VanEck Research

Long and wrong

IMF Fall 2022 Meetings Takeaways

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Summary

Investors are nervous about higher rates, but seem to be unsure. Instead of reducing duration or being selective they are tending to be index-hugging and enduring the pain of rising rates. Investors are also nervous about geopolitics, but not sure what to do, again leaning toward index-hugging. There's no conviction. Everyone's waiting for peak yields, after which they will allocate maximum long those emerging markets local currencies that hiked early and large. But for now, they're awaiting 'instructions' from US treasuries. So far, too few think the answer to rising rates is to have low duration, and are looking to slowly accumulate selective risks as yields find their peaks. There seems to be support for emerging markets, especially EMFX as an eventual winner, and something to accumulate, but are hesitant of developed markets rate rises and the flight from risky assets to do anything other than consider the index. Too many are saying, "treasuries are the boss of me".

- **"I don't know" was the most popular opinion at the Fall 2022 IMF meetings. Investors' appeared more dominated by US rates and geopolitics than ever before. There was verbal bearishness, but the positioning reaction was low tracking error i.e., failing conventionally. Investors struck us as "long and wrong".**
- **The most common question was, "when will yields peak?". Followed by questioning whether it would be via an "accident" or via a benign decline in inflation. Most saw a Fed that is not poised to pivot or pause. And we agree, but have been comfortable with lower duration than then the indices', which we found to be an unusual reaction.**
- **Record duration was issued at record low interest rates, which are now rising. Holders of those assets, and their derivatives, will be prone to accidents just like the UK pension system's.**
- **No new "Plaza Accord" is coming soon. The rising dollar is being driven by interest rate differentials that have deep and divergent drivers. There are no obvious near-term obstacles to US dollar strength against the euro and yen, other than Japanese intervention to strengthen the yen (which we expect) and an end to Japan's yield curve controls (YCC) which is further off. In this latest "crisis", emerging markets (EM) is yet again not the epicenter, nor is it the key victim. While many EMs are vulnerable, most of their debt is in their own local currencies, their external positions remain strong with some surging due to commodity windfalls, and their central banks hiked more and earlier than did developed markets (DM) central banks. EM debt will continue to suffer along with other debt, due to the bond math of rising "risk free" rates. But, market participants see EM debt, particularly EM currencies, as a key potential winner when interest rate volatility declines. At the moment, we think, they are content index-hugging, not choosing winners and losers.**

I. Developed markets/global macro

"I don't know" seemed to be the most popular view at the Fall 2022 IMF meetings. Investors appeared more focused on US rates and geopolitics for guidance than ever before. They were somewhat bearish verbally, but our sense was tracking error was a concern, thus they were seemingly content to fail conventionally. Failing conventionally has been a winning strategy for many, particularly if assets under management is high. There is nervousness about a) outflows and b) big dispersions in performance. It seems bigger investors fear outflows into cash and competitors but also see a big re-flow into bonds coming in the next quarter or so. Too many, in our view, were basing their entire strategy on waiting for a high in US yields, after which all of their investment conclusions would follow. Our view this year has been that the implication of rising rates is having low duration, which we observed as a rare, even though rising rates were a concern.

Geopolitics took a lot of oxygen out of the room. Geopolitical discussions were right off of the television set, meaning superficial to the point of misleading. China was more front-and-center, but too many business models depend on continuity with China/globalisation, making it hard to come to conclusions such as "yeah, we're done". More specifically on markets, the discussion points were so diverse, from,"is zero-COVID policy ending?" to "will G-20 be a love-fest?" to "what's up with China Property?" Investors seemed unable to come to conclusions.

It was clear that security considerations are dominating policy in China, the US, Europe, and elsewhere. In regards to Russia, there was great pessimism for the Ukraine war, i.e., it would go for longer, expand and end up a "frozen conflict" at best. There was also ongoing digestion of the Nordstream pipeline destruction and the impossibility of any adjustments in German gas imports. There was virtually zero discussion about the new security and economic cooperation zones created by Russia, China, India, Iran and some including Turkey. Sanctions on Russia's central bank were almost universally viewed as a failure, if not a boost to solidifying Eurasian groupings. US officials continued to state that sanctions are a great success. Having dealt with sanctions as far back as North Korea's, and of course Russia's, our view remains that once the machine has started, failure is irrelevant, and we see the sanctions machine gearing up for China.

