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A Global Macro Perspective: Populism, Trade and Emerging-Market Volatility

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Templeton Global Macro Chief Investment Officer Dr. Michael Hasenstab and Vice President and Deputy Director of Research, Dr. Calvin Ho, discuss emerging-market turbulence, the persistent concerns around trade policy and divergent growth trends in the developed world.

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Here are some highlights of the views by Hasenstab and Ho represented in the podcast:

- Michael Hasenstab: We have an acknowledgement that the US economy is actually pretty strong. As a result, US Treasuries have started to gap higher, and we think there's more to go.
- Michael Hasenstab: Unless populism reverses, I think the very foundation of the euro as a currency will be challenged over the next 5 to 10 years.
- Calvin Ho: Italy is not really a single country with problems. It's reflecting the problems, the infrastructure, of the euro area as a whole. What we observe is that a lot of people in Europe don't want to take short-term pain, given the long-term benefit is not certain.
- Michael Hasenstab: The emerging-market selloff in August hasn't completely snapped back yet, but we don't see any reason why it shouldn't because the fundamentals are lined up.

The full transcript of the podcast follows.

Host/Richard Banks: Hello and welcome to Talking Markets with Franklin Templeton Investments: exclusive and unique insights from Franklin Templeton. I'm your host, Richard Banks. Ahead on this episode: long-term concerns in the eurozone as a result of populism, politics and sentiment. Templeton Global Macro Chief Investment Officer Dr. Michael Hasenstab on why believes the EU could face significant challenges for years to come. Plus, taking advantage of the recent volatility in emerging markets. Dr. Calvin Ho, Templeton Global Macro vice president and deputy director of research, also issues a potential warning about the trade disputes for the medium and long term.

Host/Richard Banks: Speaking with Dr. Ho and Dr. Hasenstab is Franklin Templeton's Katie Klingensmith. Katie, take it away.

Katie Klingensmith: Thank you, Richard…Michael, let's start with you and how you view the global landscape right now, and I'm guessing it all starts with the continued economic growth in the US?

Michael Hasenstab: We have an acknowledgement that the US economy is actually pretty strong, whether you look at the ISM [Institute for Supply Management] numbers, the labour data, even the Fed's [US Federal Reserve] conversation tone is changing to acknowledge that we are at full employment, the economy is growing quite strong. You look at GDP numbers, you name it, things are strong and as a result, Treasuries have now started to gap higher and we have had a pretty big move, and we think there's far more to go. We have also seen the yen re-couple with the interest-rate differential and with [Japanese] Prime Minister [Shinzō] Abe's re-election, that keeps Abenomics in play which keeps loose policy, while the Fed tightens policy and that interest-rate differential is pushing the yen weaker.

Generally, we have now seen also some euro weakness on the back of populism concerns and budgetary issues. And on emerging markets, this reasonably good growth backdrop, plus the fact that Turkey is isolated and it isn't being contagious to the rest of the emerging markets, I think has caused some stability.

Katie Klingensmith: You mentioned the euro weakness, and I know it's an area you and your team are closely monitoring. Calvin, turning to you, what's your perspective with what's happening in the eurozone?

Calvin Ho: Well, I think the first thing to remember is 2017 was a very good year for the euro area. Growth was 2.4%, you look at when it was 2.4% the last time or higher than 2.4%, the last time was 2007. So we basically have the best year in euro last year. And what we look for is the growth start to moderate. Again, the market consensus is about 2%, next year is marginally lower than 2%, but we actually see downside risk. One reason, taking our estimate for potential growth for Euro area is about 1.5%. So it won't be a surprise to us that the growth is below the market consensus of 1.8% next year.

Katie Klingensmith: And it's the rise of populism sentiment, Michael, that has you concerned?

