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INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Published Research Team

"DM Deleveraging, EM Stressing" by Gregory Peters, Neil McLeish, Gerard Minack, and Jason Draho, Morgan Stanley, November 1, 2001

Investors face a multi-year global deleveraging cycle fraught with numerous negative feedback loops. At center stage of the deleveraging phase are European banks, which are likely to reduce balance sheets/investments, especially their emerging markets asset exposure. Given that many emerging economies still rely heavily on US$ funding and credit extension from banks in developed markets, any contraction of credit is a headwind at a time when emerging markets growth is already slowing down. Indeed, investors have not properly calibrated the intensity of the negative feedback loop between developed and emerging markets via funding channels.

The global economy is in the midst of a multi-year global deleveraging cycle fraught with numerous feedback loops. Developed markets are at the epicenter of this deleveraging, and face a long, difficult road ahead. As a result, one negative feedback loop, which investors do not yet fully appreciate, is how deleveraging in the developed world will impact economic growth in emerging markets via funding channels.

The developed-to-emerging markets feedback loop consists of four stages. The first begins with the likely deleveraging by European banks, which could see balance sheet contraction approach €2 trillion by the end of next year. Asset sales, for instance, may increase to meet higher capital ratio requirements. Further, the spreads for senior unsecured bank debt have risen to unprecedented levels, making the core bank function of lending to households and businesses uneconomical at the current cost of wholesale funding. Finally, banks have €1.7 trillion of term debt maturing through 2014. Here, banks could potentially let €1 trillion in assets simply roll off to avoid refinancing, given the high cost. Ultimately, the banks may not have much of a choice, as the current crisis has dramatically slowed the amount of term debt issued in the past four months.

The second stage of the feedback loop is the potential impact of European bank deleveraging on emerging markets. This depends heavily on the financial interconnections between emerging and developed markets, which are arguably more integrated than ever. Prior to the financial crisis, for instance, western European bank lending exposure to the United States was roughly double to that of emerging markets. At present, however, exposures to the United States and emerging markets are now about equal, at $3.75 trillion. The convergence was mainly due to an increase in emerging markets lending, which grew almost 300% between March 2000 and March 2008. This rapid credit growth in emerging markets suggests that non-core emerging markets assets are especially vulnerable to European bank deleveraging. Here, the global financial crisis provides a useful guide to estimate emerging markets asset reduction—European banks reduced total lending to emerging economies by 20%, or about €500 billion, between March 2008 and June 2009. This, coupled with the €1 trillion in assets expected to roll off balance sheets, is a rough range for emerging markets capital withdrawal.

The vulnerability to an external funding withdrawal depends on the third stage in the feedback loop—the potential emerging markets policy response to the deleveraging. On a positive note, most emerging markets countries have several policy tools at their disposal. For one, foreign reserves have increased since the financial crisis. These liquid assets can refinance foreign liabilities if existing debt is not rolled over, and thus prevent a negative run on the currency. Officials also have some monetary and fiscal policy flexibility. Indeed, policy rates in most countries are still at their peak, suggesting an easing cycle has yet to begin in earnest. On the fiscal front, meanwhile, most emerging countries have ample scope to stimulate, given that deficits and debts are in far better shape than in the developed world. However, unlike last year's developed markets growth scare, the coming emerging markets policy response may be more muted, putting growth at greater risk. Indeed, the ability to ease does not necessarily equate to an actual desire to do so. Recent weakness in emerging markets currencies, for instance, is a possible disincentive to lower policy rates, as those actions could very well serve to exacerbate the recent emerging markets foreign exchange decline.

To complete the feedback look, slower emerging markets growth stemming from European bank deleveraging has negative implications for developed markets. Indeed, roughly 80% of 2012 global GDP growth will be driven by emerging markets. Thus, any emerging markets slowdown would be an additional headwind for developed economies, as exports to emerging markets are one of the few engines of growth for recovery in the developed world.

