Weekly Intelligence Report

Our views on this week's investment events - FOR PROFESSIONAL INVESTORS - 14 June 2016

Overview

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In this edition of the Weekly Intelligence Report we have two contributions with very different but timely perspectives - the first a top down macro analysis of the health of the emerging market economies and the second a bottom up micro perspective on the state of the US economy.

In the first article Joost Van Leenders takes the pulse of **economic activity in emerging markets** and finds cause for concern. Sentiment on emerging markets (EM) has oscillated wildly in recent months, from the doom and gloom that pervaded markets at the beginning of the year, to a more optimistic assessment in the spring that has more recently given way to a renewed sense of caution. Joost sees few grounds for optimism about the near-term prospects for growth in EM: he argues the best case scenario for China is growth stabilisation, Brazil is still mired in recession and the state of the Indian economy is likely flattered by the data. Unfortunately, we may have to wait a little while longer before the much anticipated rebound in activity and earnings materialises in EM. On that basis, Joost cautions that it is too soon to go overweight EM equities and favours an underweight in dollar-denominated EM debt, where in his view spread compression has over-shot fundamentals.

In the second article, Dan Singleman peers under the bonnet/hood of the US economy using a valuable source of microdata: the **Senior Loan Officer Opinion Survey on Bank Lending Practices**. This report provides a regular update on the state of US credit markets, describing the evolution of the demand for and the supply of credit at a quarterly frequency, which can provide useful cross-check on the health of the economy. The latest data point to a selective tightening in credit conditions which some analysts have argued could signal a looming recession. However, Dan argues that this conclusion is premature and that the tightening in credit conditions thus far should only present a headwind to growth rather than presaging an outright contraction. On a more optimistic note, delinquency rates on credit cards and auto loans remain low, reflecting the supportive backdrop of an improving labour market, solid consumer confidence and low interest rates. However, looking further ahead Dan identifies the risk posed by the outstanding stock of student loan debt, which may pose a significant drag on spending of cohorts who may struggle to finance the purchase of a home or to save for retirement.

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Emerging markets: waiting for the rebound

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Investor sentiment towards emerging markets has swung wildly this year. Shortly after the start of the year concerns about slowing growth in China, capital outflows from the country and a depreciation of the renminbi as well as the prospects of US rate hikes were the cause of a generalised sell-off in emerging market currencies and equities.

Subsequently strong credit growth in China indicated that earlier monetary stimulus might be gaining traction and propping up Chinese growth. Then in March the Federal Reserve decided not to follow-up on its December rate hike and oil prices recovered. As a result of these events sentiment towards emerging markets improved significantly. Emerging market equities surged by 13% in March. More recently, sentiment has swung back towards cautiousness as signs of a growth and earnings rebound are limited.

Where could a growth rebound come from? Exports have traditionally been a prime driver of emerging market growth. However, in the past year as since the financial crisis, trade growth has been lacklustre. This may be due to a couple of factors. Firstly, the recovery in the US and in the eurozone has been slow and uneven, especially given the severity of the 2008/09 recession. This has limited the growth in demand for imports of consumption and investment goods. Looking ahead, we think the eurozone will continue to do quite well relative to its longer-term potential growth rate, but that potential rate is quite low. In the US the potential growth rate has also come down and in Japan it is barely above zero. So there's not much of an engine in developed economies to drive emerging markets forward.

Another factor behind the lacklustre global trade may be that the bulk of globalisation is behind us and that we may even see some retreat. Globalisation has contributed to global trade flows because outsourcing of production creates additional trade flows. A third factor may be the limited availability of trade financing as banks have become more cautious on how to deploy scarce capital. Finally, a global shift towards more service-oriented economies could also hold back trade growth. So far this year, trade growth has been lacklustre and there have been no signs of a pick-up. So the impairment of this traditional driver of economic growth may not be temporary

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Theoretically, economic growth in emerging markets could be driven by internal demand. But I wouldn't advise holding your breath. Though some Chinese data indicated stronger growth in March, more recent data followed the trend of a continued gradual slowdown in growth. At the start of the year I felt markets overdid the risk of a Chinese hard landing, but due to the mix of excessive credit growth, overcapacity in a number of sectors and – according to employment components of PMI data – a weak labour market, we foresee growth stabilisation at best.