Everyone was asking "when will yields peak?". This was followed whether it would be via an "accident" or via inflation progress. Most saw a Fed that is not poised to pivot or pause. Interest rate volatility is the key worry and is legitimately disconcerting, we think. Some saw the UK as the "accident", but many did not. We mentioned our suggestion, that "it" could come from a big private deal in the US, owned by a big private investor, with no transparency and thus magnified uncertainty, and this view was welcomed. Some saw the peak in yields as coming from improving,i.e., declining, inflation data. And some saw the yield curve itself as marking the moment, i.e., long-end rates simply rally after front end rates rise "too much". We're open to all of these scenarios. The problem is, with inflation at 8% and a Fed aiming for 2%, growth is very much in play. **Our sense is that we need to get to 5-handle at least on the 2-year.**

Unlike the Spring Meetings, growth is finally a key focus You may recall we noted the absence of growth fears in our Spring meeting takeaways. The IMF itself, in its World Economic Outlook (WEO) only took its 2023 global growth forecast down by 0.2% of GDP (to 2.7%). That seems to be inconsistent with the world they describe in the 186-page document. To be fair, they are clear that the risks are almost all to the downside. They offer a construction we don't usually notice in WEOs, which is that they see a 25% chance of 2.0% growth, which would be a bottom decile outcome for many decades, and 5% odds of 0.5% growth. The culprits being Europe's energy crisis, war, China, a Fed over or under-hiking. They also note that 2.7% would be the lowest growth, excluding crises, since 2001, when it was 2.5%. Also interesting was that it was the developed and biggest economies that were the problem, Europe, the US, and China as leading downturn risks.

Some saw developments in the UK as an example of bad fiscal policy being punished, and as implicitly supportive of EMs and other countries with lower debts, independent central banks and greater market-friendliness. We're however not sure DMs such as the UK are good guides, but it has been a theme of ours for over a decade that the DMs are becoming EMs and vice-versa. A key reason for our nervousness over what we see in many DMs is that we've seen these processes in EMs. What's a sustainable level of debt? DM has no idea whereas EM is defined by knowledge of the level. Why have an independent central bank? DMs have pioneered "coordination" between fiscal and monetary authorities. EMs have central banks that are solely focused on inflation, leaving markets and government fiscal plans to the fiscal authority. This will be a learning moment, at least, in our view. With the DMs as the students.

US dollar strength was a big concern watch the Japanese yes and Korean won. The idea that the US dollar has higher yields and growth, and will continue, against a gasping Europe and a Japan for now locked into low yields via yield curve control (YCC) . But that says more about Europe's energy and structural problems, and Japan's unique policy mix than it does about the US dollar, in our view. Korea will be a great example for DM focused folks, we think. When and if Japan ends YCC, we see the yen exploding stronger and the Korean won doing the same. We mention this because the idea seemed to be novel to most participants who were US dollar-bullish as a result of the top-down comparisons with Europe and Japan, making it a very interesting scenario to us.

Europe was a “downside risks to growth story”. Debt mutualisation is seen as the easiest lever to pull if there’s a “crisis”. The fact that Germany will have to shift to more expensive and inefficient energy sources was seen as “too bad”, and many came away reminded that Germany’s political system isn’t in control of decisions such as where it can purchase its gas and it’s military posture. Few saw any reason to care if the euro kept declining, a view with which we’re sympathetic.

No new “Plaza Accord” is coming soon. Some asked about another Plaza Accord, given US dollar strength. What we think gets forgotten is that the last Plaza was after the US dollar had already been declining, and was a way to get the US Congress off of its protectionist track. Those conditions don’t hold now. Today, it is about interest rate differentials. It will take a more serious crisis to get rate coordination meetings going; this seemed to be the policy line, and we agree. The Fed is fighting inflation and not worrying about the external sector. China doesn’t want to tighten. Japan wants to keep its YCC and won’t change at least until Kuroda departs while Europe is a mess of growth challenges.

It looks like the G-7 might get a mini-resurrection, given that G-20 now has countries the US considers unfriendly. There was discussion about the upcoming Bali G-20 and whether Zelensky and Putin would be in the same room together or whether countries would walk out. Anyway, with India and then Brazil as presidents of the next G-20 rounds, the US seems to expect little progress toward re-globalisation. The US construction is that globalisation was great for all, and the only problem was that it generated unequal benefits. The next G-20 could be the first Biden-Xi meeting, though that also seems subject to political posturing, we read subsequent to the IMF meetings. China is presented, by the US, as not a standard-bearer for globalisation. A tag-line was that “instead of tariffs, China will make you buy from or sell to a state owned enterprise that can and will abandon you at a moment’s notice”. This led to some concerns about renminbi weakness. We share it, but also see it as orderly.

There are hints of new facilities to help with hunger, poverty and accelerating the “energy transition”, but they are nascent and thin. The World Bank, the sister organisation to the IMF that focuses on structural and project-lending, is touting a new emissions-reduction project development program that could provide “up to US$1 trillion”. The IMF has its Resilience and Sustainability Trust (RST). Fast debt reschedulings where needed were also noted. And, the “common framework”, getting China to the table with all other creditors in these situations, looks to have gotten nowhere.

Commodities were presented positively. Risks to supply were emphasised, and we agree. The Black Sea grain flow was seen as having zero certainty. Natural gas prices were viewed as subject to upward pressure through 2024, but maybe facing a glut in 2025 and 2026 when US gas starts to flood the market. Some presenters cited an “overdue backlash on ESG” due to hunger and energy issues for the poorest countries and individuals.

