# Global

## *Thin Ice*

*Financial Markets Research*

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- *"Risk on" has dominated markets since early-February*
- *However, underlying fundamentals continue to deteriorate*
- *Indeed, we are drowning in debt*
- *As such "FX Wars" are not over: they might just be starting!*

### Why 'Thin, Thinner, Thinnest'?

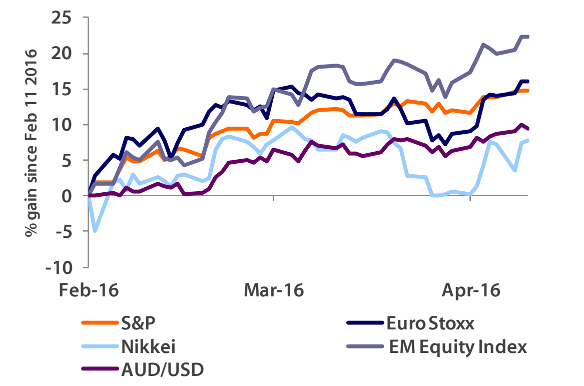
**Thin Ice** is the first part of a trilogy of 'Thought Experiment' special reports. In this first chapter we will explain that despite current market ebullience, fundamentals are terrible: the key problem is that global debt is still far too high, which is stifling growth, and risks leading us to even fiercer "FX Wars" ahead. In the second part of the trilogy, **Thinner Ice**, to be released next Monday, we will explain that the central bank response to this issue is distorting markets and damaging confidence rather than resolving the key issues: in short, central banks are as much part of the problem as they are the solution. Finally, the conclusion to the trilogy, **Thinnest Ice**, to be released the day after, is a 'thought experiment' that looks back at history from a structural perspective to see what risks are inherent in our current global paradigm.

### Why we are feeling a warm glow....for now

Right now financial markets are clearly feeling that 'risk is on'. So much so that it's perhaps hard to recall we started the year on such a different note. Indeed, the falls recorded through to February 10 in key equity markets were such that YTD gains are still relatively moderate in most cases. (See Charts 1 and 2.)

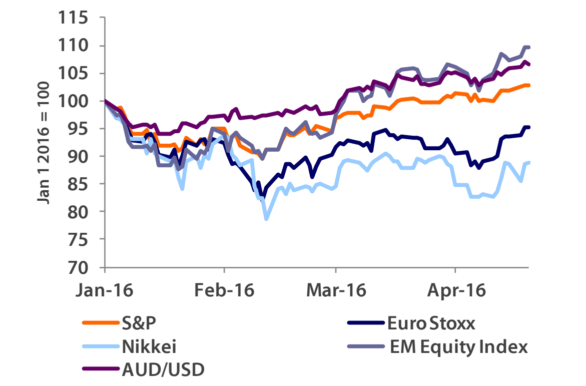
Importantly, we continue to believe that the volatility seen in January/February contains a strong warning that the global economy remains on extremely thin ice. Indeed, the challenges that remain in front of us are sufficiently daunting that it would require a significant degree of optimism to believe that there will be no repeat of January's panic ahead at any point.

Chart 1 – Quite the bounce...



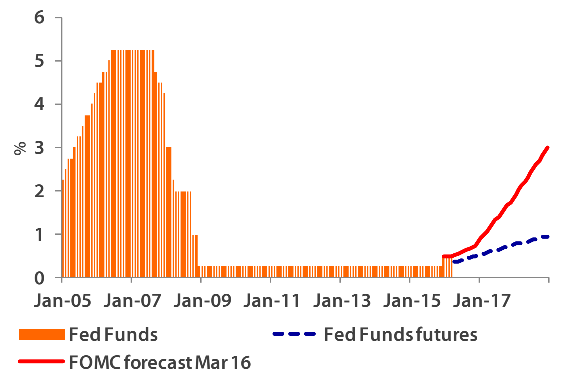

Source: Bloomberg

Chart 2 – ...but from quite the trough



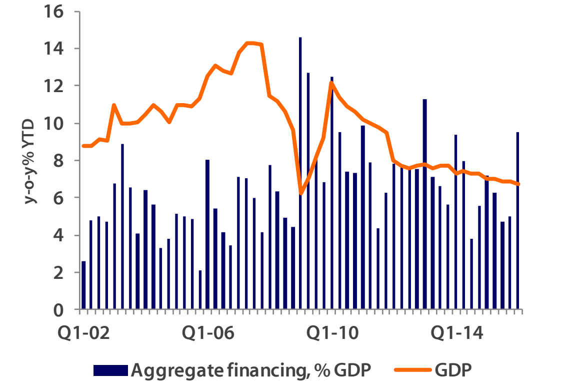

Source: Bloomberg

Chart 3 – The Fed vs. the market




Source: Bloomberg

Chart 4 – Chinese borrowing vs. reality




Sources: CEIC, Bloomberg

Until recently our post-global financial crisis recovery – and financial markets - were underpinned by two trends that acted as thick layers of ice for both to stand on:

1) **Abundant liquidity** from central banks; and

2) **Rapid growth in emerging markets**, particularly China, which lifted many boats, especially commodity producers.

