The Future of Global Investing: what is old, what is new, and China's role

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- September 2016

Current transition environment: Anticipating normalization of monetary policy

- Challenging market conditions as global risk and risk aversion along with central bank policy has dominated asset pricing
- Post-crisis Quantitative Easing world characterized by a dominant global factor (Central Bank policies)
  - Rey shows how Fed policy has been a major driver of a common global factor in asset prices, capital flows, and credit growth
  - Leading to risk-on, risk-off regime switches
  - Idiosyncratic country factors not so important
- Fed exit from Quantitative Easing & ZIRP most closely watched
  - Must guard against being on wrong side of Fed decisions
    - September 2013 FOMC meeting serves as warning
- A post-QE, non-ZIRP world offers new opportunities to add value in multi-asset investing

Has QE had any effect?

- Some literature suggests QE purchases are neutral & so ineffective
  - Analogous to Ricardian Equivalence (with representative agents in private sector seeing government & central bank assets as indistinguishable from their own)-- Eggertsson & Woodford
  - Or CB reserve money & government bonds are perfect substitutes so swapping one for the other has no effect – Curdia & Woodford
  - Leads to recommendation of forward guidance with a commitment to specific criteria for policy actions– Woodford at Jackson Hole
- Potential channels
- Porfolio balance: CB purchases of govt bonds lowers bonds in hands of public → Govt bond yields ↓ & bank deposits ↑
  - Investors buy longer duration substitutes for govt bonds, lowering term premia and yields
  - Easier credit conditions stimulate borrowing, spending, and output
- Signaling: CB bond purchase announcements lead investors to expect a lower path for future short-term rates & lowers long-term rates via the expectations channel

Evidence of QE effects in financial markets

- Many studies allow an overview of conclusions:
- Fed LSAPs:
  - Domestic medium & long-term bond yields fell & 10-year term premium fell 30–100 bps
  - Mutual fund flows:
    - QE1: mutual fund flows out of EM into US equity & bonds
    - QE2: initially mutual fund flows out of US funds into EM equities & bonds; later flows out of bonds into equity funds in US & EM as Fed bond purchases stimulated risk taking
  - LSAP announcements lowered yields in other large countries
  - The USD depreciated
  - Equity market gains suggest yield effects not due to lower growth expectations
  - Tail risk (measured by risk reversals) fell with QE announcements and subsequent bond purchases, most persistent for QE3
  - Support for both signaling and PB channel
- BOE:
  - ➢ Gilt yields reduced by 35-100 bps with similar effects on corp bonds
  - ➢ Support for both signaling and PB channel

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Evidence of QE effects in financial markets

- Dependence of data surprises on USD returns has been affected by Fed monetary policy:
  - Effect of data surprises on USD returns has changed
    - was higher pre-QE when data surprises accounted for 62% of USD returns
    - As low as 10% in early stages of QE2 regime when monetary stimulus dominates
    - Rises again to 44% in 2013 in mature QE environment when market looks for data to influence exit from policy

QE critic might say…

- Studies showing beneficial effects focus mostly on announcement & miss later reversals
- Since Fed QE started
  - The yield curve has steepened
  - Price discovery has been disrupted (almost like price controls)
  - Other central bank policies are impacted
  - Fiscal discipline is undermined
  - Financing easy for projects or roll-overs that should not occur
- Exit policy adds new risks & has already had major impacts

