End of Quantitative Easing Tapers Asian Returns? Part I

June 21, 2013

by Robert Horrocks
of Matthews Asia

When your economy is depressed, with high rates of unemployment, and interest rates at close to zero, you need aggressive monetary policy to keep activity ticking over. And what you say you will do matters just as much as what you actually do. Thus, the markets became very skittish when first U.S. Fed Reserve Chairman Ben Bernanke and then Japanese Prime Minister Shinzo Abe made public statements from which speculators inferred they were going to be less aggressive in monetary stimulus than had been expected.

First, Bernanke spoke about tapering off quantitative easing (“QE”). What he meant, or what he actually said, was that quantitative easing would taper off if U.S. growth continued to improve. All well and good, but the markets are not yet “sold” on the idea that U.S. growth is going to be all right. After all, we have just had a round of tax hikes and also some spending cuts—surely that means there is downside risk to anyone’s forecasts of the economy? Then, Abe spoke. Speculators were already selling Japanese equities after Bernanke’s comments, for fear that if the U.S. were thinking of withdrawing stimulus, what hope would there be that Japan would persist with its own money-printing experiment? Abe exacerbated their concerns because he said he was aiming for 2% real growth and 3% nominal growth, the difference, 1%, being inflation. Yet, in the market, inflation expectations were already above 1% and it is primarily through those expectations that monetary stimulus gains its force. Speculators, hearing that the authorities were planning to be less aggressive than expected, caused another abrupt sell-off in Japanese equities. If that were not enough, we then had a second round of Bernanke’s public comments that tied withdrawal of monetary stimulus to a fall in the unemployment rate to 7%. Now, 7% is hardly full employment—that is probably closer to 5% or 6%; in addition, so many people have left the workforce recently, that the “true” unemployment rate may be much higher than stated. Indeed the U.S. unemployment situation may have improved only marginally since the trough of economic activity.

So, in a matter of weeks, these two policymakers managed to dash the hopes of faster global growth and rising prices of goods and assets that were being built into the markets. Investors now fear that as soon as growth starts to pick up, central bankers will move to prevent it from accelerating, even though the economy is rising from a depressed base. The situation was further exacerbated by spikes in interbank rates in China that are a symptom of the government cracking down on domestic liquidity in an attempt to rein in credit growth. Whilst this tightening may be desirable, its timing couldn’t have been worse, given the comments from the U.S. and Japan. Indeed, it looks as if global monetary policy chiefs all “got out of the wrong side of the bed” this week. So, speculators sold everything—bonds, equities, gold, and bought U.S. dollars.

Some of the moves in the market were, in the short run at least, a little puzzling. Falling equity markets make sense in a world of “premature” monetary tightening. So does a rising U.S. dollar. But rising bond yields? Yields may well rise in the short run as part of a run to cash, but if growth does indeed slow, they will fall back down again, and, one assumes, the Fed will then need to launch QE 4, 5, 6… and 7. So, we are in a bit of a holding pattern here. Which is right? Bonds or equities? If growth is indeed picking up, the bond moves seem appropriate but equities would surely enjoy an environment of faster growth! If growth is about to disappoint, then equities are right and yields will surely fall back down—even then, the likelihood of further stimulus to correct the premature tightening would help cushion equity markets.

Now, what does this mean for Asia? Historically Asian markets have done well in periods of a weaker U.S. dollar and faster growth, so lowering peoples’ growth expectations and causing them to bid up the U.S. dollar is about the worst combination for Asian equities historically. And I do not think that Asia’s relation to global markets has changed significantly enough to nullify this past relationship. However, there are reasons to think that the effects on Asia’s equity prices may be a little more muted this time. First, valuations are already low—we have gone through a period of weak growth and a slightly appreciating U.S. dollar for the past two years. The impact on the markets has been to cause Asia’s price-to-earnings to fall close to its historical lower bound, even as earnings are depressed by cyclically weak margins. Consequently, Asia’s discount to the U.S. has widened to about 30%. In addition, Asia’s economies are in reasonable shape in regards to external exposure—only Australia, India, and Indonesia run external deficits

—and levels of external currency debt of both sovereigns and companies are substantially less worrying than they were on the eve of the 1997 Asian crisis. So, Asia’s economies are not as stretched as they were going into the U.S. dollar strengthening in the late 1990s and its equity markets, particularly North Asia, are priced quite reasonably.

In the short run, the reaction of the markets may have been induced in part by fears of the past. Nevertheless, Bernanke and Abe did no favours for Asia with their recent comments and China’s tightening will slow growth and dampen expectations further. However, for us at Matthews Asia, we are not going to try and guess the short-run fluctuations of GDP growth, nor will we try and anticipate the nervy reactions of short-run speculators or attempt to predict the future public statements of global policymakers. As always, we will continue to look much longer-term and try to identify the companies that will themselves sail through the short-term changes in economic policy and adapt themselves to the evolving aspirations and demands of their Asia customers. Very occasionally, global events like these may offer up a few bargains along the way.

www.matthewsasia.com