2016: The Death of Divergence

By Richard Thies

As we step into 2016, it is striking to us how similar the outlook appears as it did throughout 2015. Having already spilled a lot of ink on the myriad challenges that a stronger US dollar brings to risk markets, we won't focus on it again. However, we maintain that the dollar's value is the single most important variable in financial markets, currently. Additionally, it is worth noting that the biggest negative effect of a stronger dollar (tighter global financing conditions) is becoming so entrenched that nominal USD depreciation is no longer enough to reverse this state.

We have discussed the role of the dollar on financial markets in our commentaries for the past few years. Unfortunately, we don't have many new groundbreaking insights. In collecting our thoughts for the year ahead though, one thing did stand out. The concern regarding the strong dollar and tightening liquidity globally was initially focused on problem areas like commodities and emerging markets. Now we see the breadth of the impact much more clearly everywhere, not just in EM. Last year was incessantly billed as the year of divergence and decoupling, in economic and policy terms. It was to be the year the US clearly decoupled from woes in the rest of the world. That divergence story remains present in the mainstream narrative of the global economy with acclaimed pundits penning pieces with titles like, "The Great Divergence," as recently as December. In contrast to that view, we believe 2016 will be recognized as the year when economic similarities become a larger driver of asset markets. In other words, we have already passed "peak divergence."

We find this conclusion particularly important. The world's asset markets are still priced for strong divergences to continue, and in many cases accelerate, not for the gravity-inducing similarities to reassert themselves.

For the sake of brevity, we limit the discussion to what we feel are the four most important similarities, all of which appear underappreciated by the market:

1. Despite perceptions to the contrary, all of the major global economies (including those in EM) share the same cyclical characteristics of strong services activity, deeply worrisome industrial trends, and stagnant investment.

2. Tightening liquidity, and the negative growth impulse it brings, is not only an emerging market phenomenon, nor was extending too much credit to unproductive areas like commodity extraction.

3. Almost all the major economies face very real limits for further easing of monetary policy, something much misunderstood by the markets.

4. The deterioration in China's growth outlook and the ongoing major changes in its financial system are everyone's concern, even if the connection looks small in some cases.

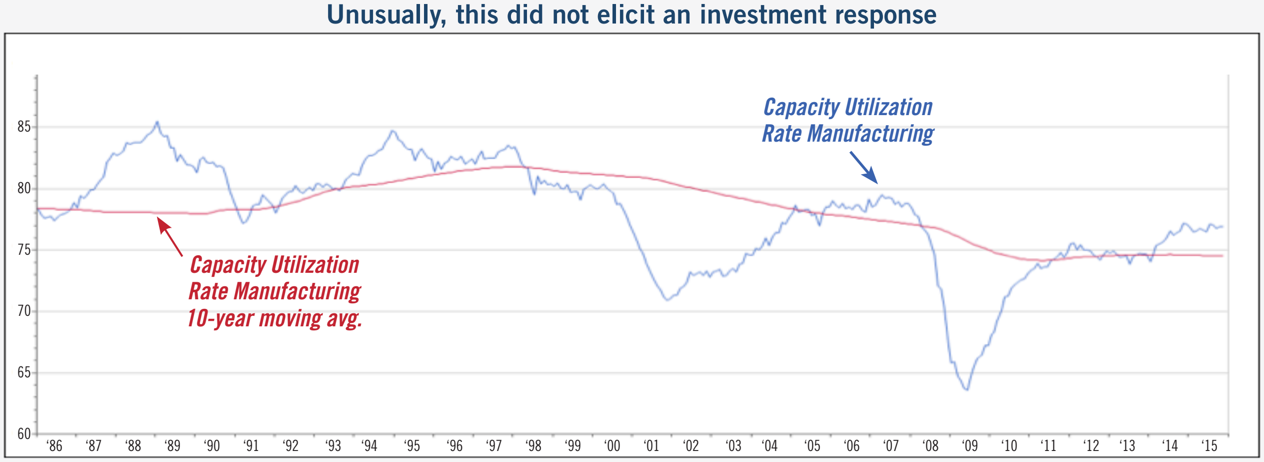
The Service Revolution

Considerable attention has been focused on the ever-slowing rate of investment growth in China. However, the characteristics of Chinese growth in recent years have much in common with other developed economies, namely two-speed growth led by the services sector. While China is the extreme example given the pace of investment growth during the first few years of the post-2008 financial crisis era, its slowdown in manufacturing is part of a global phenomenon. Namely, economic strength is now concentrated almost entirely in the nonmanufacturing sector.

