The 2016 International Monetary Fund and World Bank spring meetings

Mixed messages argue for holding emerging markets and risk assets – but warily

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We were struck by a sharp reversal of market participant and policymaker views at the April 2016 spring meetings of the International Monetary Fund (IMF) and World Bank in Washington, DC compared to the October 2015 annual meetings in Lima. Back then, policymakers were relatively sanguine, whereas both the investor and investment banking community were very worried about impending downside risks to global growth and inflation led by deflation and devaluation risk in China and financial instability in emerging markets (EM) fueled by a strong US dollar and prospects for US monetary tightening. In retrospect, policymakers were roughly right about the past two quarters, though the ride was rough.

Spring meeting takeaways

Most investors seemed fairly bullish about the near-term global economic and market outlook, thanks mainly to the US Federal Reserve's (Fed) dovish tilt and reflation in China – whereas both national and international policymakers now seem much less sanguine.

Our own overall assessment is that the outlook for global growth and performance of EM and other risky asset classes remains favorable for the next few quarters during which episodes of turbulence will likely be taken in stride. However, we strongly share official sector concerns about the sustainability of financial markets' "risk-on" sentiment or real-economy animal spirits over the next year and beyond.

Concerns are both thematic and country-specific. Price and financial stability and growth concerns center on 1) Europe and BREXIT (the possibility that the UK leaves the European Union (EU)) threatening both the UK and the eurozone, 2) Japan backsliding into deflation, 3) China and the EM complex - including Brazil, Russia and South Africa - facing credit and/or growth headwinds.

The market and policy communities did agree that the bright spots are the United States, India and Indonesia, with Argentina continuing to emerge as a turnaround story. We share this consensus, though concerns are now emerging about current US GDP performance.

In our view, EM macro and financial performance is exposed to three key "known unknowns" – both normal economic risks and political tail risks, whose impact would likely increase as bullishness becomes increasingly reflected in portfolio positioning:

1 Upside US economic surprises in activity, employment and inflation materializing consistently which could boost the US dollar, pressure commodity prices and tighten global financial conditions – or alternatively, a continued slide in US growth indicators that could resurrect recession fears (though this is not our baseline view);

2 Downside China surprises, should reflationary fiscal, monetary and credit policies prove insufficiently stimulatory given strong credit growth and still heavy overcapacity – or alternatively, should the recently resurgent growth in credit and deteriorating credit metrics prompt the authorities to dial down credit growth, undermining global reflation;

3 Key event risks could become contagious or even chronic. BREXIT is the most immediate as well as potentially damaging risk, in our view, with a short-term risk of a renewed bout of risk-off dollar strength, which could tighten global financial conditions at the expense of Europe and EM. Contentious exit talks, difficult trade talks or fissile tendencies in the rest of the EU or eurozone might also undermine confidence in global economic and financial integration.

In April, we attended the Spring Meetings of the IMF and World Bank to discuss and debate with our peers in the EM investment community and engage directly with policymakers and politicians. These include the IMF, the Fed and US Treasury, the eurozone, Japan, the UK, China, India, Brazil, Argentina, Russia, Turkey and South Africa among a host of others from other important economies in emerging Asia, Latin America, emerging Europe and the Middle East.

In addition to the above summary, we present below our key findings from these meetings, and explore the issues in greater depth vis-a-vis financial markets, global macro themes and developed and emerging market country narratives.

The contrast between the October 2015 Lima Annual Meetings and the April 2016 Washington, DC Spring Meetings was striking. Now, the market is relatively bullish whereas the policy community is drawing attention to all the major policy challenges that persist. Just two quarters ago, the market was highly skeptical and the policy community relatively sanguine about event risks, centered on China.