Michael Hasenstab: I think this is probably the biggest issue, and Calvin and I have had a lot of conversations about, as he points out, you cannot have a monetary union work unless you first have a political union and that is what the US developed over several hundred years. Building a political union to then create a monetary union at the very tail end of it. Europe created a monetary union before there was a political union and tried to force that—and that was working, I would say, up until maybe last year, up until the immigration crisis, the refugee crisis. Europe was able to come together in 2011, despite not having a fiscal union, banking union, they cobbled together half of the banking union and they made the fiscal work.

The problem is the politics driven by what people care about has changed dramatically. Now, the biggest concern is on a refugee crisis, on terrorism, on immigration and that change in voter preferences has led to the election of the Five Star Movement in Italy. It's led to a right-leaning government in Austria. It's led to very right-leaning governments in Hungary and Poland. It's led to the rise of nationalist and anti-EU parties in Germany. So this idea of political union is very hard when you have populist or ultra-nationalist voter sentiment, and politicians in control because their tendency is to turn inward, which is the opposite of a political union, that is one problem.

The other problem is [for] most of these parties, populism tends to be about spending a lot of money, and the eurozone does not work without fiscal responsibility, because if Italy isn't fiscally responsible, the Germans are not going to back neutralisation of debt. And without that common agreement to work on some sort of common fiscal union, eurozone doesn't work. So I think populism, unless that were to reverse and frankly, we don't see that reversing anywhere in the world—unless that reverses I think the very foundation of the euro as a currency will be challenged over the next 5 to 10 years. Significantly challenged.

Calvin Ho: I think what is interesting in that sense is Italy is not really a single country with problems. It's only reflecting the problems, the infrastructure, of the euro area as a whole. Each country does not have independent monetary policy. Fiscal policy is constrained by the stability rule. Now, we have the social problems, immigration, refugees, and adding together what I mentioned earlier about the outlooks moderation of the European economy as a whole, so if we put this together, we actually see downside risk.

Katie Klingensmith: So what has to happen, in your mind; what are possible solutions to these challenges?

Calvin Ho: You can think about a lump of solutions that economists have been talking about for many years. The first one is that we need to have structural reforms. If you can't change the normal exchange rate, you need to change the real exchange rate competitiveness. And of course, what we observe, the reality is a lot of people in Europe don't want to take the short-term pain, given the long-term benefit is not certain.

The second possibility is to let the people move from one place to another. People in the weak countries move to the stronger countries. Again, cultural barrier, no political unions, it is very hard to happen.

The final thing that people now push to hopefully happen, but so far is not successful, is the fiscal unions. Some countries, strong countries' resources transfer to the weak countries. But again, this becomes a political union issue that no one seems to accept.

Michael Hasenstab: That was barely possible with Greece, and Italy's debt levels are multitudes higher. So with the political change and the magnitude of the problem much larger, it's very difficult to imagine a fiscal union.

Calvin Ho: I think that it is possible. If we look back to the US developments that you mentioned, how it becomes economic unions, political unions, one important thing when we think about the US, is every important step by the US is largely driven by a crisis.

Let me just quote you a few examples:

The First World War, the US needed money, so they created a federal income tax—a crisis. In 1907, there was a banking crisis, a big one in the US—they created a Federal Reserve. In the 1930s, they had a Great Depression—they created a regulated banking system. They created deposit guarantees, insurance programs for their banking system.

So what you see is that in every crisis we have a step ahead. Now, we have 10 years in euro areas, we have a one crisis 2010-2012, the questions for us is, does the euro area have the courage to continue this difficult journey?

Katie Klingensmith: What about the ECB's [European Central Bank's] role and the possible end to its stimulus?

Calvin Ho: I think the ECB is very clear that they are going to end the QE [quantitative easing] by the end of this year. Currently, it's $15 billion per month. But they also mentioned that interest rates will not be changed—at least until the end of the summer [2019]. So I think there are two things to remember. One, currently the ECB holds more than $2 trillion of euros in their QE programmes. Those will continue to rollover, so liquidity remains to be there.

