

BINARY OPTIONS: ZERO RATES MEAN ZERO CHOICE

Investors may have had their hands forced, but the recent flow of cash into emerging markets is perfectly logical, argues Mirabaud Asset Management's Gero Jung



GERO JUNG
Chief economist

MIRABAUD ASSET MANAGEMENT

Have you met Tina? For years Tina has dominated the allocation decisions of institutional investors across the globe.

'There Is No Alternative' has become a familiar mantra in a low-growth world. With no legitimately compelling options on the table capital is forced into lacklustre assets, and this flow of cash becomes solely responsible for the sustained rise of otherwise leaden markets.

When investors' animal spirits are backed into a corner, the Tina effect takes over.

However, change is afoot. The thirst for yield in a world of zero interest rates has led institutional investors into unfamiliar territory, with emerging market debt witnessing huge inflows.

What makes it different this time is that beyond the Tina effect there are good reasons to believe these flows into emerging market debt have a fundamental basis.

Meanwhile, developed markets seem stuck in reverse.

CAN'T HIKE, WON'T HIKE

We see three main reasons why the Federal Reserve is unlikely to pull the trigger this year and proceed with an interest rate hike.

First, the Fed's mandate of 2% inflation remains clearly out of reach. 2016 will be the 10th year in which core PCE inflation – the Fed's favourite gauge – remains stuck in the 1.5-1.7% range.

Importantly, the trend is certainly not signalling an improvement in the coming months. Indeed, inflation related to housing in the US is decelerating, implying that overall domestic inflation is unlikely to strengthen.

This comes in a context where inflation for imported goods remains subdued, with lower prices imported from Chinese goods a trend that remains in place.

The second big reason why the Fed isn't likely to hike is that US economic growth is likely to disappoint.

Although third-quarter growth is likely to turn higher, helped by more buoyant inventory data, GDP growth over the past three quarters averages less than 1%, meaning overall, 2016 US economic growth will disappoint.

Specifically, economic growth is likely to fall short of the Fed's 2% projection – a number that was already downgraded in June from an earlier, even more optimistic, forecast.

Sustained weakness in the manufacturing sector is also a worry. August payroll data showed that this sector continues to suffer, shedding a net 14,000 jobs last month.

The third reason to believe the Fed won't be raising rates any time soon is the fact that inflation expectations are unambiguously pointing towards weaker expected price changes.

This is the conclusion of recent consumer surveys. According to the monthly University of Michigan survey, longer-term inflation expectations have been lowered again. Surveys from the New York Fed confirm this, showing that anticipated inflation levels are close to historic lows.

Market expectations for longer-term inflation levels – including inflation levels expected in five years' time for the five years following – remain similarly at extremely low levels.

Why would the Federal Open Market Committee – largely comprising academics – want to raise policy rates in an environment where inflation expectations are clearly weaker?

Indeed, recent policymaker speeches indicate the Fed is likely to significantly revise down the neutral policy rate.

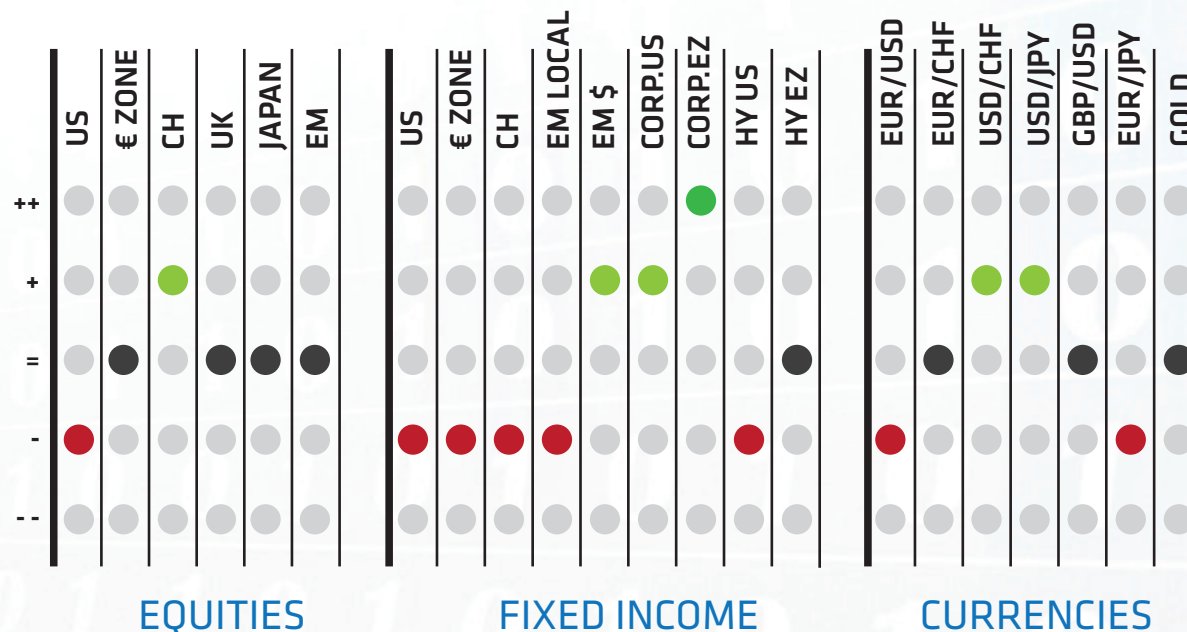
THE ONLY GAME IN TOWN

Against this backdrop it's not surprising that institutional investors are looking further afield for potential returns.

We have recently increased our allocation to emerging market sovereign debt, with the important caveat that it is denominated in foreign currency.

