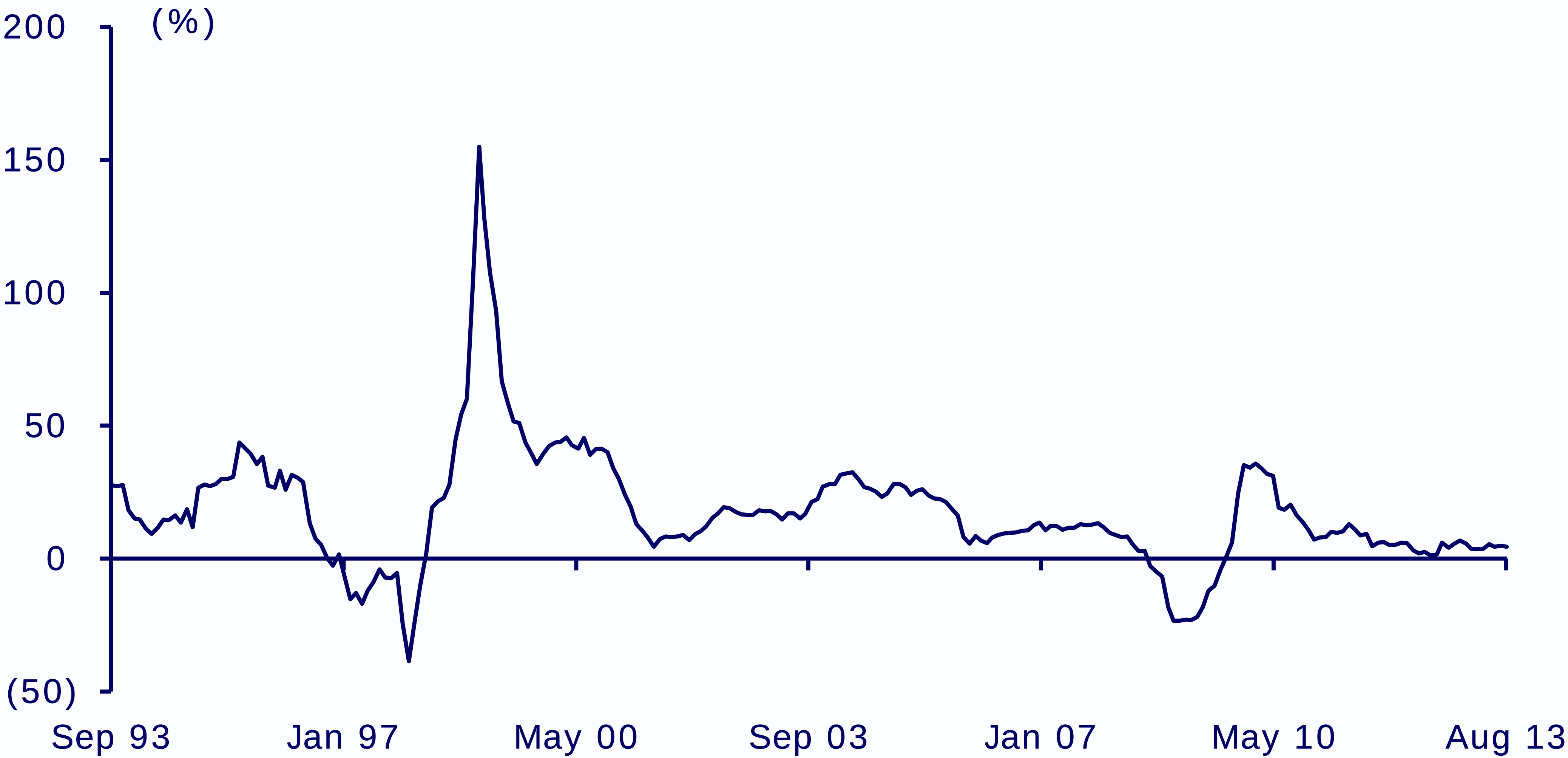
Source: Thomson Reuters Datastream

Indonesia official reserve growth



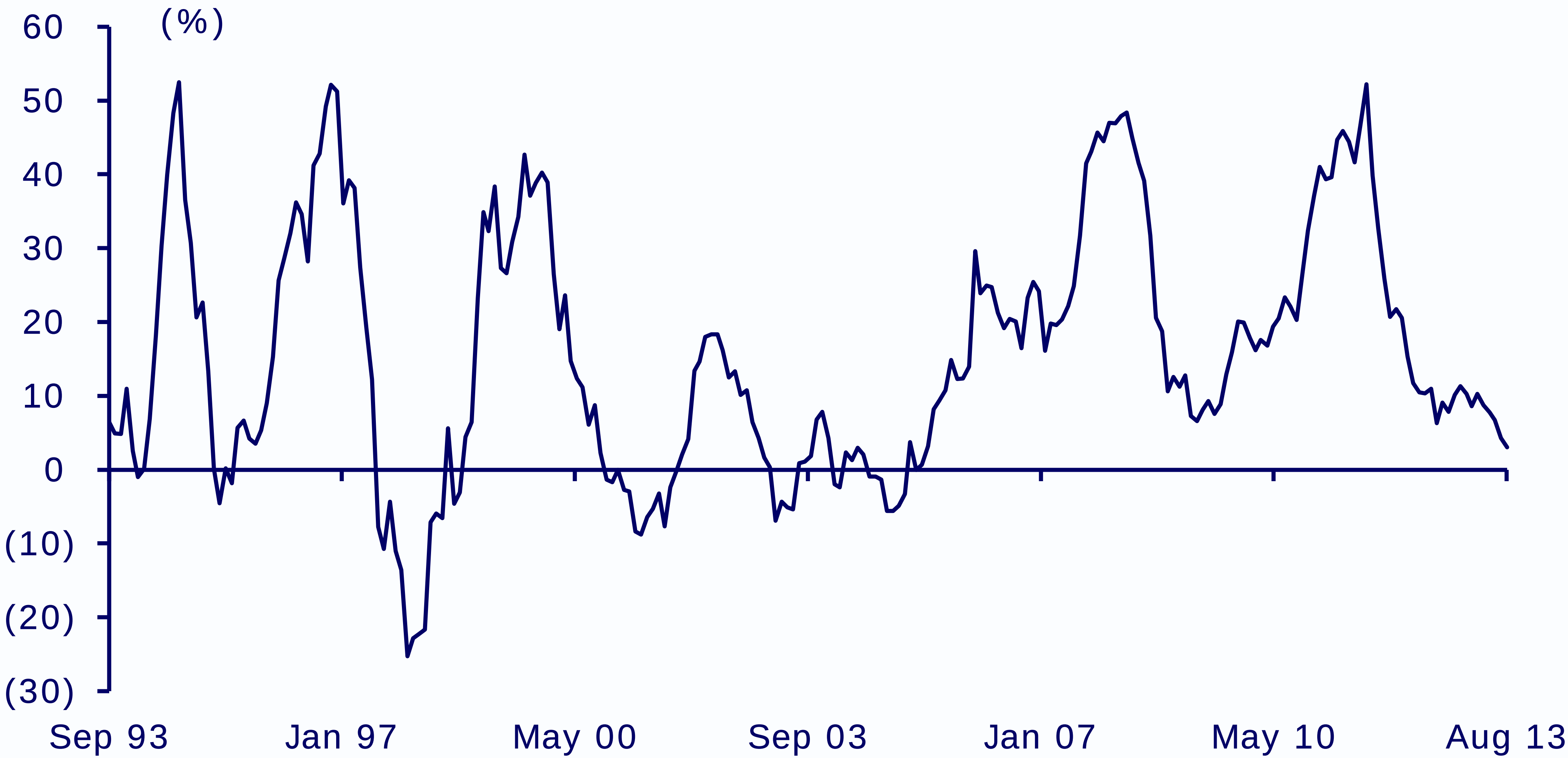
Source: Thomson Reuters Datastream

