Institutional Investor

Investors Hampered by Sovereign Debt and Political Uncertainty

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In the wake of the collapse of Lehman Brothers Holdings three years ago, governments around the world took unprecedented action to prevent their economies from plunging into a modern-day depression. The U.S. bailed out its banks with the Troubled Asset Relief Program, better known as TARP, and enacted a $787 billion stimulus package of tax cuts, public works spending and aid to state and local governments. European governments guaranteed their banks' liabilities and tried to revive growth with everything from cash-for-clunkers programs to subsidies for companies that maintained payrolls. Even the Chinese got into the act, pumping $585 billion into their economy for roads, railways and other infrastructure projects.

For a while, the medicine seemed to work. Financial markets rebounded sharply in 2009, and economies turned around too — dramatically so in emerging-markets countries and at a more modest but still steady pace in most developed countries. The U.S. and Western Europe didn't enjoy a classic V-shaped rebound, but growth appeared to gain momentum, unemployment edged lower, and most policymakers and investors felt they had dodged a bullet.

That optimism now seems woefully premature, if not misplaced. In recent months the U.S. economy has slowed to a near stall, raising fears of a double-dip recession. Europe's recovery has decelerated sharply, with problems in periphery countries threatening to weaken Germany's export-driven dynamo. Markets have swooned as weak data has piled up, eroding confidence even further. This time, however, no one is coming to the rescue.

The rise in government debt and consequent decline in sovereign creditworthiness — underscored by Standard & Poor's historic downgrade of the U.S. last month — stand out as the biggest and most pernicious legacies of the financial crisis. Public debt has surged to unprecedented peacetime levels across most of the Western world as governments stepped up spending and the recession undermined revenues. The actions may have averted catastrophe three years ago only to create new and potentially more intractable problems.

Getting debt under control in the medium term without stifling the economy in the short run is a delicate balancing act in the best of times, and these are anything but. European leaders careen from one crisis summit to the next but invariably lag a step behind market expectations, fueling doubts about their ability to save the euro in its current form. The Obama administration and the U.S. Congress have provided similarly shaky direction, rattling investors with their brinksmanship over the debt ceiling. As a result, market participants are losing confidence that politicians can strike the right balance and contain debt without killing growth.

“It's the biggest challenge we're facing,” says Michael Heise, chief economist at Munich-based German insurance giant Allianz. “It's the biggest risk for the short term and also to the medium-term development of our economies.”

For investors the debt crisis raises profound questions. The loss of Uncle Sam's triple-A rating didn't spark any sudden fear of a U.S. default, but it did dramatize the scale of the fiscal problems, the weaknesses of the political process and the negative consequences for the economy. It also served as a stark symbol of the decline of the economic might and influence of Washington and the rest of the developed world, and the relative strength of countries that the West deigned to lecture only a decade ago.

“We're in a new fiscal world order. That means subtrend growth probably for the next few years across developed markets,” says Rebecca Patterson, chief markets strategist at J.P. Morgan Asset Management in New York. By contrast, she adds, “the fundamentals in emerging markets today are not only as good as developed markets but often better.”

Investors are urgently trying to figure out how to position themselves for this new order. The task isn't easy. The U.S. downgrade shakes the very notion that U.S. Treasuries are the risk-free asset that determines the price of everything from stocks to bonds to real estate. Yet the move also sent a loud risk-off signal of imminent fiscal tightening and economic weakness, prompting a massive rally that pushed yields on ten-year Treasuries below 2 percent at one stage. No less a luminary than William Gross, the Pacific Investment Management Co. co-CIO who dumped Treasuries from his $245 billion Total Return Fund earlier this year for fear of a spike in rates, was left to publicly regret his mistake.

The search for new investing guidelines has yet to produce any grand model, but the outlines of a new approach are coming into view. An increased allocation to emerging markets is certainly part of the mix, continuing the trend of recent years. Credit perspectives are likely to play a larger role as investors place greater emphasis on balance-sheet strength, both among companies and countries. Investors are also looking to broaden their benchmarks, considering a basket of sovereign and corporate bonds rather than domestic government bonds as the centerpiece of their fixed-income portfolios; they are looking to use so-called shadow currencies such as the Canadian dollar, Swiss franc and Australian dollar as proxies for the U.S. dollar, the euro and the yen because of their governments' better fiscal and economic health.

"It seems so obvious to me that the world has to shift to a new set of benchmarks and allocations," says Jim O'Neill, chairman of Goldman Sachs Asset Management. One of the first things that should be tossed aside, he asserts, is the traditional distinction between developed markets, with their supposed security and lower returns, and emerging markets, with their perceived higher returns and higher risk. "People have to stop calling some parts of the world emerging markets," says O'Neill. "You're going to be compelled to start thinking differently."

