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| **ENGLISH** | **TRANSLATION** |
| HEADLINE: After the storm |  |
| AUTHOR: Steen Jakobsen |  |
| INTRO: Emerging markets have been battered by a debt-induced perfect storm, a dizzy US dollar and crumbling commodities prices. But there is hope – and investment opportunities ­– even though the pretend-and-extend craziness of printing money persists. |  |
| PULL QUOTE (1) “It’s no wonder that world growth is falling dramatically – the only surprise is that policymakers seem surprised!” |  |
| PULL QUOTE (2) “The perfect storm raging through emerging markets is also the biggest opportunity in decades” |  |
| The seemingly endless cycle of pretend-and-extend is threatened by muddled communication from central banks, less liquidity and a dramatic increase in volatility across all asset classes. |  |
| And the likely policy response to all of this? More of the same, of course! It does seem, however, that the market is growing increasingly immune to stimulus promises and more alert to the misguided “fairy tale” projections it has been given by central banks (and governments) throughout this crisis. |  |
| The increase in volatility and the selloff in the “safe” asset of equities now totals more than $7 trillion lost since the peak. This could bring about a new beginning – a move back towards reality as opposed to the artificial world of central bank-led credit growth. Don’t forget that the weak growth we have had since the financial crisis erupted in 2008 is almost entirely financed by an ever-increasing debt mountain. |  |
| A McKinsey Global Institute report, *“Debt and (not much) Deleveraging”,* points out that since 2007, debt has increased by a stunning $57 trillion globally, raising the ratio of global debt to GDP by17 percentage points. |  |
| The biggest issuers of this debt have been China and emerging markets, which together are accountable for more than 50% of the new debt. All of the EM countries have issued USD debt and converted it into local currencies, but as the dollar grew ever stronger, this practice engendered a perfect storm for emerging markets. |  |
| **A predictable outcome** |  |
| Pretend-and-extend triggered a negative vicious cycle whereby EM-issued, dollar-denominated debt was converted into local currencies. Then, the stronger dollar increased both the debt burden (as more dollars were needed to repay debt) and lowered commodity prices, a main export for many of the EM and certainly for the old BRIC countries. In turn, this meant less demand and less growth for EM. This happened in a world economy based on fiat money, dollar reserves, dollar-denominated commodities and debt and a rising USD. It’s no wonder that world growth is falling dramatically – the only surprise is that policymakers seem surprised! |  |
| Emerging markets are hugely important for the developed world’s growth and exports. In any given year, EM account for more than 50% of world growth – a fact that has global investors desperately searching for answers. Where will the excess returns come from in a world of shrinking profitability (caused by lower growth and inflation) and less productivity (caused by a focus on paper money returns instead of real jobs and investments)? |  |
| The expected mathematical return year-over-year for both equities and bonds remains close to or below zero for the next five years. The excess returns of stocks (and bonds) since the financial crisis will have to be replaced by sub-par returns unless our economic model has changed fundamentally, which, of course, it hasn’t. Pretend-and-extend is the very definition of insanity – “keep repeating the same experiment expecting different results” |  |
| But there is a silver lining – the perfect storm raging through emerging markets is also the biggest opportunity in decades. These markets have underperformed not only this year but also since the commodity cycle peaked in 2011. Now, valuations on all metrics, top-down and bottom-up, would be a screaming buy if not for uncertainty about the Federal Reserve, which scored an own goal in September by once again delaying the much-needed interest rate hike. |  |
| **How to play** |  |
| This Q4 publication is a defensive yet optimistic view on EM as the best-performing asset not only this coming quarter but also throughout 2016. The low-grade performance in the recent past bodes well for future returns, as it’s about two standard deviations cheap relative to the long-term trend. For the connoisseur, several markets are dirt cheap even on classic metrics such as price/earnings. These include Singapore and South Korea where forward P/E is currently trading at 12.1x and 10.9x versus US and European P/E in the mid-teens. |  |
| The way to play this will always be to enter FX trades first for reasons of liquidity and access. Many EM are not deep enough to cater for robust equity markets. In addition, academic studies show that more than 80% of all returns in EM come from FX and not from owning bonds and stocks. |  |
| Having said that, we believe EM overall are a buy – equities or credit as well as forex. The fact that we are in the midst of a perfect storm should not fool us into believing the sun will never shine again. |  |
| The Fed’s reluctance to hike rates will probably lead to no hikes in 2015 as the window of opportunity is closing. The market is increasingly pricing the likelihood of the next Fed policy move as likely to be a rate *cut* as much as a hike.    This means that the long USD trade (which the market consensus loves) is about to be tested. The path of least resistance for higher growth in the world is a weaker dollar (reduces debt burden, improves commodity prices, restarts recycling of capital from oil producers and China) and that’s what we expect the world will get. |  |
| The only concern is that growth will be so weak that we again flirt with recession, not only in Europe but also in the US. |  |
| We named our Q3 Outlook: “One-and-done” fully expecting, naively, that the Fed would deliver its telegraphed and promised first rate hike in nine years, fully expecting it to happen under the constraints of not having a US economy firing on all cylinders. |  |
| Now, we see one final round of global easing being implemented by the Bank of Japan, the European Central Bank and the Federal Reserve in Q4/Q1 as the business cycle bottoms. Fortunately, the market will by that time have weakened the dollar, increased commodity prices and restarted growth from a low level. Economics and markets are finally becoming intertwined again – meaning fundamentals matters, and that’s just about the best news ever. |  |
| Embrace the volatility of the next few months as signs that the market and economies are healing not destructing. Reality has returned and so too, will emerging markets. |  |