Clearly, the risk that credit becomes more scarce and expensive in emerging markets puts growth projections, which were already being trimmed, at risk. Domestic production, measured by PMIs, is falling across all regions and external demand, measured by export growth rate, has slowed as well. Thus, investors should remain cautious on risk assets. Among emerging markets assets, deleveraging poses the most risk to currencies, given the potential stress in funding markets and the risk of capital flight. Sovereign spreads could widen as investors liquidate or hedge positions, discounting the contingent liability risk of emerging markets governments needing to support domestic banks if funding is withdrawn. Emerging markets equities are also at risk, but more so because of negative growth implications.

"China: Is Shadow Banking Another Subprime Debt?" by Yiping Huang, Krishna Hegde, Jian Chang, and Lingxiu Yang, Barclays Capital, October 25, 2011

The health of the Chinese economy and its banking sector are coming under increased scrutiny. The rise of "shadow banking," or trust lending, and the risks involved, could have a significant impact on the Chinese economy. The shadow banking system in China has grown as a response to the oppressive nature of the centrally planned Chinese banking system and tight monetary conditions. While there are some benefits to allowing credit to get into the hands of borrowers that otherwise would not be able to receive it, the nature of the off–balance sheet financial innovation and the associated risks are not without consequences.

As overleveraged sovereigns in Europe come under pressure and fears rise over the global economy slipping back into recession, the health of the Chinese economy and its banking sector are coming under increased scrutiny. The rapid rise of "shadow banking," or trust lending, is in focus, as over 20% of new societal financing comes from this channel, which has historically been poorly regulated. Some investors fear that a disorderly unwind, or forced deleveraging, of these vehicles could trigger a negative feedback loop across asset markets, similar to what was seen in the United States during the subprime crisis.

The risks presented by a poorly supervised shadow banking system are significant, but the reasons behind its growth should be taken into consideration. Developed as a response to the oppressive nature of the centrally planned Chinese banking system and tight monetary conditions, the shadow system brings together borrowers that otherwise would not be able to receive credit with individuals that seek higher yields for their savings than they can earn through traditional bank deposits. Investors have two channels: trust companies that sell loans and financial institutions that repackage them via wealth management products. As many of the destinations for loans are infrastructure, real estate, and other commercial projects, investors are concerned that slowing growth and falling property prices may jeopardize these investments. Observers are also wary of trust financing due to memories of China's trust industry, the history of which was characterized by massive losses and bankruptcies in the late 1990s.

The more recent experience with off–balance sheet financing during the U.S. subprime debt crisis illustrates the painful effects when poorly regulated vehicles delever after the bursting of asset bubbles. These comparisons are understandable, but it is important to realize that there are key differences between the subprime debt crisis in the United States and trust financing in China. Investors in U.S. subprime debt were primarily financial institutions and the debt was often wrapped up in complex derivatives or leveraged securities that magnified losses once the loans underlying the securities began to go bad. In China, the main investors in securities issued by trust are individuals that are desperate for any investment that will allow them to earn a return above inflation.

Chinese officials are not blind to the risks that off–balance sheet financing poses to the Chinese economy; in fact, it was the Chinese authorities that brought the topic to the world's attention. In August 2011, the People's Bank of China began to mandate that banks include off–balance sheet transactions when tallying the amount of reserves they need to hold to protect against potential losses. In October, regulators took additional steps to require that all financial institutions provide details of their off–balance sheet transactions.

New regulations have increased transparency and help in assessing the size of off–balance sheet liabilities, but simply identifying the risks in the system is different than doing something to contain them. Recently, a number of small- and medium-sized businesses—often the beneficiaries of trust finance—have failed, and declines in home prices in a number of cities are also stoking concerns. Some trust lending is likely to default in the year ahead, and loans to property developers seem the most vulnerable. Any defaults may in turn spark redemption requests by investors that, given limited access to information, may fear the worst. The good news is that home prices are falling in part because of government policies that discourage the use of leverage in home purchases; as such, the government could alleviate some of the pressure if it viewed the drop in property prices as creating systemic risks.