We won't belabor poor global output but it's worth questioning consensus a bit. Everyone we talk to explains poor production with some form of "well, China's slowing." That is undoubtedly a large part of it. However, we question whether that accurately explains why the US manufacturing sector has been operating above trend capacity utilization for several years with no investment response (Exhibit 1), or for example, why tech investment and output has cratered in recent quarters.

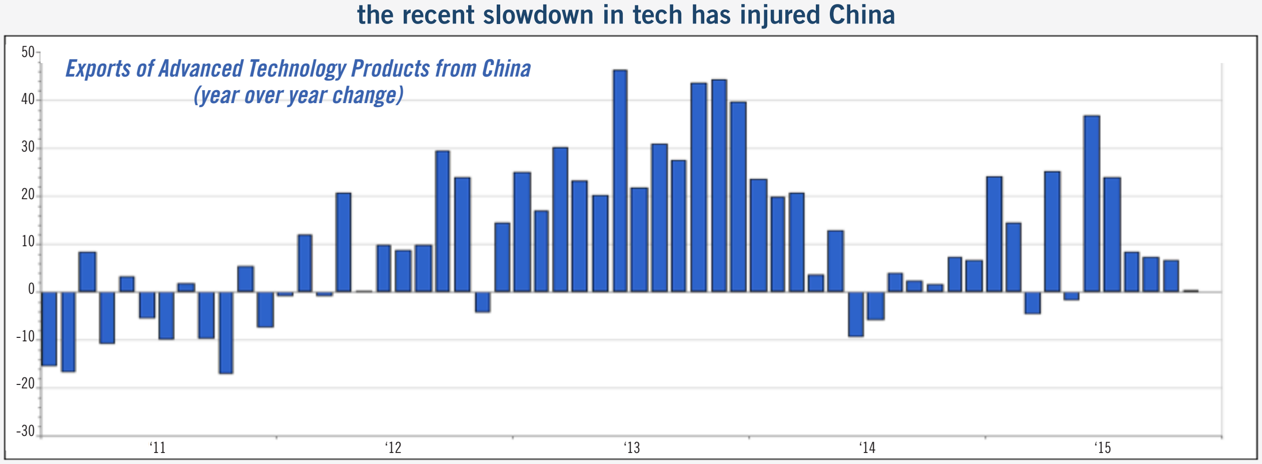
Relatedly, we think one of the least appreciated elements of the current slowdown is the drag that China has faced from the current global slowdown in the technology industry. When people picture the Chinese economy, they tend to think only of steel mills, not of a country with 40% of its exports being advanced tech goods. That export group was growing 40% year over year in June and is now negative, one of the sharpest reversals we've witnessed (Exhibit 2). Regardless, growth everywhere has been less goods intensive and as a result, production industries have done poorly.

EXHIBIT 1: US capacity utilization has been above trend levels for several years. Unusually, this did not elicit an investment response



Source: FactSet, Driehaus Capital Management

EXHIBIT 2: An underappreciated issue is how much the recent slowdown in tech has injured China