Risks associated with normalization of policy

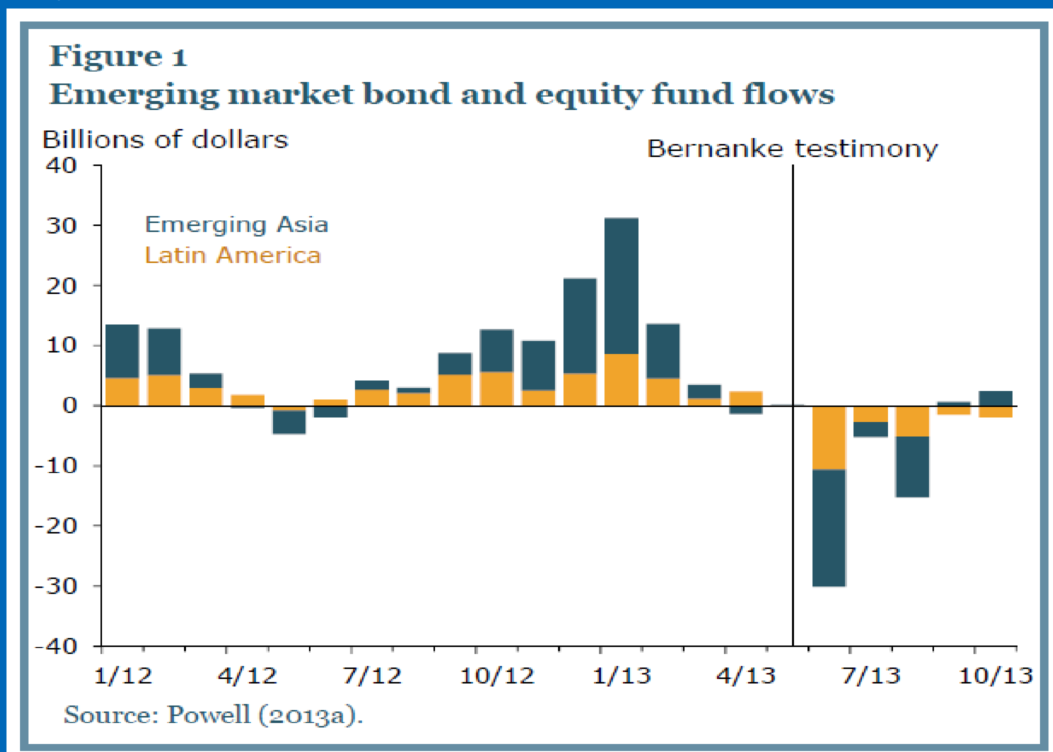
- Near-term market effects of announcements (…May 2013)
- Shift expectations causing large asset price moves & volatility spikes

- Medium term economic risks
- Inflation rises if CB behind the curve
- Super-low risk premium on risky assets ends, leading to large portfolio shifts out of riskier assets
- Bubbles may be forming in some markets that burst with exit
  - Some assets that did very well in the “risk on” environment of QE may face risk of significant sell-off

- Longer term economic risks
- Sustainability of government debt as CB bond purchases end and interest rates rise

Lessons (so far) regarding policy exit effects

- Countries with larger fiscal and current account deficits (so more dependent on foreign capital) are more prone to capital outflows as liquidity tightens and investor concern rises over ability of country to honor its external liabilities
  - Following Bernanke's May "taper tantrum" 2013 speech, large capital outflows experienced in EM debt & equity markets