Korea official reserve growth



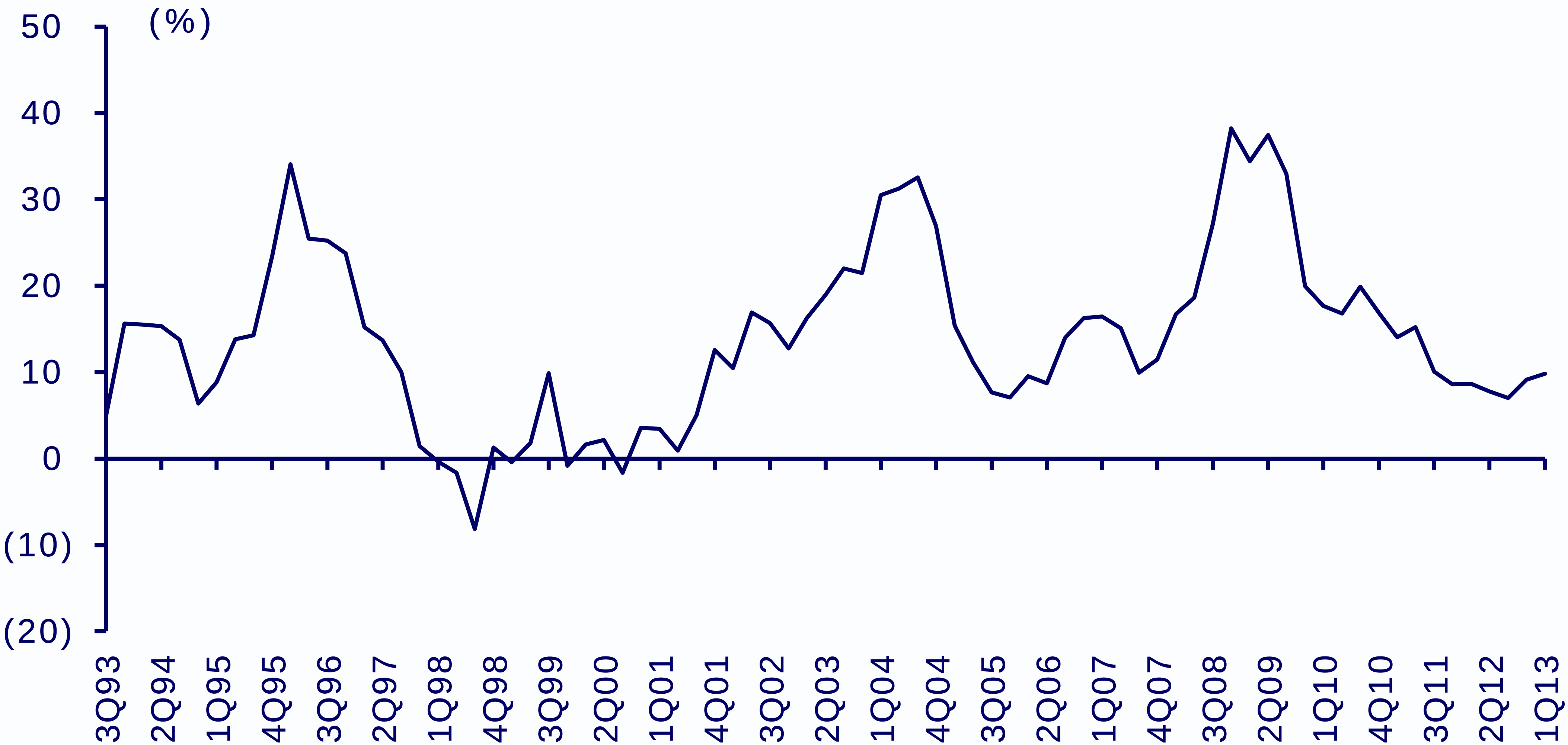
Source: Thomson Reuters Datastream

Philippines official reserve growth



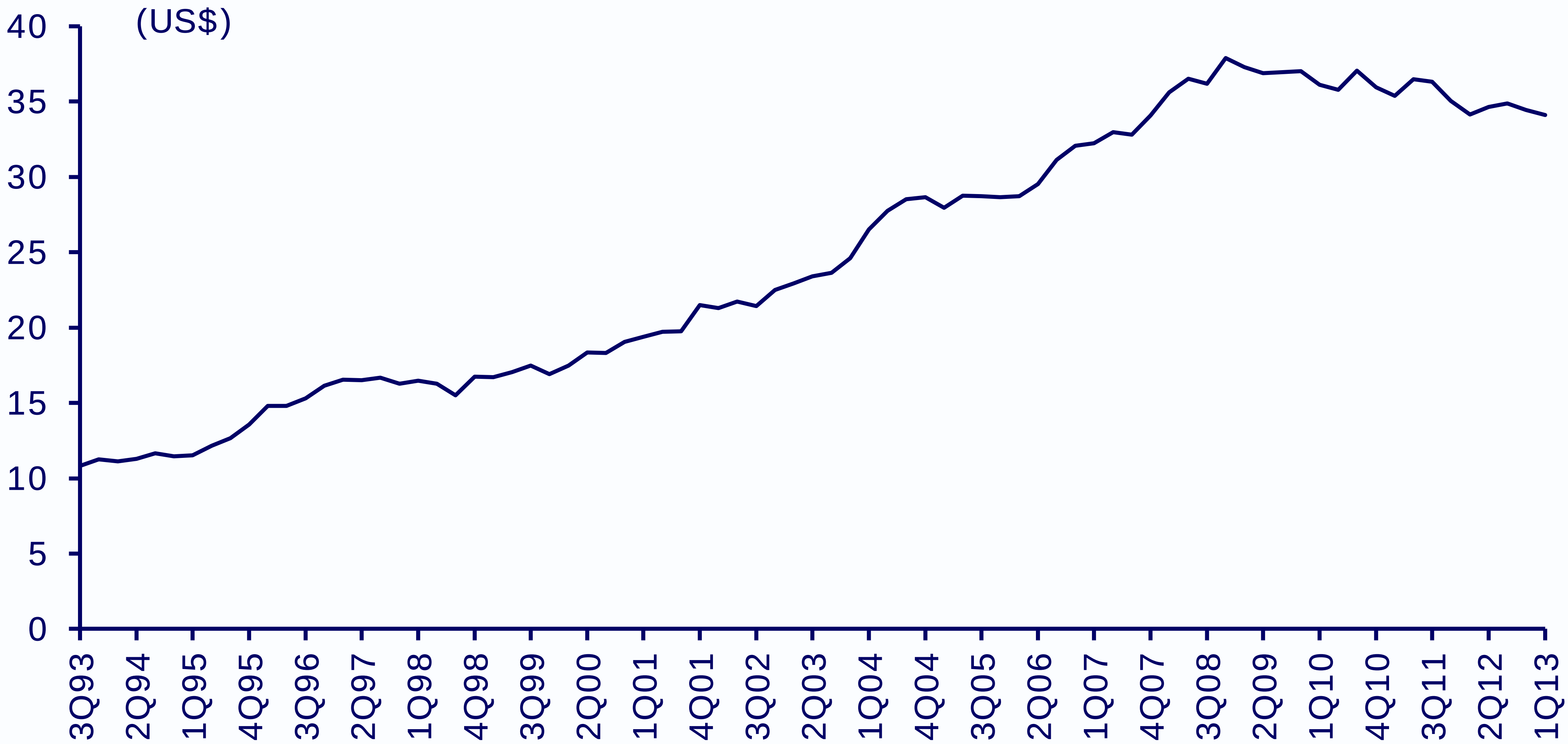
Source: Thomson Reuters Datastream