The second thing is more important, it is what you mentioned about Italy. Whenever the ECB changes the interest rate, the high interest rates tighten. There is a consequence on the bond yield of those elected governments, and we estimate that the best sustainabilities of Italy might not be sustainable if the interest rate is higher than 3.5%, 3.6%. So I think there is a real political constraint and economic constraint in the ECB to prevent them tightening too much and as a result, the dollar, euro, we still see these interest differentials continue to widen—will be positive to the dollar.

Katie Klingensmith: Coming back to the US, Michael, you've been expecting this type of recent rise in the 10-year US Treasury yield. What do you see looking ahead?

Michael Hasenstab: A year ago, when it was at 2% and we said very easily it will get to 3%, we didn't get a lot of believers. It's now a little bit above 3%, it could easily get above 4%. Again, we got a lot of questions, but looking at the perfect storm that has lined up to push US yields higher, it becomes in our mind, a very compelling argument. You have US economic activity from deregulation, to tax cuts to finally getting some investment being quite robust certainly growing above potential.

On the inflationary side, you have a labour market that is definitely running at full capacity, I mean you could look at any of the metrics. Whether it's people who are forced to take temporary jobs that want full-time jobs, they are now getting full-time jobs. Whether it's the wage price data that shows, finally, you're starting to see acceleration.

We have a full labour market and it's getting tighter, that's inflationary. The trade disputes. I don't think they have escalated to a trade war, but there are trade disputes that are meaning US consumers are going to pay more for their goods. We have benefitted from cheap Chinese goods/imports, now we are going to pay more for those. All of those factors, I think, are inflationary. There are certainly no growing deflationary pressures.

Then you look at the US government and typically, in the past, a Republican administration would show some sort of fiscal restraint—zero fiscal restraint—pretty much at this point it doesn't matter what party you are from, those politicians seem to want to spend money that we don't have. So, you have growing fiscal deficits. On top of that, you now have less buyers. The Fed, unlike the ECB—the ECB is no longer going to do QE but they are not unwinding their balance sheet—the Fed has a programme to unwind its balance sheet, so they are not going to be able to finance the deficit that they had been financing in the past. And foreign buyers with reserve growth stabilised, maybe you get a little bit of an increase from some of the higher oil prices, but most of those countries, you know, take Saudi Arabia, for example, are running such massive fiscal deficits that even oil at 100, they are not going to be accumulating the reserves that they once were. So, Chinese aren't accumulating reserves. Oil exporting countries because of domestic problems and fiscal deficits are not, so you don't have the two biggest buyers that we have had, foreign governments or the US government. So all those coming together that's why this move, maybe some people thought it was a surprise, you know, with huge gap in Treasury yields, it shouldn't be a surprise and it probably has further to go.

Katie Klingensmith: You touched on the trade tensions, but Calvin, you're still not overly concerned about what's transpiring?

Calvin Ho: I think the first thing to remember is we don't really know the outcome at this point. If you look at the WTO [World Trade Organization] tariff data point, US tariff is about 3.5%. [South] Korea for example, according to the statistics, is about 10%. So if the outcome turns out that the Korea tariff is going down and not going up in the US side, then it's actually an improvement.

The second thing we should also remember is we actually see some sign of compromise. We see Canada, Mexico and the US put together an agreement. We see [South] Korea and the US also have agreement now. So we see some positive signs. But if you get into the specific trade tensions effects, I think we should remember—first of all, the US is relatively a closed economy—export for GDP or import for GDP is below 20% of GDP. Then you add times the tariff, times the subset of the export or import, as the personal GDP it is very small. So I think at the first order, effects on tariff to growth is quite small, not to mention that we have regulations in the US, we have tax reform in the US, those stimulus will easily offset the small impacts of the trade tensions, the trade effects.

However, I think there is some medium-term or long-term issues that should be concerned. A simple example is if we remember in 2008-2009, when the global economy was close to a collapse, every central bank coordinated together—eased interest rates, swapped out with each other's—a number of economies, governments put fiscal stimulus all at the same time because they trust each other. Now, if the trade tensions become a mistrust among the government, if we get into the end of the cycle, do we have a confidence that all these governments will work together in an effective manner like what we saw in 2008-2009? But this is more like a medium-term, a long-term issue is that we pay attention. I think people are sometimes are overdone about tariff impacts on the US economy, again it's marginal.