## Why we are back on thin ice (layer 1)

*Notably, both of these ice layers started to melt earlier in the year – which is a key part of the reason why markets fell so hard and 'risk was off' in January and early February.*

Of course, we saw the first layer begin to melt with the well-telegraphed first US rate hike in a decade in December 2015, with the Fed's path remaining officially towards further gradual tightening. It was no real surprise market turbulence followed in the wake of that decision and that message.

Back in December our Fed-watcher Philip Marey was predicting two further 25bp hikes this year, much less than the four hikes the Fed's own 'dot plot' pointed to. The Fed's view was notably revised down to just two 25bp hikes at the March FOMC meeting, and our house view remains the same, albeit with risks seen to the downside.

However, even that rate of policy tightening is still likely to prove challenging for markets if seen. Indeed, cognizant of the Fed's wider global role, financial markets continue to price for far less tightening in 2016, and that difference in outlook grows starker as we head into 2017 and 2018. Fed Funds futures were only expecting US rates around 1% by end-2018 at the time of writing when the Fed is talking about 3%. (See Chart 3.) It goes without saying that a Fed policy error via over-tightening would prove calamitous, while a sudden rush from rates markets to 'catch up with the Fed' could also prove destabilizing.

## Why we are back on thin ice (layer 2)

In terms of the second supportive ice layer, emerging markets' growth rates have declined precipitously in the last few years: of the four BRICs economies, only India is seeing faster rates of economic expansion relative to the recent past.

A large part of the problem in emerging markets stems from the fact that China, a key commodity consumer, continues to see a steady deceleration in its trend pace of economic expansion despite increasingly desperate efforts to maintain official GDP growth within the government's 6.5-7.0% y-o-y target range. Worryingly, as we pointed out in a recent CNY special, the more China relies on debt-driven stimulus to grow at over 6.5% now, the greater the risks of a debt crisis and/or getting stuck in the "middle income trap" further down the line. After all, China's GDP growth can was only kicked down the road again in Q1 via a massive *USD1 trillion* in new borrowing, equal to 9.5% of GDP, and even so headline growth of 6.7% y-o-y was still well below the levels of a few years ago. (See Chart 4.)

| Chart 5 –This was bad enough | Chart 6 – This is even worse! |
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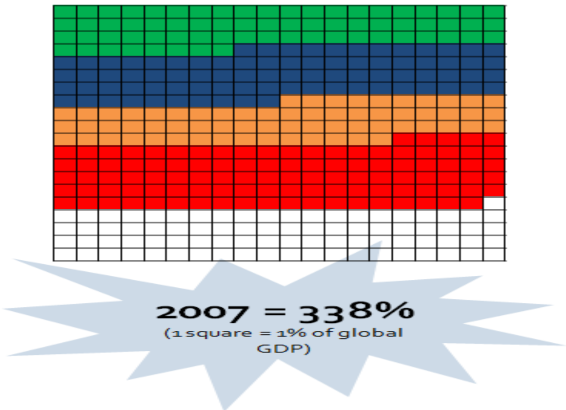
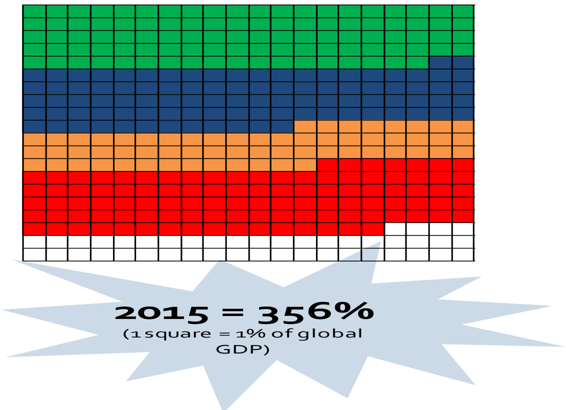
|   |   |
| *Sources: Bloomberg, CEIC, IMF, World Bank, Rabobank* | *NB 1 square = 1% of global GDP* |

*Government debt; Non-financial corporation debt; household debt; financial corporation debt*

Meanwhile, neither Europe nor Japan, both struggling with their own respective structural economic malaise, are in an obvious position to step forwards as global growth drivers if the US and China (and other emerging markets) step back. Potentially, therefore, no-one is going to do so ahead.

Such a lot to do on such thin ice!


## Why the ice may not hold us anymore

Global growth is held down by long-running structural issues in almost all key economies, something that is admitted by institutions such as the IMF. However, still less well recognized is that **global growth also continues to be weighed down by a huge debt overhang**. Worryingly, that obstacle, familiar to those coming from the post-Keynesian and Austrian schools of economic thinking but apparently eluding the more conventional thinking at central banks, has only grown higher since the end of global financial crisis.

To illustrate the point, whereas in 2007 estimated total debt-to-global GDP stood at 338%, as of end-2015 it was up to 356%. Furthermore, with China borrowing aggressively again in Q1, and with US corporations also issuing large volumes of new debt in order to fund share buybacks and M&A, that aggregate figure is likely to head well above 360% of global GDP by end-H1 2016. (See Chart 5 and 6.) In short, as a planet we are in more debt now than we were back in 2007, just before the global financial crisis. That's hardly reassuring.