Growth in value of Treasuries owned by foreign central banks



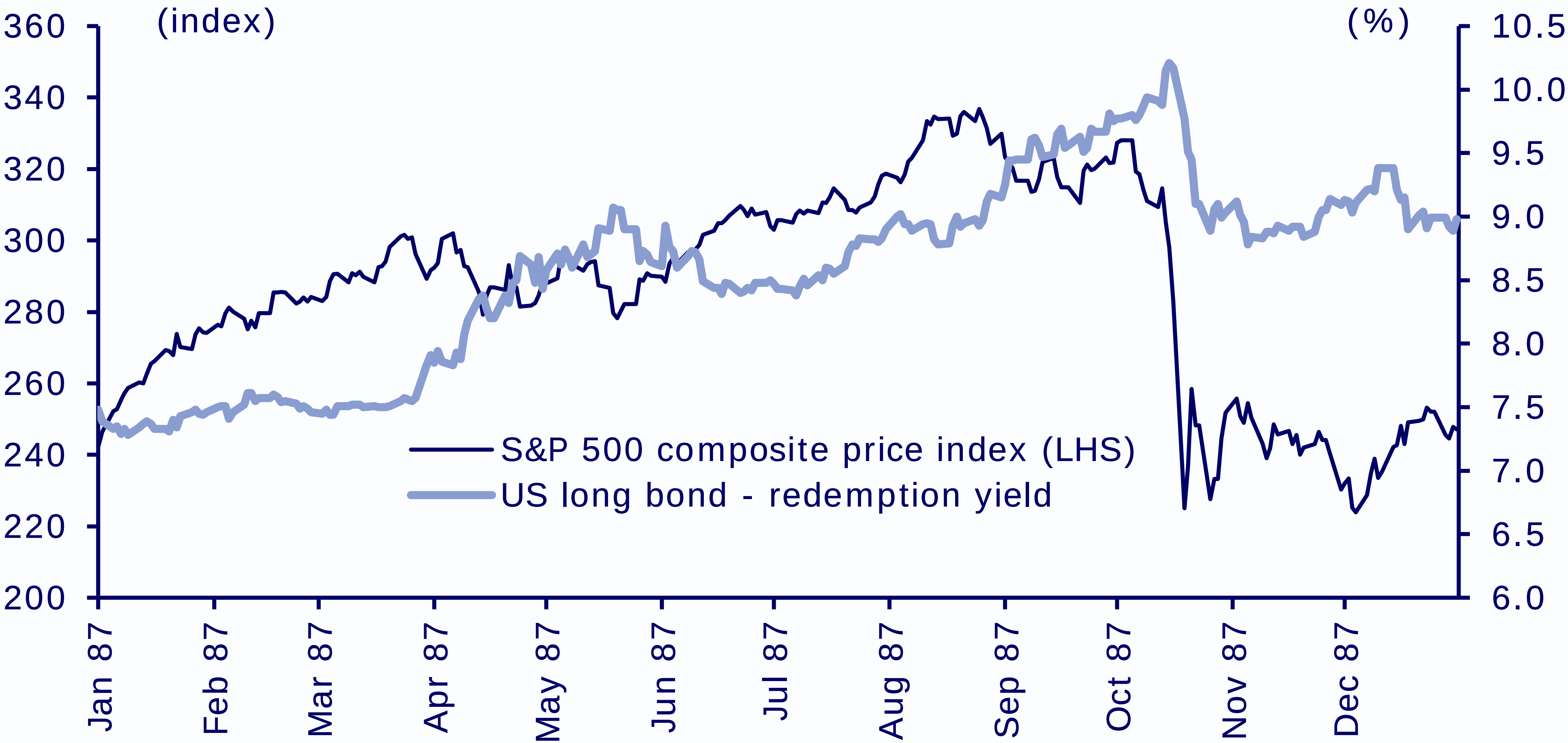
Source: Thomson Reuters Datastream

Foreign central bank ownership of the US Treasury market