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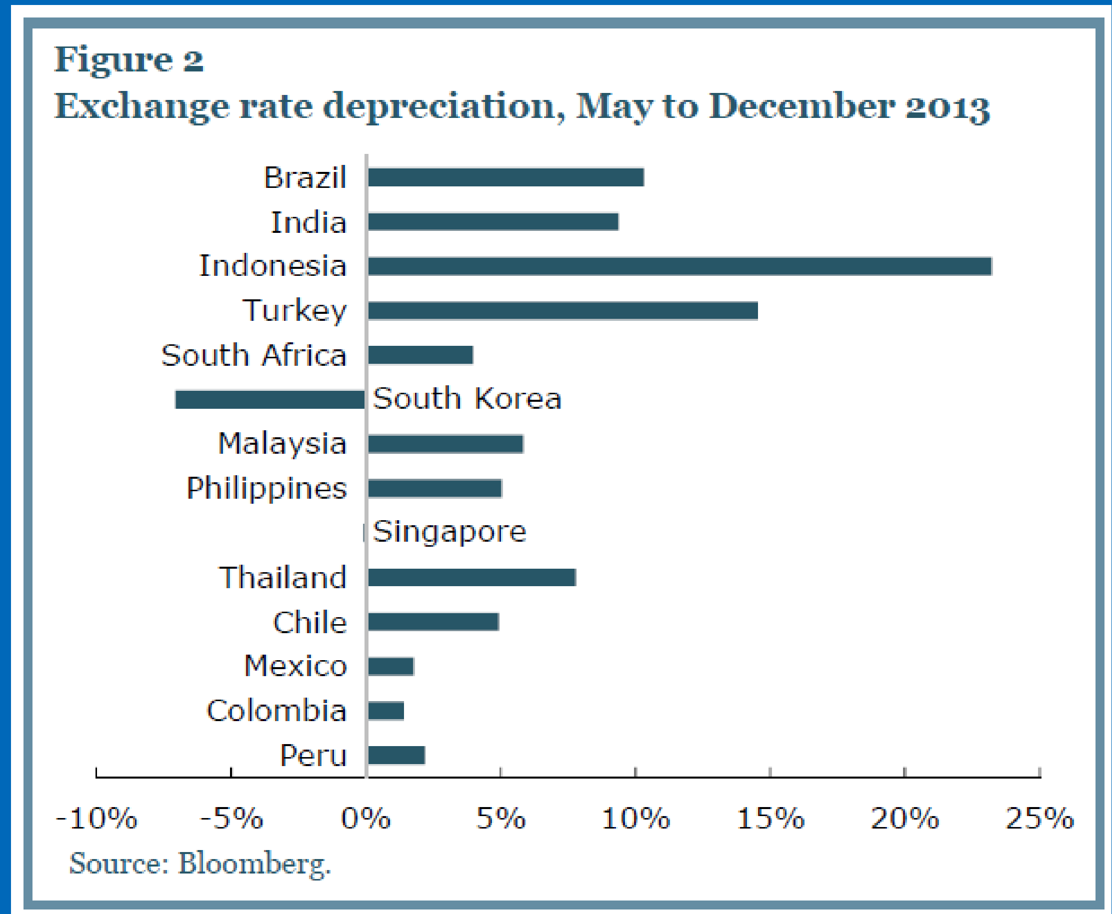
Countries with weakest fundamentals: Brazil, India, Indonesia, Turkey, S. Africa have largest sell-off post May 22, 2013

- *CNY appreciated 2%*



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What else happened in month following May 2013 Bernanke statement?

- 10 year US Treasury yield up 65bps
- USD appreciates 2% against EUR; 5% against Japan
- EM sovereign credit spreads up
  - Brazil 125 bps
  - Russia 150 bps
  - Turkey 223 bps
- Equity markets down
  - S&P 500 5%
  - MSCI Europe 11%
  - *SHCOMP* *13%*
  - MSCI EM 15%

Looking Forward to Post QE-ZIRP Environment

- “Normal” means:
- Higher interest rates, but lower in steady-state than pre-crisis
- Greater cross-country interest differentials
- Lower cross-asset return correlations
- Idiosyncratic macroeconomic differences across countries matter more than “risk on/off” global factor

Post-QE-ZIRP Opportunity Set Will Increase for Active Investing in Multi-Asset Portfolios

- As importance of global factor falls, country idiosyncratic factors matter more
  - Will not be *just* about getting central bank decisions and risk on/off correct, but understanding fundamental drivers of asset returns across countries
- Cross-asset correlations lower
  - Better asset allocation opportunities
- Central bank policy has pushed investors into riskier assets (depressed risk premia), as this ends and assets are repriced, more traditional sources of return will come back into favor

The future: not like the recent past

- EM super risk premium days are over
  - Market integration has come a long way
  - But still expect faster growth
- Learn to trade bonds from short as well as long side
  - As liquidity support withdrawn, rates should rise…but…
  - With inflation targeting central banks, don't expect long run of rising rates to mirror the long fall in rates
  - Shrinking govt budget deficits tend to lower rates as crisis fades into past
  - Slower economic growth means lower rates
  - Demographics support lower rates than otherwise
    - Retired borrow less and hold fixed income rather than equities
- As rates rise, the reach for yield that has priced super-low risk premia on risky assets will reprice risk differentials in credit markets
- Will equity earnings rise relative to rising discount rates?

