BlueBay
Asset Management

Cross currents risk policy mistake

August 2015

China's surprise currency devaluation and manufacturing downturn is the catalyst for the sell-off across global financial markets and a dramatic reminder of the treacherous global macro cross-currents that pose significant risks for investors and challenges to policymakers.

Chill deflationary winds from China and commodities are intensifying just as the US Federal Reserve readies itself to raise interest rates for the first time in almost a decade. China has become a key source of global macro and market uncertainty and increases the risk of a policy mistake by the Fed.

China's shift towards a more flexible exchange rate regime is a significant policy change motivated by the weaknesses of the Chinese economy, as well as being a necessary reform for the International Monetary Fund to confer global reserve currency status on the renminbi. China has not yet become an aggressive participant in the global "currency war" but it is clear it will no longer be an innocent bystander after a more than 10 per cent real appreciation of the exchange rate over the past year.

The flow of weaker than expected indicators of activity and the boom and bust in Chinese equity markets underline the challenges facing Beijing. The potential for policy mistakes are rising as China seeks to rebalance its economy to a "new normal" less reliant on credit-intensive heavy industries, while sustaining growth and employment. Too tight monetary policies could precipitate a recession, but much easier credit conditions could prompt a further unsustainable debt splurge and increase risks to financial stability.

If forthcoming economic data fail to validate policymakers' expectations of a pick-up in the Chinese economy during the second half of the year, pressure will mount on the authorities to allow a more pronounced currency depreciation that would mark a dangerous escalation of the currency war.

The divergence in the monetary stance between the US and the world's other major economies is a symptom of an unbalanced global economy exacerbated by the excess savings of Europe and Japan. Reliance on China and other emerging economies to sustain global demand in the aftermath of the financial crisis has exhausted their existing growth models.

Emerging markets face a period of subpar growth as they address macro-financial imbalances that arose during the years of easy credit induced by the global hunt for yield, and implement structural reforms to boost potential growth. Europe and Japan both face profound structural obstacles to sustaining stronger growth that are disguised by quantitative easing-induced currency weakness.

The disinflationary impulse from China via lower commodity prices and a stronger US dollar render it increasingly difficult for the Fed to be "reasonably confident" that inflation will move back to its 2 per cent target in the foreseeable future. Yet is also evident that the US is approaching full employment as its business and credit cycle matures, warranting a tightening of financial conditions and lift-off from zero interest rates set during the emergency of the great financial crash.

In our view, the Fed may try to square the circle by raising rates next month and simultaneously signal an even more gradual and data-dependent path for interest rates. But if global growth fails to

pick-up and deflationary headwinds intensify, it could be forced into a policy reversal and blamed for a growth slowdown during a presidential election year.

The start of previous Fed rate rise cycles has nearly always been accompanied by policy tightening by other major central banks. This time will be very different. Further monetary easing by the European Central Bank and Bank of Japan cannot be discounted and is more than likely from China. Divergent monetary policies will underpin greater cross-asset volatility and challenge fragile financial markets and stretched asset valuations.

The potential for a policy mistake by the Fed as well as the Chinese authorities is on the rise. Global growth is more precarious today than at any time since the Great Recession. The US economy is ready for higher interest rates, the global economy is not. Against such a backdrop, capital preservation and fundamental value should be the watchwords for investors seeking to navigate turbulent financial markets.

A version of this article was published in the Financial Times on 25 August 2015

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