We believe the EM/risk recovery seems likely to continue in the near future thanks to the reflationary support of a more dovish Fed, a weak dollar and China's stimulus, while the reasons for worry are medium-term. Hence we expect episodic pullbacks, driven by specific event risks. Moderate event risks are likely to be taken in stride by the markets as long as the reflationary environment continues. But if the needle moves back from reflation hope to deflation risk, EM and risk assets could significantly re-price. For example, the OPEC Doha disappointment has proven well contained, given that the main story - reflation in China and delayed Fed tightening and a subdued dollar - seems likely to persist, supporting EM and risk assets.

Spring meetings macro takeaways

Upcoming major event risks include BREXIT, as well as forthcoming rounds of European Central Bank (ECB) and Bank of Japan (BoJ) easing. The most important event risk remains the consequences of China's reflation strategy – do China and other EMs use the risk-on reprieve generated by reflation to adjust or to go back to business as usual? If the latter, the reckoning may be later, but may also be more severe. One key issue is whether, when and how China restrains the recent rapid credit growth after it has generated a mid-cycle recovery.

The Fed remains a potential flashpoint for EM and risk assets, given the view that US growth is above potential according to some Fed officials, and the strength in US consumption, employment and consumer credit. But given the risk of US dollar strength due to ECB and BoJ easing, from BREXIT, and the resulting potential pressure on China and EM, we believe there are good reasons for Fed rhetoric to remain dovish, or at worst mixed, rather than hawkish.

Since the Spring Meetings, the UK's "Remain" campaign has gained traction in several polls and benefited from direct statements in support of continued UK membership in the EU by US President Obama and other UK allies. Still, the campaign has several weeks to run, and this now moderated tail risk may return to the fore. The BoJ disappointed market consensus hopes for easing at its April meeting, again in line with our own house view, contributing to the weak US dollar and risk-on environment, along with further US data and policy signals which reduce the chances of Fed hikes. However, deflationary pressures persist in the eurozone and in Japan, suggesting further monetary or credit easing might lie ahead.

Mixed messages on portfolio flows, exposures and the EM balance of payments

There was a contrast across views about the degree to which the investor community has participated in the EM rebound. There were doubts about flows from both a balance of payments and portfolio flow perspective. Both sell-side and buy-side participants expressed doubts about the recent stabilization and nascent recovery in portfolio flows. The financial market community has also become more acutely aware of the concentration of capital outflows in China on a balance of payments basis, compared to relative stability seen elsewhere, now even in Russia and Brazil.

Policy makers believe that whatever the current positioning, the near-term recovery and optimism is likely to run into the serious macro adjustment problems that lie ahead if and when China again restrains credit growth, potentially sometime later this year. However, on balance, it seems reasonable to expect portfolio flows to continue to return to EM as long as the overall environment is risk-supportive, i.e. as long as China reflation persists and the Fed holds off. After all, there have been large retail investment outflows which show signs of returning and indications of institutional interest.

Mixed messages on global and country macro

A contrast continues between economic stabilization and risky asset recovery, on the one hand, and daunting, unresolved policy challenges for several major economies on the other - especially Europe, Japan, China, Brazil, South Africa and Turkey. Europe event risks are high (BREXIT), while headwinds for Europe's cyclical recovery were perceived to lie ahead. Japan faces the policy conundrum of needing to ease to counteract yen strength, but without being seen as restarting the currency war dynamic.

ECB President Draghi pledged to do whatever it takes to generate price stability and raise inflation. We believe the BoJ must follow suit since it has acknowledged that its current policy stance is not yet working. Forthcoming BoJ and future ECB easing measures will therefore need to be more creative, in our view, in order to respect these global constraints while supporting domestic objectives. The logic of this policy narrative, in our view, is that the focus of policy needs to shift more heavily toward fiscal support and structural reform in both the eurozone and Japan. To the extent that these are constrained by political obstacles or high public debt levels, we believe monetary policy will need to focus on reflating domestic credit markets more directly, rather than using more deeply negative interest rates, which would tend to weaken the euro or the yen through capital outflows. Such policies may import some inflation in the short run through a weaker exchange rate, but have, since the financial crisis, tended only to temporarily boost growth through exports often at the expense of other regions. More recently, such measures have indirectly boosted the dollar by weakening the euro and the yen, in turn putting more pressure on China and the EM complex, exacerbating global financial instability as well as undermining banking systems and the credit transmission mechanism.