Alpha Opportunities Ahead

- Exceptional CB policies as dominant factor will be behind us
- Global macro investing will see a resurgence of interest due to enhanced opportunity set

China: Risks and Opportunities for Investors

- Talk about more and worry about more than anything other than US
- Can’t avoid the risks, as investment opportunities too attractive
- So what do we do?

Lessons from China: surprises shake the world

- Surprise devaluations had shocking effects on global markets
  - Aug 11, 2015 (3%) & Jan 6, 2016 (1%)
- Market feared the beginning of larger depreciation & large capital outflows
- Aug 11 effects (1 week, 1 month after)
  - SPX falls 0.3%, 7%
  - SHCOMP falls 5%, 21%
  - DAX falls 6%, 14%
- Jan 6 effects (1 week, 1 month after)
  - SPX falls 6%, 7%
  - SHCOMP falls 11%, 17%
  - DAX falls 3%, 10%

CNY surprises and equity returns

- $(Index\ Return)_t = \alpha + \beta * CNYSurprise_t + \gamma(Oil\ Returns)_t + \varepsilon_t$
  - *CNYSurprise* = $(CNY - E(CNY))/\ E(CNY)$)
  - *E(CNY)* = 1-week NDF that settles on same day as spot 1-week later
  - Filter for top and bottom 5% of surprises to just include large shocks
  - Oil conditioner included
  - Estimate Aug 24, 2010 – Jan 31, 2016
  - Neg & sig for Australia, S. Korea,
  - Pos & sig for Japan & UK
  - Insig for US, Germany, EM index

		Intercept	Beta_Surprise	Beta_Oil
AUS	Coefficent	-0.0005	-0.0483	0.2382
	P-value	0.3391	0.0076*	<0.0001
US	Coefficent	0.0003	0.0021	0.3306
	P-value	0.5101	0.9526	<0.0001
SK	Coefficent	-0.0003	-0.0839	0.2479
	P-value	0.637	0.0003*	<0.0001
Germany	Coefficent	0.0002	0.0205	0.4591
	P-value	0.821	0.4221	<0.0001
Japan	Coefficent	0.0004	0.182	0.2268
	P-value	0.6281	<0.0001*	0.0067
UK	Coefficent	-0.001	0.053	0.5394
	P-value	0.8596	0.0160*	<0.0001
EMCI	Coefficent	-0.0005	0.0116	0.2273
	P-value	0.0391	0.4686	<0.0001

Relationship changing lately

- Aug 2015 & Jan 2016 CNY surprises led S&P down, but lately S&P more independent from CNY depreciation
  - Market move from fear to acceptance of depreciation due to better communication of FX policy, acceptance of CNY overvaluation, & USD sales (reserves falling) to manage CNY

