The Dog That Didn't Bark

Gregory: 'Is there any other point to which you would wish to draw my attention?'
Holmes: 'To the curious incident of the dog in the night-time.'
Gregory: 'The dog did nothing in the night-time.'
Holmes: 'That was the curious incident.'
From 'Silver Blaze' by Sir Arthur Conan-Doyle

'Absence of evidence is not evidence of absence!'  
Donald Rumsfeld, military strategist

Worldwide, debt levels are elevated. Also, in emerging markets at least, signs of an anti-capital bias in government circles are increasing. Yet interest rates in most markets worldwide are at multi-generational lows. In investments, as with many things in life, valuable information is often to be found where there are inconsistencies. What has happened to the bond vigilantes? That dog is not barking.

So we think it would be dangerous to look at interest rates and surmise that all is well with the world. As Rumsfeld said, absence of evidence is not evidence of absence.

Economics teaches us that the factors of production are land, capital and labour. In a free market, the relative scarcity of each factor would be reflected in its price. The more abundant a factor (or input) is, the lower its price should be – at least theoretically. In such a free market system, the role of government would be limited to ameliorate the effect of any externalities, and in so doing make markets more efficient by allowing prices to reflect the full social cost of doing business. Of course, contrary to reality, governments tend to see externalities everywhere, which is why it’s the one part of an economy that’s always growing. I’ll deal with this issue in more depth later.

The relative scarcity of labour is reflected in wages – at least in a free market. This is an important signal. If too many workers are attracted to an industry, the wage levels in that industry decline relative to other industries. Workers would then be encouraged to leave the oversupplied industry and move to the undersupplied one. This of course assumes a reasonable level of education and mobility in the work force. As an aside, a poorly educated workforce is one of the few externalities that governments can and should attend to. The combination of a flexible and well-educated labour force is extremely powerful economically, and countries where this has been achieved have progressed very well.

Just as the price of labour is reflected in wage levels, the price of capital is reflected in interest rates. Where capital is abundant, interest rates tend to be low. For capital to be abundant, or at least not scarce, it needs an environment in which the basics are in place, such as the rule of law, entrenched property rights, a stable labour force and some level of continuity and certainty with regards to how government interacts with the real economy. Again, this is (or at least should be) the remit of governments – to make sure such an environment is in place and not to counteract it. Historically, developed markets have had more of these conditions present, which is one of the reasons why interest rates in these economies have been consistently lower than in emerging markets. And, to the extent that all assets are priced off the yield curve, lower interest rates also mean higher asset values, on average, over time.

In short, countries that are attractive to capital have lower interest rates and higher asset valuations. Other conditions generally associated with a benign, capital friendly environment are lower unemployment, more business formation and relatively less governmental red tape. Developed markets have tended to exhibit such characteristics. Chart 1 shows bond yields in developed markets relative to emerging markets as a proxy for prevailing interest rates. It’s clear that developed market bond yields have historically been 3% to 5% lower than those of emerging markets.
Despite widespread hope and optimism around emerging markets, recent events have tended to reinforce our view that emerging markets are generally capital-unfriendly places, and to compensate for this, they need to have high interest rates – and lower asset (including equity) valuation levels. Today, emerging markets are characterised by social tension, increasing government intervention leading to low quality employment opportunities and job losses, less business formation, less competition, and the undermining of legal and property rights.

Russia is in the process of annexing a part of one of its neighbours unilaterally, and its economy is characterised by high levels of corruption and crony capitalism. Oligarchs milk the system in Russia, then export the proceeds to acquire high-end London property. The fault does not lie in London! In Turkey, the government has banned YouTube and Twitter due to evidence of corrupt government activities being disseminated via social media. In Brazil, the president displays a distinctly anti-market rhetoric. Recently, S&P downgraded Brazil’s debt rating to one notch above junk. Last year, India imposed capital controls – the ultimate sign of an unattractive environment for capital. Ghana and Nigeria followed suit in quick succession. And in South Africa, recently proposed legislation would give the government 20% of any new energy project for free, plus up to 50% at a ‘fair price’, to be determined by the government. At the same time, bilateral trade agreements with developed markets are being rescinded. Stability and certainty – key ingredients for investment – are being eroded.

These types of conditions tend to scare capital away – and, in the equity market at least, that seems to be happening. Investors are voting with their feet, as they should. Chart 2 shows how emerging markets have performed relative to developed markets. Since 2010, at the top of the hype around the whole BRICS growth potential, emerging markets have underperformed developed markets by around a third.

But that’s in constant (US dollar) currency terms. In local terms, Argentina, South Africa and India are hitting all-time highs on a daily basis. Russia, China, Thailand and Turkey are not far off their all-time highs.

So what is happening? It seems that emerging markets are importing the worst of all worlds.

From the West, they are importing financial repression – low interest rates to subsidise indebted entities (the government). For more on this topic, see ‘Investment Strategy in 2013 and Beyond’ in REVIEW 24, April 2013. Financial repression artificially lowers interest rates...
and inflates asset prices, denominated in local currency terms. The creation of money doesn’t create new real resources, it just allocates existing resources amongst entities. Some win, some lose. The main losers are surplus capital entities – that is savers and pensioners – while the main winners are debtors. Through the mechanism of artificially low interest rates, savers are subsidising debtors.

From the East (China, to be exact) emerging markets are importing the concept of a ‘developmental state’. This entails a government that knows better than the market and allocates resources in order to develop certain sectors of the economy in the hope that this will create jobs. Typically, governments misallocate resources spectacularly in this process. They inhibit competition through the creation of state owned monopolies. They destroy capital through investing in old, outdated technology – such as printing presses, steel-making capability and coal fired power stations. And they reduce the growth of industry – and therefore employment – through mind-boggling red tape. What they fail to understand is that China’s success has not been built on ‘smart government’ but on excess credit.

Emerging market politicians are committing a crime against their constituents as they continually undermine their countries’ growth potential. The normal response would be for interest rates to rise, reflecting the poor conditions for investment, and to act as an attractor for capital. But, so far, this dog hasn’t barked. Instead, currencies act as a release valve from the twin evils of financial repression and ‘smart government’. It’s no surprise then that most emerging market currencies have depreciated significantly over the past few years. And if more countries follow India’s lead in imposing capital controls – a not unlikely event in this brave new world of ‘smart government’ – currencies could take a further hit.

At RECM, we have no idea whether this will happen or not, but the chances are not zero. Today, we think that many emerging market currencies are somewhat undervalued fundamentally. And if you don’t believe us, the 15 most undervalued currencies according to the Economists’ Big Mac index are all emerging market currencies. As an aside, Japan is the only developed market with an undervalued currency, according to this methodology.

But despite this undervaluation, we remain hesitant to allocate capital to emerging markets. We think governments’ enthusiasm for market manipulation still has a long road to run, and this may well continue to be reflected in currency movements.

Piet Viljoen