Despite these overarching issues, there was generally a greater sense of optimism about the near-term EM outlook among the investor community, which was present in force. Many concurred with our concerns about the lack of adjustment and resolution of credit problems, macro and cyclical imbalances and structural challenges, but many now see these as major but future risks. Furthermore, the receding balance of payments pressures in many countries otherwise at significant risk - especially Brazil, Turkey and South Africa in declining order - are likely to keep supporting market enthusiasm.

The recent China reflation and Fed tilt toward dovishness is another reprieve, but the question remains – which countries will use the relief rally as an opportunity to adjust and build buffers for when potential pressures resume? The critical question is about China itself – will it use reflation as a window of opportunity to improve the financial system, engage in state-owned enterprise (SoE) reform, and thereby rebalance more smoothly in order to liberalize the capital account and make the exchange rate more flexible in a less disruptive manner? The jury remains out, skepticism remains high – but the challenges look likely to be delayed by a couple of quarters following the IMF's inclusion of the Chinese currency, the renminbi, in its basket of reserve currencies or Special Drawing Rights (SDR) (after which the incentives to maintain stability are perceived to be somewhat less strong), or a turn of the screw by the Fed.

Key developed market (DM) economy narratives and policy challenges

US: A prevailing view was that upside US data surprises could undermine risky assets. Contrast existed between Fed dovishness and the views expressed by a number of senior Fed and other officials that the US continues to grow above trend, the labor market is healthy and tightening, and that, therefore, we will eventually see more inflation pressures. There was some discussion of US political risk, but the consensus appears to be shifting to the idea that there would be general continuity in US macro policies.

Japan: The BoJ seemed to suggest it is likely to return to easing, offering three explanations for the weak results of its easing program, without focusing on the relative under-delivery of the structural arrow of Abenomics (policy program to boost growth):

4 The theory of quantitative easing (QE) is wrong - though the US QE experience negates this, in our view.

5 Bad luck and external shocks have undermined the effectiveness of BoJ quantitative and qualitative easing (QQE).

6 The BoJ itself hasn't done enough, so will need to do more.

With reform outside the monetary policy purview and the politics as complex as ever, the message seemed to be that the BoJ will return to the lab and figure out new measures that do not divert global trade, but that directly reflate domestic demand.

The EU and eurozone: The main focus of DM event risk and economic performance was once again Europe, at least on par with Japan, thanks both to eurozone disinflation and the potentially disruptive threat of a BREXIT. The view was that BREXIT risk has risen, based on recent polls, creating greater uncertainty about the macro and market impact. There was concern that the chances of a risk-off reaction have risen accordingly, which seems increasingly likely to move from sterling and UK asset markets to infect at least the European region, and possibly the US dollar and yen, in turn pressuring China and EM.

The UK: There was rising concern about BREXIT given polls suggesting an even split between those in favor of remaining and those in favor of leaving the EU and widespread uncertainty about the immediate and longer-term financial and economic implications. This may well prove to be political theater, but the uncertainty could eventually infect other markets. Wider, more persistent ramifications cannot be ruled out in a negative BREXIT scenario. There could be an immediate risk-off orientation in Europe itself, in which sterling would suffer further downside because of the UK's outsized current account deficit. The euro could also fall because of reduced exports to the UK, and a reduced trading relationship with the world's fifth largest national economy could also pressure investment, requiring yet more monetary stimulus in the eurozone. Potential global spillovers include stronger safe harbor currencies such as the US dollar, yen and Swiss franc, which, in turn, could conceivably put downward pressure on the Chinese currency; China has a very important trading relationship with the EU. Another realignment of the major currencies with broad-based US dollar and yen strength and pressure on China could once again infect commodity markets, tighten global financial conditions and resurrect both terms-of-trade and financing shocks for EM countries.