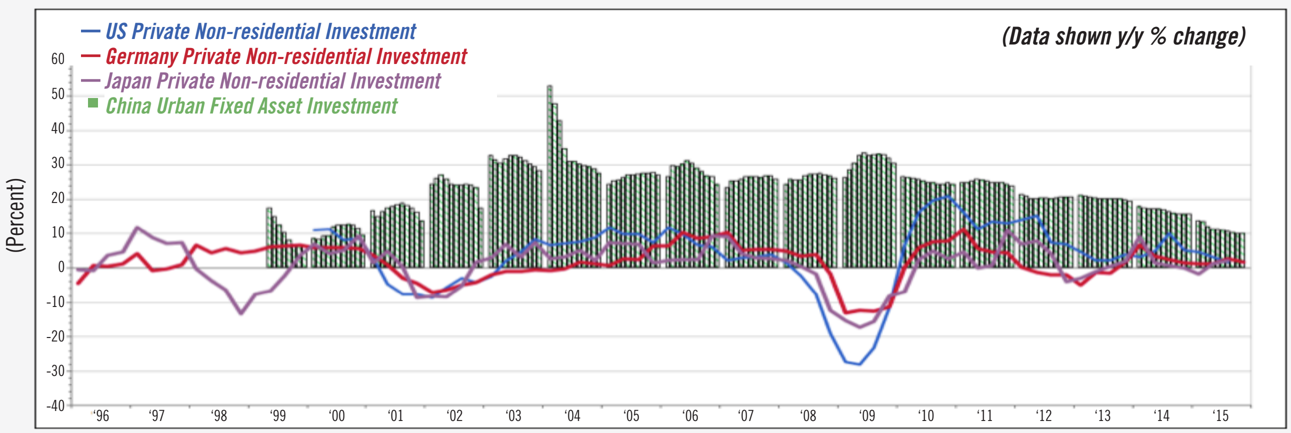
Source: FactSet, Driehaus Capital Management

The slowdown in global production has received a bit more attention of late, but of greater concern is that private investment has still not rebounded to its 2011 levels in any area outside of housing. Also, more important longer-term indicators, such as private investment in nonresidential structures, have started to decline. This is true not just in China but everywhere (Exhibit 3). The only area of private investment in the US that has been resilient of late has been residential. We will discuss this in a bit more detail later, but the conclusion is simple. No major economies in the world have seen acceleration in investment in recent years.

The flip side of this is that the services sector is doing relatively well. This is true in the US, it's true in Germany, and regardless of what people tell you, it has been true in China. The rate of growth in Chinese services has slowed from its breakneck pace but even amid the volatility, retail sales have kept a 10% growth rate. Services, and retail in particular, were one of the first things to recover after the financial crisis. Looking at sales by volume in the US (Exhibit 4, blue bars), you'd be hard-pressed to see any cyclical changes at all. Similarly, the core European markets are in a strong upcycle. US data shows this divergence the most clearly but it looks the same almost everywhere. The reality is that we've never seen a cycle quite like this and with this much divergence (Exhibit 5). One point to note is that services-led growth is generally less volatile, and less volatile growth warrants a lower equity risk premium.

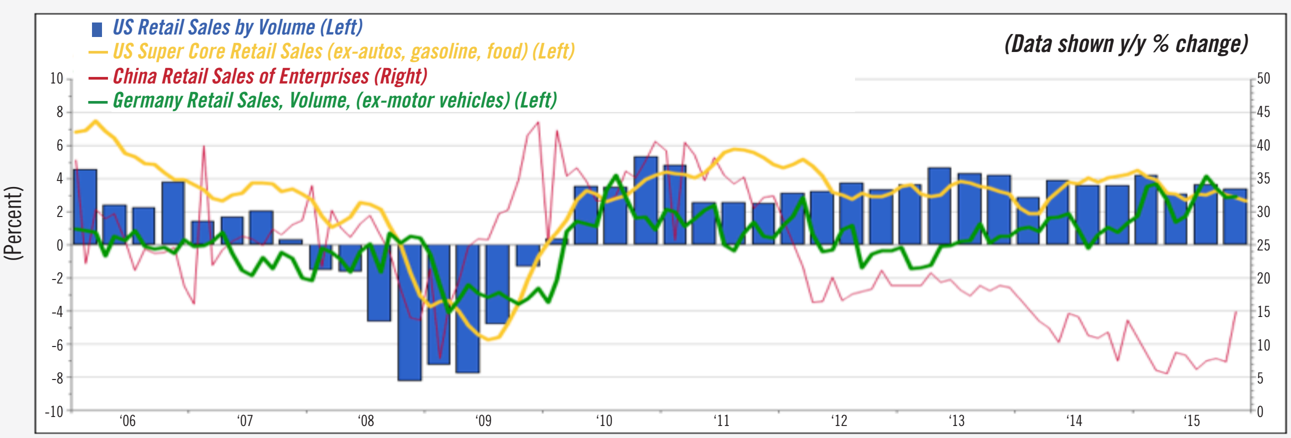
Why is this happening? There is no simple conclusive answer. We believe that the data, even in the US, may poorly capture the ongoing economic changes. That obviously isn't enough to explain everything, however. Importantly, we believe that monetary policy's ability to stimulate nominal spending is much more effective on consumption than it is on stimulating investments. One reason we have never seen a