II. Emerging Markets

US dollar strength was a big concern here. The IMF pushed that risk, putting in the top three challenges to EM. We saw the same in our investor discussions, the US dollar was loved. Brazil was a recent exception, as it started its hiking cycle so early and so aggressively. We were struck by how dominant the “dollar view” was for EM folks who are normally, like ourselves, inclined to ask “what dollar cross are you talking about, exactly?”. EM folks worried about rising US rates, global growth, tended to see EMFX as a kind-of monolith. Our view is that EMFX is nicely set up given their earlier and larger rate hikes, as well as some of their superior debt statistics, and that one has to have a currency-by-currency view. We are especially excited by some Asian EMFXs.

EM being in “good” shape was mentioned a lot, despite bearishness, that related to bearishness on DM growth and interest rates. It was broadly lauded that EM central banks hiked earlier and larger than DM central banks. And, it was broadly observed that many EMs have excellent external positions. It was also reiterated that EMs stopped emergency spending on COVID due to fiscal constraints earlier than the profligate DMs, and EM’s generally lower levels of debt should be a positive.

The China discussion, particularly on politics, became more sophisticated. President Xi was presented as taking advantage of populist resentment against the rich, which was politically sustainable. Poverty alleviation is popular. Liberal intellectuals are not an important constituency right now. Military reform also got discussed. China has fully left the Soviet-era model of a heavy ground force army, and towards the US model of a multi-force approach, i.e., land, sea, air, space. We were also reminded that Xi is seen by many as having saved the Communist Party when he went after Bo Xi Lai as an alternative force. The young are joining the party, and dominate new membership. Security is the priority, and we could sense an almost disdainful attitude toward growth–focused policy. Security, health, and stability struck us as the key watchwords. Xi’s political capital seems likely to be invested toward those goals.

Finally, on the relationship with Russia, the (interpreted) line from China seemed to be that "if you (the west) win in Ukraine and Russia, you have already told us we are next". The Chinese view the US as the generator of global geopolitical risk, and many other countries and investors appeared to agree with this framing. **Central and Eastern Europe was mixed.** Hungary's central bank came off as 'hawkish', and as catching up. Yields are high and they are concerned about currency weakness, We are attracted to local-currency bonds in this setup. Poland came off as 'dovish' and as risking a currency-inflation spiral. Fiscal policy and monetary policy are too stimulative, it struck us. On Ukraine, the US struck us as focused on ensuring financing and on supporting the country's domestic spending priorities. We have a position in their bonds, but have had only tactical approaches in Ukraine this year. EMEA ratings, we should note, have been very volatile this year, which is uncommon for that region, but the result of the war.

Asia came off well. Offshore investment in a lot of the EMs here declined significantly, Indonesia being noteworthy, which means that the central bank has more flexibility on exchange rate management, i.e., they don't have to worry about outflows as much. Overall, fiscal policy is good, external accounts are strong, and they are simply following the DMs in their hiking cycles bynot going big and early like the Latin American countries, and their currencies are still stable because their fundamentals are strong. They don't need to over-hike to generate credibility.

Latin America was loved, but we think it was not selective enough. Brazil was lauded. They hiked earlier and more than any other central banks, and are already seeing hints of progress on the inflation front. We had exposure to Brazil local earlier in the year but closed it because it hit our valuation targets and we are awaiting possible opportunities going into the second round of presidential elections. Mexico also got high marks, and we'd agree there. Mexico elected a leftist populist who remains well-liked, kept to his fiscal targets and made the central bank's objective function a stable currency. Colombia comes off to us as a possible accident waiting to happen but it was loved. We think there should be worry over the new government's policy inclinations, and see Colombia as closer to a frontier African credit than a double-B Latin American Credit. Peru impressed, as we think it should. Its famed institutions worked and the country has reasonable fiscal and monetary policy despite a market-unfriendly president, whose Finance Minister and Central Bank head are very orthodox. Chile seems to be working its way through its political growing pains, and many appreciated that extremely market-unfriendly results from its Constitutional re-think haven't materialised.

Turkey was interesting, but not because it was attractive. .We've criticised its heterodox policy mix for a long time, and only own one unique US dollar-denominated bond. Turkey was interesting due to the multiple alliances it is joining or courting. Russia and Saudi Arabia are widely viewed as behind the surprise surge in Turkish central bank reserves, which were a key weakness. This is a big, under-noticed development. We've referred to two countries as "hinges of history" in our writings over the past decade – Ukraine (now in play), and Turkey (get out your popcorn). Pontification on the speed with which history is proceeding at the moment are spot-on in our opinion. The recent OPEC meeting is a good example of this. As are Russian-Turkish proposals to help gas flow to Europe via Turkstream.

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