Katie Klingensmith: Alright, let's spend a few minutes on emerging markets now. A lot of volatility over the summer, even fears of EM contagion. But Calvin, we have seen some stability of late.

Calvin Ho: Well, I think the best way to think about this is to look back for the history, what has happened in 1980s, 1980s is basically a lost decade in South America. And in the 1990s we had—basically all around the EM—one crisis after another. And again, over these past periods, we more or less have three stages in the crisis. The first stage is those countries in the Pac exchange rate [Pacific], they have overvalued the currency, they have current account deficit, so they get a lot of pressure, then they let you go which is the first stage, contagious to each other.

The second stage is people, investors, economists start to question things like, can Thailand government get debt sustainable—which is the first country in the 1997 crisis—or did [South] Korea fix that in the corporate which transfers into the government, which caused solvency issues and of course it happens. The last stage is the IMF jumps in and put packages in different countries and solve the problem.

Now in August, we have more or less the first stage, we see there is a number of EM's having contagions to currencies under pressure. The question for us is whether we are in a second stage. Does anyone talk about Thailand for example, the first country in crisis in 1997? Anyone talk about the debt as sustainable or not sustainable? It seems like investors now, we are close to the end of first stage or beginning of second stage that people recognise that, yeah, there is pressure, but there is no solvency issues in those countries. I think there is a major difference between what we had before and what we have now.

Michael Hasenstab: I think to add on to that, the good news is we have had numerous periods of these exchange-rate pressures. I mean, this isn't the first time the Brazil real has broke 4%, it happened before. So we have had that first-stage test, and never has the second stage developed. So we haven't seen any major corporate defaults or any major sovereign defaults on the back of weaker exchange rates, which tells us that that ripple effect of weak exchange-rate causing a debt has been broken for countries that have learned lessons from the past and we have seen across Latin America, across Asia. Now, I think Turkey is a separate issue, its domestic policies are obviously unsustainable and that is in its own separate camp. But, you know, we have had massive depreciations and no serious ramifications to the real economy or to that sustainability. So we see it has an opportunity because the market is immediately panicked, exchange rate depreciates, country is going to default, it's not the case.

Katie Klingensmith: What about concerns of these countries being vulnerable to capital outflows?

Michael Hasenstab: A lot of the capital has left. I mean, take Argentina for example, they have been shut out the capital markets for the last 10-15 years, there is no foreign capital. So there's really nothing to leave. You have seen some volatility, there are a few countries that have a little bit more, some have a little bit less but with the rate differential, Mexican rates 7.5% relative to US treasury yields at let's say 3.25%, that is such a huge gap. Or Argentina at 60%, that risk of interest-rate differential is collapsing or reversing in a number of these higher-yielding countries because they have already had elevated rates, I think is a pretty minimal risk. There are certain countries with low yields that that interest-rate differential will flip and they are more vulnerable.

So in emerging markets, they are not all the same, we have focused on countries that do have a yield advantage, we focus on countries that have better dollar local exchange-rate liability management that don't have huge indebtedness issues and we focus on countries where the politics has moved towards more prudent policymaking and away from the populism that we see in places like Italy, the US or UK. So you have to be very selective, but I think there are some opportunities and just because the Fed hikes 25 or 50 basis points does not mean that Mexico is going to default. Mexico's vulnerabilities in the tequila crisis in '94-'95 are completely different entity than they are today.

Katie Klingensmith: You mentioned Argentina, and it has been a country getting a lot of attention recently with the financial and economic challenges there. Michael, how do you view the situation along with the really aggressive monetary policy response from President Macri and the government?