EXHIBIT 3:
China isn't the only economy seeing a nonresidential investment slowdown the past few years



Source: FactSet, Driehaus Capital Management

EXHIBIT 4:
Retail sales—China is red line and uses the right axis

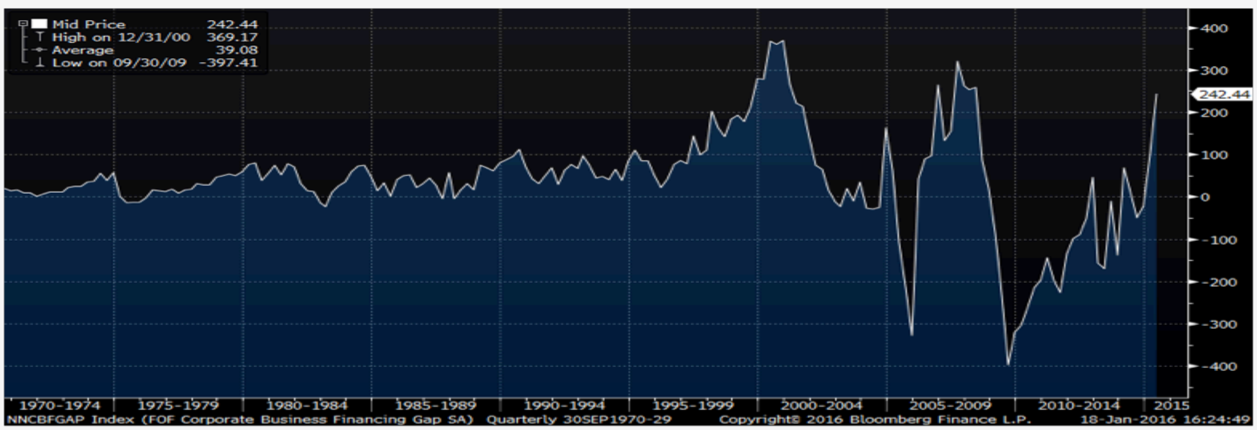


Source: FactSet, Driehaus Capital Management

EXHIBIT 5: Divergences in services and manufacturing PMIs show how disconnected growth is currently

Source: Bloomberg

EXHIBIT 6: The US corporate financing gap is the highest since the previous crisis



Source: Bloomberg

cycle just like this is that typically a strong services and consumption demand pulls manufacturing demand. That is not happening, either because demand has been less goods-intensive, as the trade data suggests, or because production capacity was already sufficient as a result of Chinese expansion. We think it's both but place more weight on the former.

Can this divergence continue? Looking at the US, it is easy to conclude that it can, judging by things such as consumer confidence, current housing market indicators and auto sales. Effectively, the strength in services in most markets has had to do with relatively tighter labor, and the higher real wages that accompany it, insulating things like retail sales, even in emerging markets and China. Thus, resilience, but not strength, can continue as long as labor remains tight. We worry, however, about the corporate sector's ability, as a whole, to finance much more. As it stands today, corporates in the US have the highest financing gap (total expenditures, including buybacks, minus internally generated cash flows) since the financial crisis (Exhibit 6).