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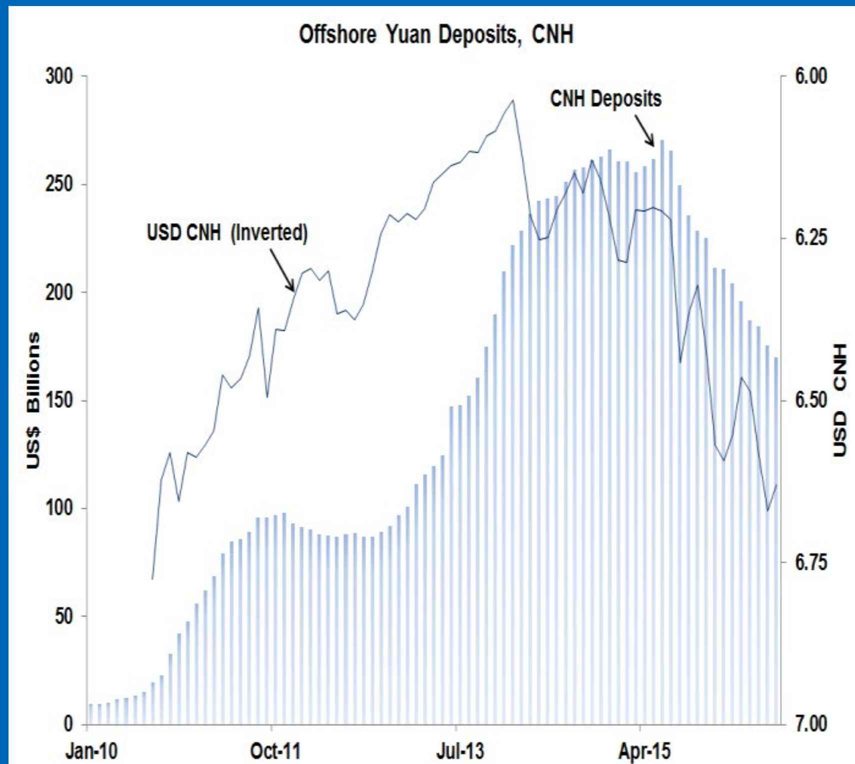
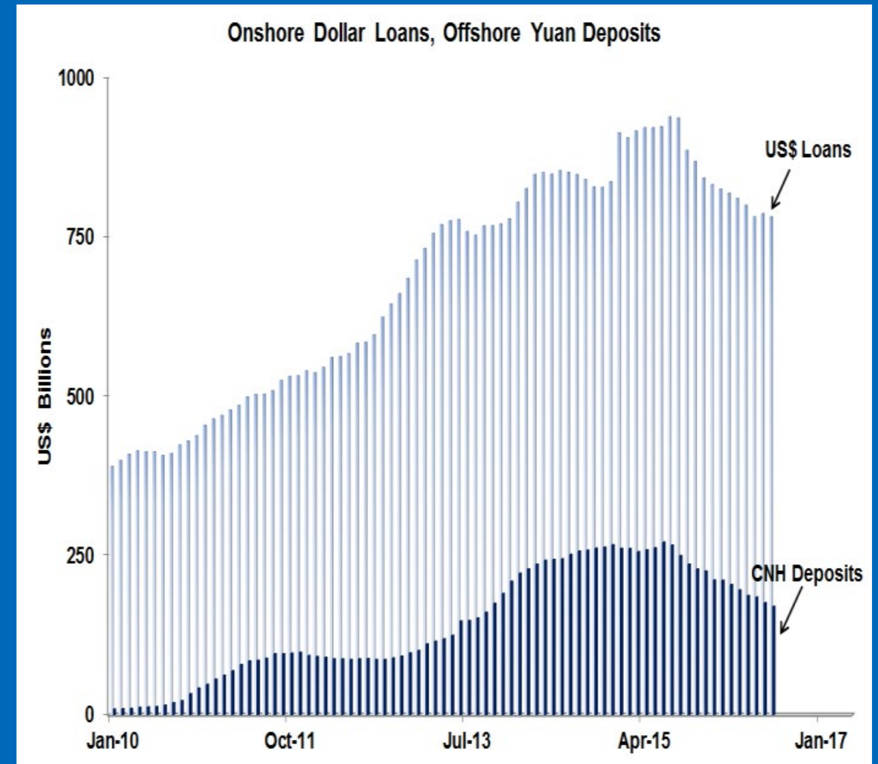
Yet, may be healthy fear of further depreciation

