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"Taper Tantrum 2.0 – a modest green"

By Jefferson V. DeAngelis, CFA, Chief Investment Officer

After a noticeable delay, spring arrived in the Midwest. With the warm weather, things are starting to green up and thoughts turn to summer pursuits. Spring's arrival kicks off a torrent of activity at the local golf clubs as greenskeepers busily ready the greens and fairways for summer play. For them, an annual problem is restoring unhealthy patches of grass on the greens. The common remedy of using a broad fertilizer, while practical, is problematic. When applied correctly, it revives brown patches but causes rapid and uneven growth in the healthier spots. If applied incorrectly, too much fertilizer kills the healthy grasses without cultivating the brown spots. Ultimately, what the groundskeepers, and the players, desire are healthy trimmed greens that are relatively flat with a few gentle slopes and undulations.

In a similar fashion, central banks face the dilemma of restoring national economies showing slower signs of life without killing off healthy ones, and seek stability over wild undulations. Excess liquidity provided by a global expansion in central bank balance sheets has left emerging markets vulnerable to temporary reductions in accommodation. At the margin, the policy of promoting low interest rates in most of the developed world has produced the desired effect of stimulating demand. Growth in the United States is stable somewhere in the mid two percent range. European growth has stalled recently but appears to be on the mend. Even Japan, which has been largely dormant for decades is showing signs of life. In contrast, many of the fastest-growing emerging countries have slowed. China, India and Turkey are growing at a strong pace to the developed world albeit slower than before the financial crisis. The Mideast has rebounded in line with the unanticipated pick up in petroleum prices. Most of Latin America is heading in the right direction despite increasing political risk.

Commensurate with this noticeable pickup in economic activity is an increase in the level of debt necessary to sustain it. Debt to GDP ratios are rising across the world but much faster and unsustainable in the developed world. China's debt ratio is half of that of the U.S. Turkey's it is one fifth. Across Europe, debt ratios exceed that of the U.S. In Japan, the ratio exceeds twice that of the U.S. Herein lies the problem, any attempt to sustain debt-financed growth in the developed world disproportionately affects our emerging market neighbors.

The impact is most evident on capital flows into the emerging markets. In many emerging market countries, borrowers found it advantageous to borrow in hard currency markets where interest rates were low. Investors periodically, as now seems to be the case, become concerned that these borrowers will have difficulty paying off their debts. Yet, most of the emerging market debt burden lies within the private sector. The governments have been more cautious this cycle in their use of hard currency debts. In fact, most emerging market countries have focused on building reserves following their experience with capital flows during the 1998 currency crisis.

A similar scare occurred in 2013 when then Federal Reserve Chairman, Ben Bernanke, hinted at the need to raise U.S. interest rates following a period of extraordinary monetary accommodation. Since then, interest rates have risen at a gradual pace without a noticeable effect on the creditworthiness of sovereign debtors. As already mentioned, emerging market countries, on average, have debt ratios far behind their developed market peers. Policymakers in most emerging market countries understand the risk of dollar-denominated liabilities. Most have been strategically building local capital markets to ensure a diversified source of capital to fund internal development.

The current taper tantrum is consistent with the historical context of fear of increased risk within emerging debt markets corresponding to U.S. dollar strength. Ironically, while the dollar has strengthened recently, the trend over the last year has been clearly lower. We view the current dollar strength as transitory and corrective. For the most part, the current weakness in many emerging market currencies are reversals of strength earlier in the year. Of course, there are exceptions, notably the Argentine Peso and Turkish Lira, which draw the headlines casting negative sentiment on all emerging markets.

In trying to encourage and grow the U.S. economy, policymakers are seeking to normalize U.S. interest rates. However, their actions risk the broader dollarized global economy. In the short run, the Federal Reserve is likely to ignore the impact on emerging market economies. In the event of a more pronounced impact on global growth, the Fed would be likely to reverse course or at least pause. We live in a globally integrated economy that depends on the dollar as its reserve currency. The Fed's policy has broad implications beyond the borders of the U.S. Efforts to spruce up one patch could have unintended consequences for the rest.

The central banks of developed nations can selfishly try to preserve their delicate economic advantage by flooding the world with cheap money. However, like the greenkeeper tending to his fragile greens, central bankers must be measured and thoughtful in their actions to avoid negative secondary effects. Poor planning or implementation could risk the brown spots overtaking the green ones.

172 N Broadway, Suite 300 | Milwaukee, WI 53202 | 414.755.0461 | www.nwpcapital.com