In short, the global economy has a very similar composition in all major places. The services sector is resilient due to several factors but highly affected by tighter labor markets, and the investment and output side of the global economy is poor. This is not an emerging markets or Chinese problem, exclusively. The point is not that this isn't a big deal for China or emerging markets—economies that rely more on manufacturing are clearly more at risk from its slowdown—but that it is significant and less appreciated in developed markets. *In any case, services-led growth without productivity growth is a poor quality growth and ultimately not sustainable.*

Always Thirstiest After the Flood

Tightening liquidity may seem an odd issue to mention given the monetary policies we have been living through, but it is here. In our view, relative changes in liquidity, particularly in banking sectors and the level of credit impulse, are as important as absolute levels. Through that lens, global liquidity is getting tighter. In short, we are believers in flow rather than stocks when it comes to credit and asset purchases. That framework has proven even more reliable in the current low-growth world. The tightening global liquidity environment has implications on the global economy's condition as well as relative preferences within it.

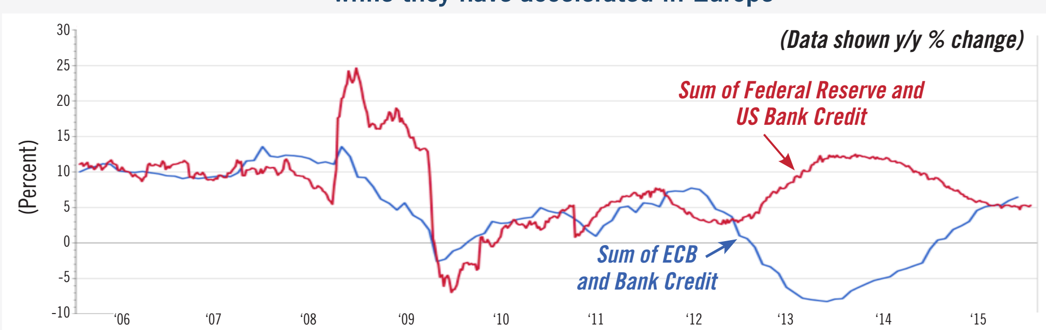
We have long highlighted the combined growth rate of central bank credit (asset purchases) and commercial bank credit. Both forms of credit create nominal spending power for the economy that didn't previously exist, which is incredibly important in an era of low private leverage growth. There is a misconception that central bank credit is of lower quality than commercial bank credit, but in the near term the effect is quite similar. In the US, since the end of 2014, this measure had correctly indicated that the second half of 2015 would start to see a slowdown, particularly on spending. Conversely, the opposite was taking place in Europe since 2014, and data have consistently surprised to the upside on the continent since that time (Exhibit 7).

Going forward, the outlook is similar. Credit conditions are improving in Europe with commercial bank credit growing more quickly along with a supportive central bank purchasing program. Importantly, the European corporates are also very unexposed to the single biggest factor that is tightening financial conditions—the US dollar. In the US, credit conditions are clearly tightening. For the first time since the 2011 European scare, loan officers are tightening lending standards across the board, especially in investment-related areas.

Similarly, despite long-term bond yields that remain anchored at low nominal levels, most alternative measures of financial conditions have tightened. For example, the Federal Reserve-blessed method of calculating the 'shadow interest rate' in the economy has tightened by 300 basis points since the Fed adopted a more hawkish stance in 2014 (Exhibit 8).

With default rates rising as well, it would be rare for credit growth in the US to accelerate under these conditions. In emerging markets, the situation is far more extreme with the twin negative effects of tightening USD liquidity and deteriorating asset quality making for slower credit growth and tighter lending standards. In sum, with the exception of Europe, financing conditions are tighter everywhere.

EXHIBIT 7: Credit impulses to the US have deteriorated consistently since late 2014 while they have accelerated in Europe



Source: FactSet, Driehaus Capital Management

EXHIBIT 8: Loan officers have already started tightening lending conditions at the margin (% of loan officers reporting a net tightening in lending standards for commercial and industrial loans)

Source: Bloomberg

Easy Come, Easy Gone

In addition to sharing common cyclical features and liquidity situations, the major global economies share another trait: limited ability to ease monetary policy further—something we think is very misunderstood. There is a common narrative that this country or that country "will just do more QE if they need to." At the current moment and for the near-term foreseeable future, we do not believe that is an option.