- Offshore yuan (CNH) deposits following USDCNH down & USD loans falling as well





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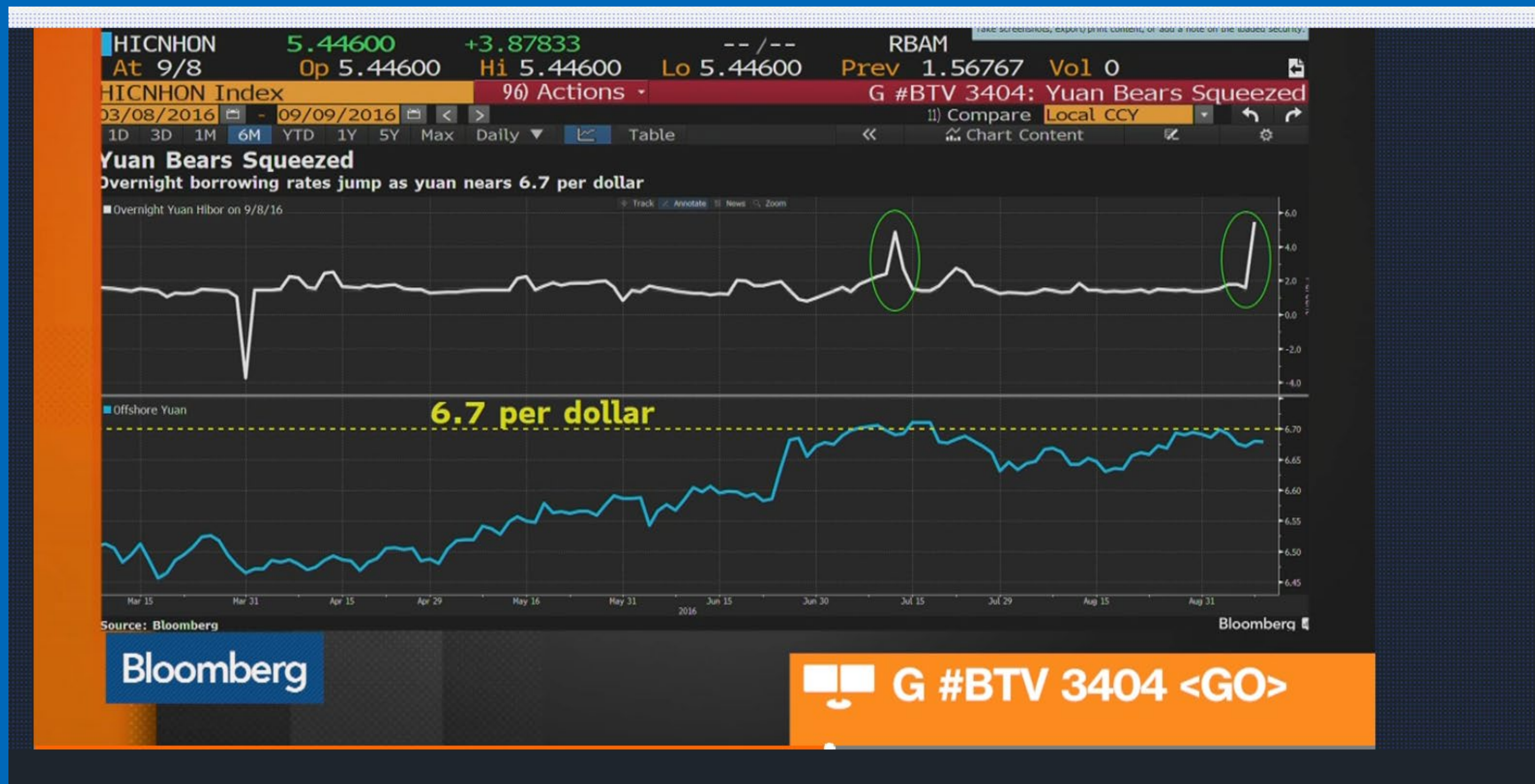
Limit CNY depreciation prior to SDR inclusion?

- HIBOR intervention related to holding CNY to 6.70?