True, with global interest rates so low, servicing this debt is mostly manageable – though notably China is already experiencing debt stress at current levels, even as it borrows yet more. However, as we've explored before in other specials (here, for example), the link between debt and growth means carrying such a high debt load makes any acceleration in global growth very hard achieve.

In short, it's hard to see where higher global growth can realistically stem from in terms of country and sector (i.e., government, households, non-financial and financial businesses). US businesses and Chinese consumers are perhaps the two hopes that remain. However, with Capex/GDP ratios still below their pre-crisis levels, US firms appear relatively reticent to borrow for that reason, whereas share buybacks and/or M&A activity appear to have been a significant motive instead. In China, the latest 5-year plan appears to have again over-looked boosting incomes for the key household sector in favour of supporting heavy industry and infrastructure; and although it is a near-term positive that Chinese mortgage borrowing was up 25.5% y-o-y in Q1 2016, the fact that this is due to a clear housing bubble is far less comforting given we know what happens when these burst. As such, global growth has very few supporting pillars.

For the many countries that all now need to delever simultaneously, exporting their way out is their only option, or the least painful. Or, as it can also be rightly put, stealing growth from others when you can't generate your own. However, logically not everyone can do this at once. That's a theme we explored in depth last year with a special on "Currency and Wars" – and it remains true today.

## Why the ice could break soon

We therefore currently find ourselves in a complex four-way Mexican stand-off where the US wants a weaker USD, or at least a stable USD, even as it aims to raise rates; Europe wants a weaker EUR; Japan *needs* a weaker JPY; and China – despite official denials – also *needs* a weaker CNY. That potentially spells major trouble ahead for markets.

Fed Chair Janet Yellen's late March speech sent a clear message that the Fed does not want to see a stronger USD ahead. However, is that stance compatible with it normalizing interest rates? If the Fed has to concede its hands are tied on rates by the global economy, US Treasury yields will come down further if the US economy is seen absent of inflation pressures. That would push EUR and JPY higher, increasing their own deflationary pressures.

The BoJ are openly unhappy with USD/JPY having recently tested as low as 108, which threatens the major gain from "Abenomics" to date – a weaker JPY. Of course, the ECB are also unhappy with EUR/USD back around 1.13 despite all of the extra liquidity they are providing. Both central banks would almost certainly have to respond to a falling USD, should it occur. In that scenario, could China then allow CNY to appreciate vs. EUR and JPY, or would it too also have intervene? This all risks far greater currency volatility, or "FX Wars" to come.

However, if it looks like US inflation is on the horizon and the Fed *still* keeps rates on hold, longer-dated Treasury yields may rise rapidly, dragging USD higher with it. That's far from the most likely scenario, but it would also prove potentially destabilizing for debt-laden and/or emerging market economies, even if it meant a weaker EUR and JPY. Moreover, in that scenario the USD would of course rise again, and China would again have to act to prevent CNY being dragged higher by it – although capital outflows seeking higher yields would arguably do the job of weakening CNY for it.

Back in December and January this very same escalation in FX Wars from China was arguably already underway until global market panic forced a temporary halt: once the fall in CNY and the risk of Fed hikes stopped in tandem, risk sentiment quickly picked up again.

For now there appears to be an tentative unspoken understanding between the PBoC and the Fed: the former won't let USD/CNY stray too far from 6.50 as long as the latter doesn't move on rates again. However, only if *no-one* moves at all can we prevent the market ice starting to break again – and everyone needs to move at some point.

For example, even if the Fed holds and US yields don't decline, the BoJ or the ECB may still be forced to act again to weaken their currencies soon to fight deflation. Indeed, the BoJ notably meeting at the end of April disappointed expectations for yet more stimulus; subsequently USD/JPY lost as much as 2% to under 109 again, showing Japan that more radical policy steps are still needed. Such action would push USD higher by default, which would again risk capital flight from China and/or forcing the PBoC's hand on CNY once more.

The Fed Awakens...and next, the Empire Strikes Back


Furthermore, even if the BoJ can swallow the appreciation in JPY this year, this FX stand-off can arguably only be sustained for another few months. The clock is arguably still ticking loudly given that capital outflows from China are continuing regardless of efforts to clamp down on them. Indeed, we are still firmly of the view that China will eventually have to allow CNY to find a level significantly lower than at present to deal with its structural economic problems: *our forecast remains that in 12 months USD/CNY will be around 7.60, or nearly 15% higher than where it is trading today*.

In short, despite the apparent 'ceasefire' in the global currency war that may or may not have been unofficially declared at the 2016 G-20 meeting in Shanghai, it won't be long until we see a further, larger, more destabilizing round of FX 'combat'. Our Achilles' heel of global debt, which is getting worse, not better, makes that sadly inevitable.

That's one way we see real Thin Ice for markets ahead. It's perhaps a depressing thought, but accepting the reality of the situation requires it.

In part two of this trilogy, **Thinner Ice**, we will examine why the same central banks who are driving these FX Wars are as much a part of the global problem as they are its solution.

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