First, it should be clear to most that more quantitative easing is not coming any time soon in the US. Even should the economy start to weaken more notably this year, until labor slack starts to grow again, it would be difficult to justify. Of course, it would be an option to cut rates back or not tighten as much as is currently priced into the market, but nominal rates have proven to have much less of an effect than does buying bonds or not buying bonds. Given how quickly labor supply has tightened with such low top-line growth, it is reasonable to assume it would take a significant contraction in growth to create much new labor slack. The good news is that if that does happen, the supply of bonds is still there when the Fed decides to buy them again.

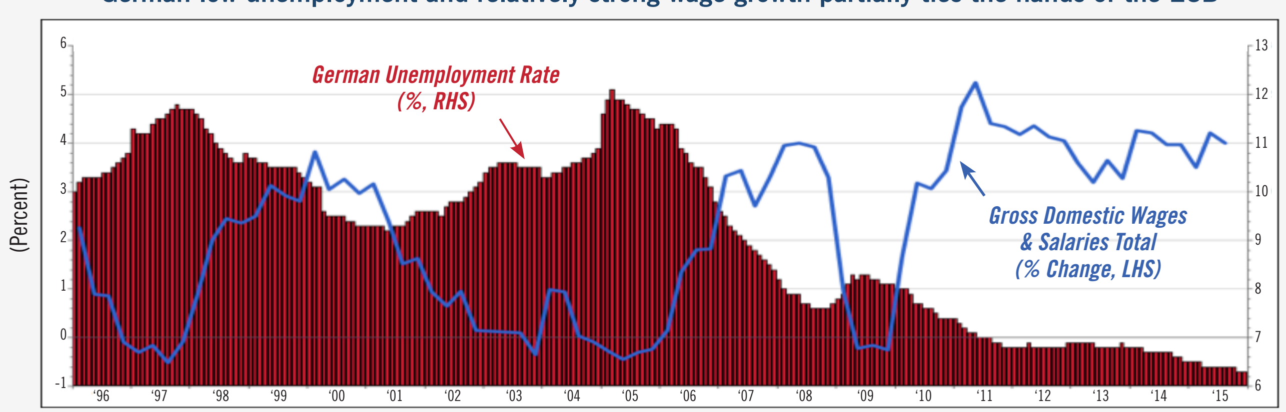
Contrast the US situation with the scenario facing the European Central Bank. The ECB faces two major constraints to pursuing significantly easier monetary policy. We believe that the disappointment from ECB President Mario Draghi in early-December reflected these constraints to a large extent.

The first constraint is that Europe's biggest and most important economy, Germany, faces arguably a tighter labor market than the US and has already seen wage growth in excess of that in the US (Exhibit 9). While part of the "solution" for Europe to regain internal balance is a less-competitive Germany with higher inflation than other countries, the current dynamics will strongly limit the ECB's ability to pursue more unconventional easing.

Second, the ECB faces logistical constraints on further policy changes. The most effective weapon they have had thus far is a weaker euro. Euro weakness is mainly a function of rate differentials with other major countries, so at minimum they need US rates to keep rising as it is not clear they can reduce their deposit rates much further (from -30 basis points) without creating serious unintended consequences. On the other hand, their bond buying program remains small by global standards (less than 10% of GDP versus 20% of GDP in the US). The problem is that because of several constraints—mainly doing purchases in accordance with the ECB's capital key and not owning more than 25% of issues—they actually cannot buy much more unless they want to run out of bonds to buy. Liquidity has already become a serious issue for the ECB and unless they change the rules completely (which they may have to do someday), they physically won't be able to do much more.