Eurozone periphery: The consensus was still that ECB action would help lend support. The real EU concerns remain long-term cohesion and integration, given the ongoing problems of sharing federal money without a federal political or fiscal union and a still highly incomplete banking and capital market union. On this front, there is a school of thought that BREXIT, by threatening further fissile tendencies in many EU countries, in the core and periphery alike, could drive the eurozone toward closer integration.

Continental Europe: The notion that newer EU members, especially those with ambiguous EU commitment and questionable macro policies, would come under pressure is gaining currency - a concern we have had for some time. Poland and, to a lesser degree, Hungary are potentially in the line of fire, in our view.

Key EM economy narratives and policy challenges

China: Market participants were more willing to give China the benefit of the doubt than at the October 2015 Lima meetings – though most were convinced that the credit reflation strategy will generate more trouble in the future. As such, signs of credit restraint or credit problems will likely regenerate concerns, as will significant US dollar strength. Meanwhile, however, the view was that risk is on and reflation is underway in China and the market seems willing to go along for the ride.

The rebound in property investment, rising property prices across all tiers of cities, and exceptionally high credit growth all reconfirm that China is receding as a source of severe deflation pressure for the time being. On this basis, Chinese credit growth is resuming its role as a contributor to growth in domestic and global demand for commodities. Thus, the good news is that reflation takes away the pressure of deflation; the bad news, however, is that it shifts the focus away from rebalancing and reform. And reflation does not ensure against credit growth going into the capitalization of interest and evergreening of loans and forbearance on non-performing loans; nor does it do anything to impose hard budget constraints on SoEs and discourage moral hazard. Perhaps most worryingly, it leaves open the question of what will happen when credit has to be restrained again.

The official consensus, which seems reasonable to us, was that this need not lead to a financial crisis, given the reality that the Chinese sovereign, local government, enterprise and bank balance sheets, in fact, behave in a consolidated rather than autonomous fashion. Hence bank liability runs are still unlikely, in our view – as long as capital controls remain. A number of prominent China watchers reckoned that this policy strategy will remain in place at least until SDR implementation in October, after which the incentives for China to see domestic and global stabilization as very tightly aligned may be revisited. After that, the rise in contingent and implicit fiscal liabilities may well become more of a concern, prompting credit restraint and less support for the global economy, including the EM/commodity complex. If so, it would be highly encouraging if there were significant SoE reforms and restructuring of bank balance sheets in the interim. If not, it would suggest to us that little had changed.

An important risk to the view that China will not experience traditional banking pressures is that the proliferation of complex wealth management and trust instruments, rapid credit growth and persistent overcapacity could undermine regulatory control of the financial system. Liberalizing financial markets generally and integrating the market with the rest of the world has often preceded financial instability in a variety of EM and DM economies. For the time being, this risk is being managed by a gradual process of liberalization as well as some tightening of controls on resident capital outflows, but we will continue to monitor this challenge very closely.

India: The market community appeared to remain comfortable, despite the lack of structural reform. This should continue to work well, in our view, given the high degree of insulation of a closed economy, the good luck of being among the countries that benefit the most from collapsing commodity prices, and proper macro management policies of external adjustment, monetary policy refinement and federal fiscal consolidation. These factors should be more than adequate to compensate for the lack of structural reform, the complexity of federal and local politics which seem unlikely to deliver greater speed on reform, and the difficulty of state fiscal adjustment given local elections. A good monsoon should pave the way for interest rate cuts. We believe market participants invested in Indian fixed income assets are likely to remain so.