Several factors explain this decision to move into the sector. The Tina effect of cash needing to find a home, wherever that home may be, is certainly one factor.

MIRABAUD ASSET MANAGEMENT - TACTICAL ASSET ALLOCATION



SOURCE: Mirabaud Asset Management

Given historically low returns on their home turf – a situation that is unlikely to change in the short term – institutional investors around the globe have been pouring money into emerging markets, and will continue to do so.

With a large chunk of industrialised countries' sovereign debt showing yields that are in negative territory, the positive yields on offer from emerging markets are likely to attract more inflows.

From a relative point of view, if one expects the US Fed to keep rates stable with subdued inflationary pressures, an emerging market bond yielding 5% on average seems attractive relative to the meagre sub-2% return of a 10-year US Treasury bond.

'Given historically low returns on their home turf – a situation that is unlikely to change in the short term – institutional investors around the globe have been pouring money into emerging markets'

STRENGTH IN DEPTH

The sheer size of the emerging market debt market is also a draw.

Globally, the total stock of emerging market bonds – standing at \$18 trillion at the end of 2015 – provides an ample pool of securities to choose from. Not only is that substantial compared with the liquid \$16 trillion (BIS data) US government debt market, but also compared with the \$13 trillion of industrialised country sovereign debt market that currently trades at negative yields.

Overall, economic fundamentals in emerging markets are improving.

For instance, the Purchasing Managers' Index again rose above 50 – its equilibrium level – during the summer. The average current account is in surplus by nearly 1% of GDP, and public debt continues to decline.

The improvement in fundamentals is even more significant given that, in a period of low volatility, the factors specific to emerging countries are important drivers of performance ahead of global factors.

This comes in a context where fears of a hard landing in Chinese economic growth are clearly receding. Indeed, the latest activity data points to a stabilisation of Chinese growth.

WHERE NEXT FOR MARKETS?

At the global level, the weak growth environment is unlikely to change.

This was one message from the annual central bankers' meeting in Jackson Hole, where the focus was the theme of new monetary policy measures.

The symposium ended with a relatively clear conclusion: despite several years of ambitious support measures – both at the monetary and fiscal policy level – global growth remains below its long-term average of 3.7% for the fifth consecutive year.

Also, as recently noted by the International Monetary Fund, although the G20 pledged two years ago to implement measures to grow GDP by a further two percentage points over the next five years, the structural measures implemented only allowed for half of that goal to be reached.

Growth will remain moderate in 2016–2017 and monetary policies will remain very accommodating.

WHY EQUITY MARKETS ARE OVERCOOKED

We would not recommend chasing equities at current levels, as we believe that this summer's global rally has pushed them into overbought territory.

Consequently, we recommend a neutral stance in equities, staying conservatively positioned relative to a benchmark allocation to global stocks.

At the same time, as we expect that monetary policy extremism is likely to continue, we believe that the bond rally – including the one observed in corporate bonds and emerging market debt – is likely to continue. We retain our overweight position in bonds.

Despite gaping macro disequilibria, this summer's rotation back into risk assets is notable by the fact that the fundamentals of the global economy have not improved.

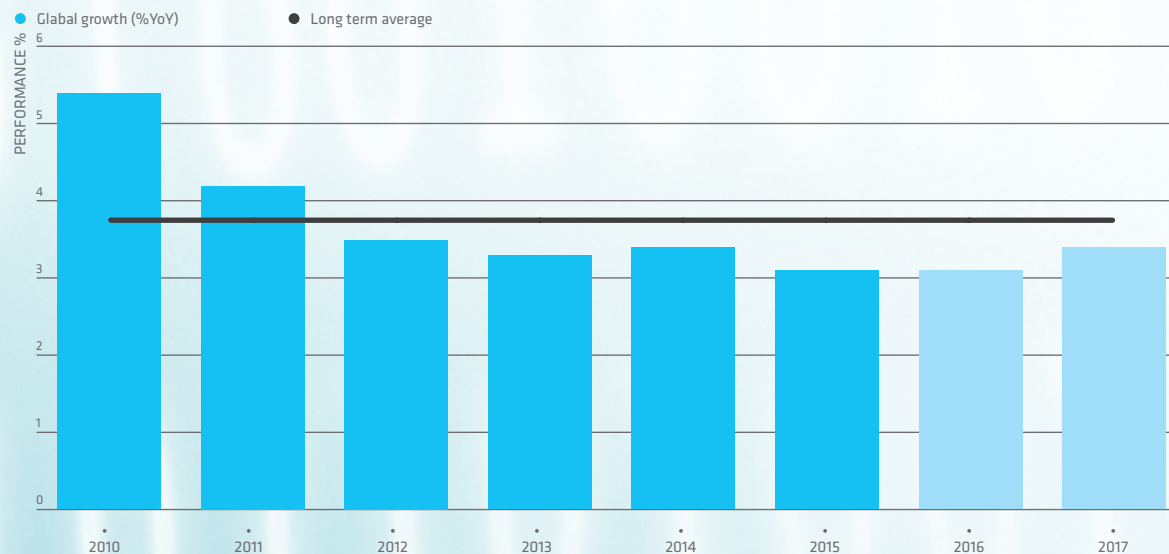
Manufacturing activity remains in the doldrums, productivity continues to disappoint, investment remains subdued and global trade activity remains weak.

‘Despite several years of ambitious support measures – both at the monetary and fiscal policy level – global growth remains below its long-term average of 3.7% for the fifth consecutive year’

Despite more robust domestic demand on the back of solid consumption behavior global GDP growth remains lacklustre.

On a fundamental level, we remain uncomfortable with the recent strong rise in risk assets.

GLOBAL GROWTH REMAINS LACKLUSTRE



SOURCE: IMF