Source: Thomson Reuters Datastream

US bond yields and equity prices, 1987



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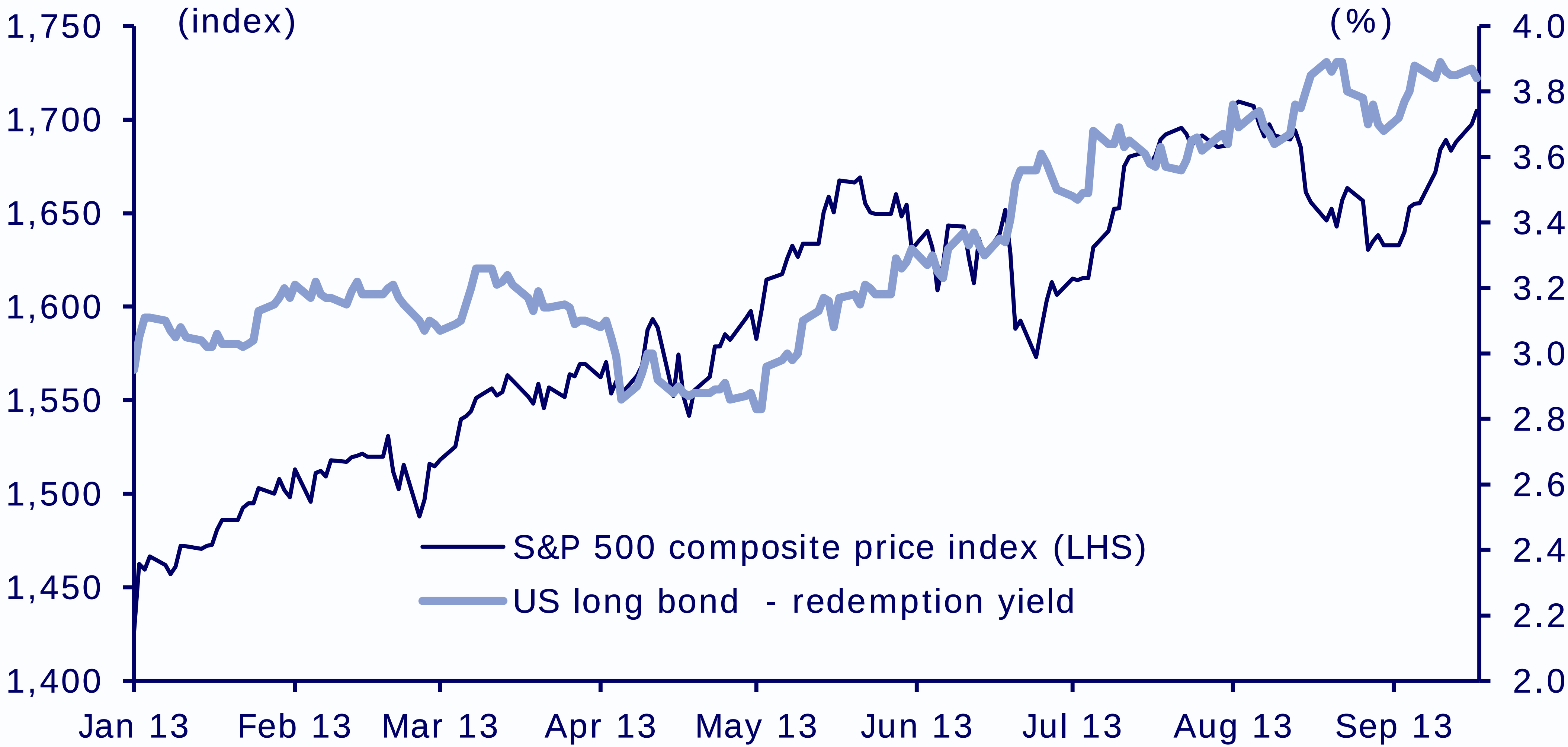
US bond yields and equity prices, 2013



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Conclusion

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- Major debt defaults are likely in Eastern Europe
- Deleveraging baby boomers stop US recovery
- We are near to the trap of which Bernanke warned us
- QE is not a safety net for asset prices
- US equities are very vulnerable at 23X CAPE

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