Brazil is still mired in a deep recession. Political upheaval has left deep wounds in the economy. The new administration has announced some positive measures, but implementation may be challenging. In an economy where unemployment is rising rapidly, real wages are falling, and where an earlier credit binge has yet to be addressed, a quick recovery looks unlikely. Monetary easing will come, but high inflation means the central bank has limited policy options. Austerity is a necessity, but cutting government expenses or raising taxes will not be supportive for growth in the middle of a deep recession. There is no easy way out for Brazil; meaning, in our view, a quick recovery is not in the cards.

Elsewhere, economic growth in Russia is set to improve and will return to positive territory soon following the rebound in oil prices. The official Indian growth numbers look a bit inflated given the underlying data and some weaknesses in the banking sector, but the country is nonetheless contributing to global growth. In the rest of Asia the cyclical economies of Korea and Taiwan are struggling to cope with modest global growth, while some of the Southeast Asian economies are holding up better.

On the monetary front we foresee divergence. With the Chinese authorities recognising the risks of more stimulus, sticky inflation in India and low rates and high consumer debt in Korea, there is little scope left for rate cuts in Asia. We think rates will be cut in Brazil, but we are not among those anticipating aggressive easing. The central bank may operate cautiously to preserve credibility. In Russia we also think more rate cuts are possible.

Our view is markets may well have to wait longer for any rebound in economic and earnings growth in emerging markets. Developing and developed markets appear to have settled into a low growth and low inflation environment.

The view of BNP Paribas Investment Partners' Multi Asset Solutions team is that based on the broad asset class perspective, it is too early to overweight emerging market equities relative to our benchmarks. We have a neutral tactical position. Low valuations indicate better perspectives longer-term, so we have a sizeable exposure to emerging market equities in our medium-term asset allocation. We are underweight emerging market debt denominated in US dollars, as we think that the tighter spreads are not justified by underlying economic fundamentals.

Emerging market exports

Source: Bloomberg, BNP Paribas Investment Partners
*13 countries' data weighted by nominal trade in USD

A lingering consumer credit problem

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Years ago while furthering my debt-funded education I found myself studying abroad in Swansea, Wales. I came across many cultural norms which were different than what I was accustomed to back in the U.S. To get a better understanding of how others perceived me, I decided to pick up a book called the Xenophobes Guide to the American. Right from the beginning the book zeros in on the American people and U.S. government's obsession with acronyms. The US Federal Reserve is no exception to this norm and provides a dizzying amount of data and publications updated with various frequencies and cryptic naming conventions such as the Z.1, H.8, G.19 and my personal favorite, FRED.

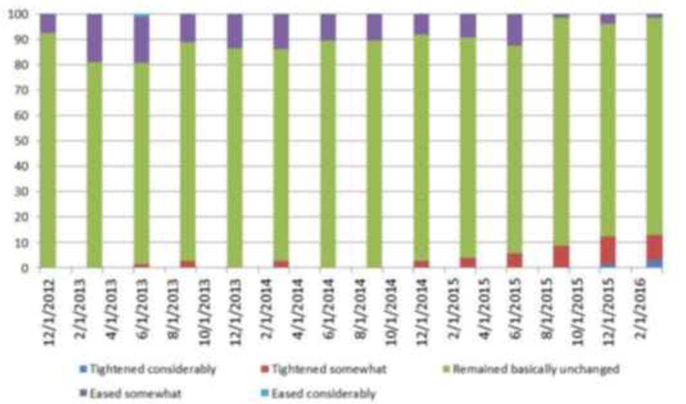
One of the more closely followed and scrutinized, with its own memorable acronym, is the SLOOS report or more accurately, The Senior Loan Officer Opinion Survey on Bank Lending Practices. This report is published every quarter and tracks changes in the standards and terms of the banks' lending, state of business and household demand for loans.

Much attention is given to the causal relationship between current and expected delinquencies and the future availability of credit.

Commercial loan delinquency rates bottomed nationally in the fourth quarter of 2014 following the financial crisis and have steadily increased every quarter since. Much of this has to do with the Energy sector as it adjusts to a lower oil price. In fact the percentage of delinquent commercial loans has increased from 0.49% in the fourth quarter 2014 to 1.25% in the first quarter 2016. While the outright number may not sound like much of a worry, the pace at which non-performing loans are increasing coupled with the expectation for them to continue higher as more companies struggle to adjust, has provided enough justification for bank managers to tighten current lending standards.