On balance, it seems unlikely that deterioration in the shadow banking sector poses systemic economic or financial risks. Increased regulation by the Chinese government and the limited involvement of financial institutions lower the risk of a vicious cycle of falling asset prices. Still, the fact that off–balance sheet lending has expanded so much over the last few years illustrates the unintended consequences of government policy, and losses on vehicles, if excessive, may trigger social and political tensions.

"Going Down," by Douglas Borthwick, November 11, 2011, Welling@Weeden

The U.S. dollar is falling, and this trend, which has been supported by various factors, will take a lot to reverse. Among the factors that have supported the trend are China's desire to hedge against the risk of "sharp US$ depreciation"; reserve diversification in South Korea and other Asian nations; the interest rate differential between the United States and many countries; and finally, actions by the Federal Reserve and desires of the current administration.

Since August 2010, the US$ index has fallen while the euro has strengthened, two trends that are likely to continue. US$ weakness is supported by several drivers, which include China and other Asian nations diversifying their currency reserves, interest rate differentials between the United States and other countries, and policy objectives in the United States.

China has publicly stated its displeasure with US$ weakness, and used its ability to diversify its foreign currency reserves as a threat. Given that approximately 70% of China's $3.2 trillion of current reserves are held in US$ assets, re-weighting its reserves would put sharp downward pressure on the U.S. dollar. One option would be for China to re-weight its reserves according to trading volumes; just 13% of its trade is with the United States. Another option would be to recalibrate according to International Monetary Fund (IMF) Special Drawing Right (SDR) weightings; these have just a 44% US$ weight. In fact, in November 2010, the IMF increased the weighting of euros in SDRs and decreased the US$ weighting, bringing about a rebalancing from central banks that follow the SDR allocation. There is an obvious causal relationship between the USD/CNY and the USD/SDR; when China enters into its diversification program, the USD/CNY strengthens and the U.S. dollar weakens against other SDR components. Similarly, when China relaxes its peg to the U.S. dollar, the U.S. dollar also drops against the index.

The value of the USD/CNY is very important for neighboring Asian countires, as they all compete for international trade. A weaker renminbi gives China an advantage, making its exports cheaper relative to its neighbors. As a result, Asian nations regularly intervene to try to stop their currencies from appreciating against the U.S. dollar. However, many do not keep the currency, and later conduct sales to diversify their reserves. These interventions are not staged at specified times, as doing so would pin the market against them. Instead, they keep constant offers in the market, creating consistent selling pressure on the U.S. dollar and reining in its strength.

Interest rate differentials have also been an important factor for US$ weakness. Lower-yielding currencies, such as the yen and the franc, are traditionally seen as "funding" currencies, used to finance the purchase of higher-yielding currencies and assets. The U.S. dollar is now a funding currency, and interest rates near zero in the United States weaken it relative to other currencies. Relative to the euro, interest rate differentials weakened it until this summer. However, in June, "Operation Twist" pushed U.S. short-end rates even lower; this may cap the dollar's downside against the euro unless interest rates rise in Europe.

Further action by the Fed may place the U.S. dollar under additional pressure. QE2 has come and gone, and now some Fed officials are suggesting that further quantitative easing will help boost asset prices. Indeed, the Fed has recently commented that it have more ammunition left for further action, if the economy calls for it.

The U.S. dollar is falling, and it will take a lot for this trend to reverse. Asian central banks are continuous sellers, with China's stated goal of renminbi flexibility leading the charge. Once again, QE is waiting in the wings, potentially acting as a backstop to Europe. A strong U.S. dollar is no longer in the interest of the United States. Indeed, President Obama stated toward the end of 2010 that he wanted to double U.S. exports over five years, which cannot be achieved without a weaker U.S. dollar. Lately, the U.S. stock market has shown remarkable sensitivity to US$ strength. After all, U.S. multinationals see demand for their exports dry up as the U.S. dollar appreciates. US$ weakness is likely to be the norm going forward, with Asian and Latin American currencies strengthening. ■

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