Brazil: Brazil was still seen as a potential turnaround story following a possible impeachment, which is still proceeding, but remains a multi-step, tortuous process. Investors are focusing on the specifics and even minutia of the politics and legalities of impeachment, as well as the bigger picture of the popular pressure for political change. Most are not yet focusing on the policy challenge that lies ahead. The best solution, in our view, social security reform, requires constitutional reform, which seems unlikely; rather the adjustment is likely to take the form of yet more taxes and discretionary and temporary spending cuts. A proper fiscal overhaul would probably require a new president with a new popular mandate as well as a new Congress – after all, Vice President Temer as well as other key members of his Brazilian Democratic Movement Party (PMDB) and many senior opposition figures are also tainted by corruption allegations and investigations. All that would require new elections, or have to wait until the October 2018 Presidential and general elections. Therefore, even if President Dilma is impeached, Brazil seems unlikely to be able to make the most of forthcoming political change. At least the headlong rush toward a fiscal crisis may be averted by the hope of impeachment and the improvement in the structure of current account financing via an improved trade balance and more foreign direct investment funding.

Argentina: Argentina is probably the most attractive turnaround story in the world economy for now and optimism about the turnaround continued. The speed with which the new Macri administration has moved to get Argentina back to normal is impressive on many fronts. Market participants were impressed by the key players in the economic cabinet - some of whom they have known from Wall Street, among them Economy Minister Alfonso Prat Gay, and Central Bank President Federico Sturzenegger - which is helping to restore the credibility of a former financial rogue nation.

We concur with the official view that rationalizing foreign exchange regulations by unifying the myriad multiple exchange rates and capital controls will continue to deliver dividends by reducing implicit fiscal subsidies and barriers to trade and investment. We are especially gratified to see that the process is going just as discussed with the Finance Minister during the presidential campaign – with respect to both their diagnosis of the problems, the prescription and the side effects – for example, low levels of international reserves and high levels of bond supply. The medium term-policy challenges will remain, therefore, as there will need to be further fiscal adjustment - subsidy removal and significant energy price increases - and a continuing transitional fiscal deficit that will need to be financed with even more bond issuance. Implementing the reform and adjustment will require President Macri to coalesce issue-specific parliamentary coalitions for each piece of legislation, given that his administration is in a small minority in both houses of Congress. The current global macro backdrop is Argentina–supportive in our view – risk-on and a dovish US dollar backdrop. But Argentina's return to the fold is still swimming against the overall tide of a weak global economy with fragilities in major trading partners in China and elsewhere in Asia and Europe. On balance, we remain favorably disposed to the new administration and expect the dramatic improvement in the quality of policymaking to keep Argentina on the front burner of the markets as a turnaround story.

Russia: Russia came across as a key winner in the macro policy stakes with high marks for technocratic monetary and fiscal policy strategies, including allowing ruble flexibility, keeping policy tight and inflation expectations as restrained as weak oil prices and a weak ruble would allow. However, the key issues of structural reform and improvements in the business environment to encourage investment and diversification away from commodities is still constrained by politics. A weak ruble is therefore a key plank of import substitution and expenditure switching away from consumption. In our view, a weak, relatively high inflation economy seems likely to remain the order of the day.

South Africa: The overall story remains one of the most challenging in EM, with little evidence of any improvement in the growth problem and still limited improvement in the inflation outlook, despite the slowdown and rising output gap. As such, some of the most prominent officials acknowledged their policy challenges and political issues quite clearly, retaining their customary credibility, but without being able to offer any strong assurance on structural reform, particularly of the labor market as the municipal elections approach, nor of being able to avoid further rounds of pro-cyclical tightening in the face of a substantial negative output gap. We believe rating downgrades still lie ahead.

Turkey: Despite political and policy challenges - President Erdogan's executive presidency ambitions, the change in central bank governor, and regional turbulence - improved macro data are supportive – including the external adjustment thanks to falling energy import prices, relatively strong fiscal performance and the pass through to lower inflation. These positive economic forces should combine to keep Turkey afloat, in our view, and should potentially shield against a rating downgrade to below investment grade. The central bank governor nominee has been well received by the market community, although the market will likely need to watch closely to see how the renewal of the full Monetary Policy Committee plays out – four out of five voters are being replaced this year.

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