In the most recent SLOOS report we learned that for the first time since the end of the financial crisis banks are no longer easing credit conditions across certain segments and have continued to increase tightening standards as seen in chart below.

Application for C&I loans - large and middle-market firms, all respondants



Source: Senior Loan Officer Opinion Survey on Bank Lending Practices (SLOOS)

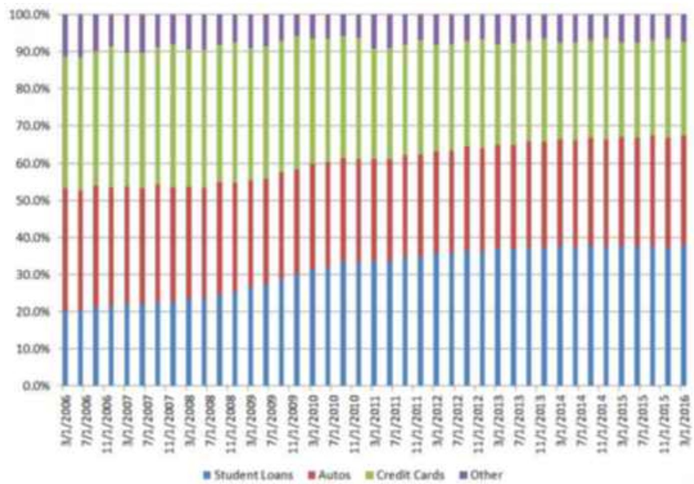
Some market participants are pointing to the decline in this series as a harbinger for a recession. While we agree that the transmission mechanism from increased delinquencies to tighter lending standards will likely reduce future potential growth, it is too early to suggest any broad based spillover to areas in the economy to suggest a looming recession.

Turning to consumer credit it's hard not to notice that nearly all financial metrics have improved since the great financial crisis some eight years ago. Consumer segments such as credit cards and autos are all experiencing lower delinquency rates from an improving jobs markets, consumer confidence and re-financeability. However one area of consumer credit which has yet to see a drop in serious delinquencies is student loan debt.

Much like the U.S. government did to encourage household formation it also did for the student loan market. It did this as a way to prepare for a demographically changing workforce and to improve productivity all through the goals of higher education.

Using data from the Federal Reserve's Z.1 and G.19 it shows that since the beginning of 2006 student loan debt, largely through the US government, has increased from $481bn to $1.35tr at end of March 2016 or roughly a 180% increase. In the chart below student loan debt as a percentage of total consumer credit has increased from 20% in 2006 to roughly 38% ten years later. Offsetting this increase has been a decline in credit cards as presumingly (current author included) students took on additional debt to finance spending habits which previously might have been financed by credit cards. Rather unfortunately serious delinquencies rising from student loan debt at the end of the financial crisis in 2009 have risen at a national level of 8.3% to 11% today. Making the problem more difficult than other areas of consumer credit is that in most cases student loan debt is non-dischargeable in bankruptcy making it more difficult for consumers to restructure their debt.

US consumer credit outstanding



Source: Board of Governors of the Federal Reserve System (US)

Rising commercial delinquencies and tightening credit standards both potentially suggest a lower path for US investment and consumption. Investors would be well served to respect these market signals and to closely monitor future data releases from the Federal Reserve in the coming months and quarters to identify any further deteriorating credit conditions.

As for student loans the message is clear, either borrowers find employment at a wage level commensurate enough to service their debt burden or a change to the bankruptcy laws needs to be considered. Anything short of this could suggest that future economic growth may face headwinds from a cohort potentially unable to finance buying a home or saving for retirement.

More of our thoughts on the market

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FFTW weekly commentary
by Richard Barwell, Senior Economist
and Steven Friedman, Senior Investment Strategist
13 June 2016

Weekly strategy update
by Joost van Leenders, CFA, Chief Economist
9 June 2016

Asset allocation monthly
by Joost van Leenders, CFA, Chief Economist
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China's supply-side reform is not what you think
by Chi Lo, Senior Economist, Greater China
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Central Bank Watch
by Richard Barwell, Senior Economist
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