The Japanese situation is similar to the ECB's second constraint, but even more limiting on its face. Given how long the Bank of Japan (BOJ) has been playing the quantitative-easing game and how few high-collateral, securitized assets there are in the market, there is a supply constraint coming for them too, though farther away given the huge debt burden and high outstanding Japanese government bonds. In short, at the current pace of purchases, which greatly exceed net issuance, the BOJ will own over half the bond market. The

EXHIBIT 9:
German low unemployment and relatively strong wage growth partially ties the hands of the ECB



Source: FactSet, Driehaus Capital Management

high pension ownership of the remainder of the market means that finding willing sellers will prove difficult. The BOJ has already tried to get around this by expanding asset purchases into other areas like ETFs. The problem is that they already own between 50-60% of the ETF market in Japan, meaning the central bank owns relevant stakes in several public companies, which is a slippery slope to say the least.

Finally, the situation in emerging markets is wholly different, but at the moment equally constraining. The most important of these involves China, where there are hard limits to quantitative-based and policy rate-driven monetary easing as long as net capital outflows remain negative and the Chinese renminbi (CNY) does not float more freely. Ultimately, this year it will become obvious to all participants that China's only chance to enact appropriate (easier) monetary policy is to let the currency weaken further. That this will help the country at the margin makes this a case of when, not if. In other emerging markets, currency weakness and inflation are the bigger constraints to responding to weak domestic demand with easier monetary policy. We believe there will be scope for easing policy in many key emerging markets over the next year. Policymakers should start to realize that a weaker currency with lower local rates is more important than a more stable currency and worse local growth.

The Whole World's a China Shop

There is one final, underappreciated characteristic shared by economies around the world: the effect of a changing China. A very broad subject, but we are concerned with the common interpretation of China's slowing growth and with the changes in its currency policy. Several commentators have recently attempted to demonstrate that the impact of a slowing Chinese economy will be small for the US. The basis for that argument is usually some combination of 1) the US has very low export exposure to China, 2) the prospect of importing deflation to the US and the rest of the world is low because Chinese labor costs are still rising faster than peers, and 3) the risks to the global economy from the Chinese banking system are relatively smaller because of its isolation and that Chinese growth has been *mostly* self-financed. Technically, these points are all true.

Still, we caution against such a conclusion. First, China has been the chief supporter of global growth for the past six years and you cannot isolate its effect on the global cycle by looking at it alone. You also must consider the derivative economies and the effect their growth has had on the global cycle. China buys roughly 10% of global exports, some of which are for re-export, so the true number is likely in the 5-7% range. That number is not terrifyingly high in absolute terms. It is high, though, when you consider the absolute level of growth in other economies, and thus the limited capacity of the rest of the world to absorb downside shocks emanating from China.

Further, as we discussed earlier, the CNY will weaken this year. *For the long term, we think it is an undeniable positive that the world's second largest economy will have a currency that better reflects its economy and is more appropriately valued.* In the short term, the idea that reversing one of the world's biggest-ever carry trades will have limited effect on the global economy is misguided.

During the past eight years, the relative economic fortunes of countries have been very much linked to which had weaker currencies. China has been living with a historically overvalued currency for years now and that is about to change. That will have negative effects on the countries whose currencies will appreciate against it. Similarly, the period of strength in China has coincided with softer factors that will reverse in this environment. Namely, the rapid accumulation of US Treasurys by China (and other EMs) is over, and the recycling of money into developed country real estate markets will slow. While relatively insulated, the Chinese banking system is still a $35 trillion system. That is more than twice the size of the US banking system by assets. While it is not linked as directly to the US system, it is extremely linked to the Hong Kong banking system, which is certainly tied to the global system.

A CNY depreciation will likely coincide with a material increase in losses at the Chinese banks. Even a modest 10% recognized loss ($3.5 trillion) would exceed the country's reserves and ability to recapitalize. The point is that the global economy can't escape the downdraft of a $35 trillion banking system having problems. This is not to say that China's slowdown and FX transition will cause collapse but that a simple dismissal of its effect, or saying it won't significantly affect the US, using basic analysis does not capture the full, wide-ranging effect.