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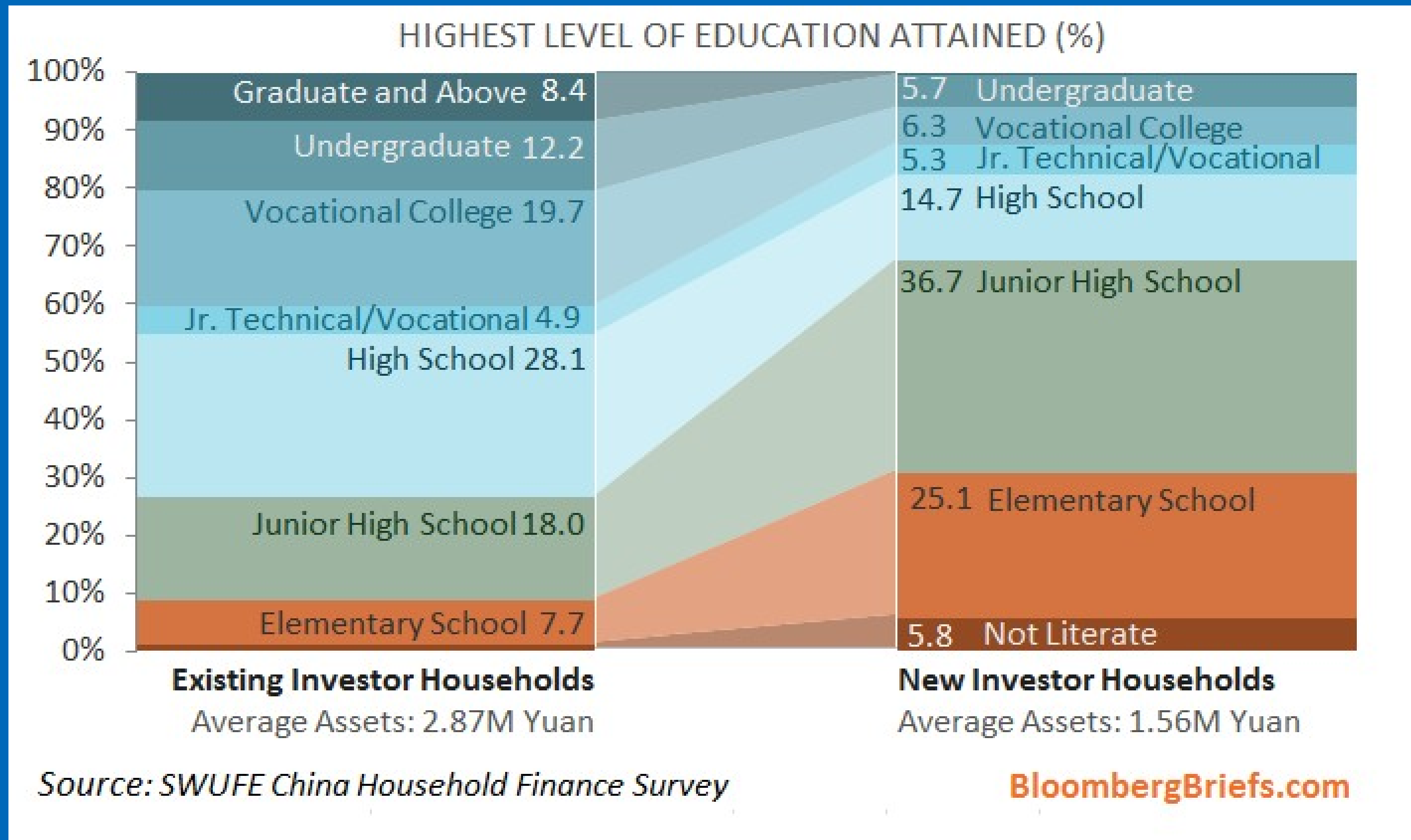
Investor beware: Chinese equity markets

What does it mean when uninformed investors enter the stock market in large numbers? Is this the start of a Chinese equity bubble? View from April 2015



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Investor beware: Chinese equities can provide a wild ride

- From mid-2014 to mid-2015 as new accounts opened quickly, SHCOMP increased 152%
- From peak mid-June 2015, SHCOMP fell 25% by 7/3/15
- Trough reached 2/5/16 47% below mid 2015 peak
- Now fairly stable over past year

Investors should worry more about China than any other country: *risks and opportunities*

- It is second largest country now (maybe first…)
- Policy changes can be unpredictable with large consequences
  - "national team" equity purchases to support market
  - "circuit breakers" in equity markets imposed and then removed
  - Policymakers need to stay out of market and let prices fluctuate—don't target equity prices
- Financial market liberalization has long way to go—many risks here
  - But huge opportunity also as Chinese investors underinvested in foreign assets & global investors are underinvested in Chinese assets
  - Foreign ownership of China's equity & bond markets is less than 2%, but other Asian EM markets see 31% foreign ownership for equities & 20% for bonds
  - Further opening of Chinese markets, will reshape global portfolio capital flows