Michael Hasenstab: I think they are doing every policy decision correctly following an orthodox, and it's not just us saying it in from the private sector. The IMF's package of close to $57 billion and provides, I think, a huge endorsement that these are the right policies. The IMF does not sign up for a $50+ billion-dollar project without being very confident that all the right policies are being pursued for debt sustainability and so I think that's a pretty clear signal. They're like the global accountant for debt sustainability and they have signed off on it. So then the election 12 months from now, [Mauricio] Macri's popularity did take a little bit of a hit because of this volatility, but 12 months is a long time.

Things are stabilising and if they can stabilise, I think we can see his popularity come back. We also look around the other sort of political entities that are there and we have seen parts of the old Peronist party has split, [Cristina] Kirchner and then a more moderate component. Macri's party had worked with that moderate Peronist group to pass a lot of very tough and important legislation, so there certainly are rational actors in that group. There are a number of politicians who have risen in popularity, Governor of BA for example, very prudent orthodox policy. So when we look around the landscape, we don't think the country is just dependent upon one personality even though we think that one personality has done an excellent job. We see a lot of other political outcomes that could also be positive for the country.

Katie Klingensmith: Speaking about politics and elections, Brazil is in the middle of the election process right now with one candidate, Fernando Haddad, viewed as being on the extreme left and the other, Jair Bolsonaro, on the extreme right. Is this concerning for the opportunities there?

Michael Hasenstab: I think what's important in Brazil is that either election outcome, we have seen the end of the old PT [Workers Party], populist high levels of corruption, excessive amounts of spending. The selection or the voter preference for whether it be Haddad or Bolsonaro is saying that people don't want that anymore. They don't want reckless fiscal policy, they want to crackdown on corruption, either left or right, both candidates have gotten that message and would get elected on that platform and I think that platform of more responsible fiscal policy, of less corruption is good for investors. And so, I think what our focus, is going to be, is evaluating each candidate's economic platforms. But the research and the trips we have done proceeding up to this point, tell us that we think at the margin, we are going to see a positive change under either outcome.

Katie Klingensmith: And moving to Asia, we've seen a lot of recent pressure on the rupee in India and the rupiah in Indonesia. Any concerns in these two countries?

Michael Hasenstab: I think the market is overreacting. I think their vulnerabilities both to oil, both to slightly higher US Treasury yields are overstated, vis-a-vis what the exchange rate has done. The current accounts are funded. The fiscal policy has been quite prudent, in Indonesia's case, for close to a decade. They do not have high levels of indebtedness, and again, they have dealt with this exchange rate depreciation without any debt sustainability problems, corporate defaults, etc. So, we think that the market has overreacted.

I think that if you have a three-month time horizon, EM investing is very difficult. And if you have a couple-of-year horizon, you can exploit these panic selloffs that are not fundamental in nature, so I think we have seen, since [the US] taper tantrum [in 2013], about half a dozen of these and we have seen a snapback, almost each time. The selloff in in August hasn't completely snapped back yet, but we don't see any reason why it shouldn't because the fundamentals are lined up. So, I think it's investors who try to time it too short and get cute, get burned. And kind of buy when it gets stable, and then there is a selloff and panic and sell. If you sold at the bottom of each one of those, you have probably given up on the asset class. So, I think a longer horizon is important and country differentiation is important.

Katie Klingensmith: What about environmental, social and governance in emerging markets, how much are you taking ESG into account currently and looking ahead to the future?

Michael Hasenstab: I think ESG, to us, is something that is embedded in emerging-market analysis. If you don't analyse the government structure of a country, social cohesion dynamics, if you don't look at environmental implications for how a country can grow or health care costs or social issues, you are not understanding the country. And so it's something that our team has always looked at extensively, but we never quantified it in terms of a number. So recently we went through that exercise of extracting ESG metrics from all of the analysts' research, that gave us an index, a base level, of what all the countries are and said okay, now let's project where we think this country will be three years from now and let's align, like our investments, with the positive delta, the positive expected change.

Katie Klingensmith: Dr. Michael Hasenstab and Dr. Calvin Ho, thank you both for your time and insights.

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