Going Forward

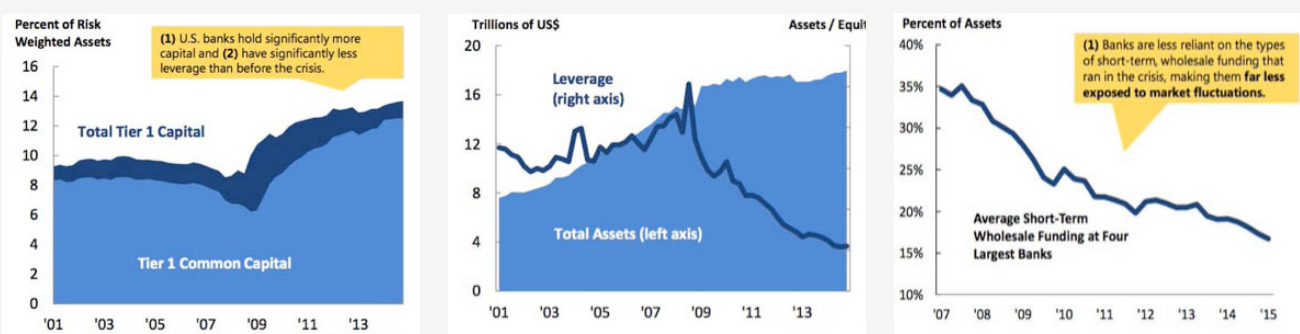
It has become almost a cliché in the past few months but we, too, are expecting higher volatility this year. In describing the current state of the global economy, we see many striking similarities that the major global economies share, which we think is poorly understood. That is important because equities and the path of interest rates are not priced similarly across these countries, and thus currency dynamics will likely change significantly over the next few years.

With regard to disparate equity valuations, we find some interesting observations. There are many ways to slice equity prices and compare them across countries. From a macro level, we have always found the banking sector to be the most instructive. Core measures of value like the market cap-to-deposits ratio do a good job measuring the market's pricing of the future value of a unit of deposits. In crisis scenarios (US in early 2009, Europe in 2011, Japan several times, etc.), the trough valuation has bottomed between 0.05 and 0.06. Currently, the big cap Japanese banks trade at a market cap/deposits ratio of 0.05, the European banks around 0.08, the big Chinese banks around 0.06 to 0.07, and the biggest US banks at 0.11 to 0.12. There are certainly some good reasons for the disparity, but it's clear that some areas are closer to pricing a bear-case outcome than others, and significantly so. Using history as a guide, we are focusing investments on countries that are more closely pricing bear-case outcomes, where we see potential margin improvements or positive reforms, and the ability to reduce real interest rates in the future.

There are silver linings in the global scenario we have laid out. First, the majority of global consumption is done by actors who benefit from lower oil and commodity prices. Our argument since last year has been that the net effect of lower oil would be negative as households save more, less money is spent on investment, and thus net spending in the economy decreases and monetary velocity slows. This has been the case. Despite that, relative winners persist and the background for innovative companies to benefit in that environment is still positive. As the economy has moved toward a less industrial composition, the volatility of growth has also declined. So, while we expect lower top line growth in all markets, the stability of it will be better. This is not a bad thing across the board and it provides active managers opportunities to find growth companies, particularly in this era of rapid technological change.

Secondly, while the equity market has rallied more than some deem reasonable given margin and revenue headwinds, this expansion has definitely not been one of great excess in developed markets as banks and households deleveraged throughout the cycle. This is broadly true everywhere in developed markets, which should limit the downside risks of a potential slowdown. For reference, using the Fed's data, leverage in the banking industry has fallen from about 14x (assets/equity) in 2008 to under 4x today. The industry has gone from a 35% reliance on short-term deposits to 15%, which makes the sector safer and less affected by market volatility (Exhibit 10). In short, while developed market policymakers may lack further easing capabilities, they have helped boost the loss absorption capacity of their systems, which we may be thankful for sooner rather than later.

EXHIBIT 10:
The loss-absorption capacity has greatly increased since previous slowdown



Source: US Federal Reserve

About the Author

Richard Thies is an assistant portfolio manager. He provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. He also conducts in-depth analyses of specific events and potential scenarios at the region, country and sector levels.

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