The scale of the debt explosion in most advanced countries is staggering. According to International Monetary Fund data, since 2007 gross government debt has risen by a third in the euro area, to a projected 87 percent of gross domestic product at the end of this year; by nearly two thirds in the U.S., to 99.3 percent of GDP; and by more than three quarters in the U.K., to 81.9 percent of GDP. For all three areas debt stands at levels not seen since the aftermath of World War II.

Such surges in debt typically occur after systemic financial crises, as governments support overstretched banks and households. Unwinding that debt is a long process, taking about seven years, on average, economists Carmen Reinhart and Kenneth Rogoff, authors of the book This Time Is Different, wrote in a recent paper. In a recent online column, Rogoff argued that the West didn't suffer a business-cycle recession; instead, it is continuing to experience a prolonged great contraction comparable in nature, if not in scale, to the Great Depression. Extraordinarily, after three years economies in the U.S., Europe and Japan still haven't recovered their precrisis output levels. "The real problem is that the global economy is badly overleveraged, and there is no quick escape without a scheme to transfer wealth from creditors to debtors, either through defaults, financial repression, or inflation," Rogoff wrote.

The debt overhang looks set to weigh on the advanced economies for years to come. A recent study by Stephen Cecchetti, head of the monetary and economics department at the Bank for International Settlements in Basel, Switzerland, found that government debt tends to reduce growth once it reaches a range of 80 to 100 percent. The same holds true for household debt. Three years of painful delevering has reduced U.S. household debt to about 115 percent of disposable income from a precrisis peak of 130 percent, but that is still well above the rate of about 90 percent that prevailed as recently as the late 1990s.
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“Debt is going to be a drag on growth,” says Cecchetti. “We’ve pretty much hit the limit of where we can go.”

Developed economies have indeed slowed significantly in recent months. Recent revisions show that the U.S. grew at a rate of less than 1 percent in the first half. Economists at Morgan Stanley last month slashed their 2012 growth forecast for the U.S. to 2.1 percent from 3.0 percent, and to 0.5 percent from 1.2 percent for the euro area. Economists at Bank of America Merrill Lynch now put the risk of a new recession at 40 percent.

The economic slowdown, as well as a growing sense that policymakers in the U.S. and Europe have few tools left to remedy the situation, explains the declines in equity markets in recent months, analysts and investors say. “We started off with a private sector crisis, which has rolled over into a public sector crisis. There isn’t anywhere to roll this crisis onto next,” says Alan Brown, chief investment officer at Schroders in London. “We’ve exhausted all fiscal options. All we’re left with is unconventional monetary policy. That’s a very uncomfortable position because we’re not sure how that works or if it works at all.”

At the Federal Reserve’s annual symposium at Jackson Hole, Wyoming, last month, chairman Ben Bernanke said the central bank was prepared to act to support the economy, but he offered no clear hint of a new round of quantitative easing — a reflection of growing opposition within the policymaking Federal Open Market Committee. The Fed will hold a two-day FOMC meeting later this month, a sign that Bernanke may try to rally support for fresh action, but few analysts are holding their breath.

There was an atmosphere of resignation among the policymakers and academics at Jackson Hole, says Barry Eichengreen, an economics professor at the University of California, Berkeley. “There isn’t a sense on anyone’s part that there is room for policy maneuver.” Eichengreen would like to see the U.S. government combine short-term support for the economy with credible tax and entitlement reforms to reduce the deficit in the medium term — a strategy that the new IMF managing director, Christine Lagarde, advocated at Jackson Hole — but he sees little political backing for such a stance following the heated debt ceiling debate. “We’re in a corner where people have convinced themselves that there’s no room for short-term fiscal stimulus,” Eichengreen adds.

Markets are now starting to price in the effects of the new austerity policies, and the picture isn’t pretty. “Here’s where I get a little bit scared,” J.P. Morgan’s Patterson said in a presentation to clients last month. “We’re going to see a number of the biggest economies in the world embarking on fiscal tightening at the same time, something we simply haven’t seen in decades.”

It’s not just austerity itself but the politics surrounding it that make investors nervous. The bitter showdown over the U.S. debt ceiling — in which the Obama administration and Congress fought down to the wire and a few Republicans in the House of Representatives actually advocated default — generated enormous market volatility. “It was very damaging to psychology and risk-taking,” says Joseph Carson, director of economic research at AllianceBernstein Investments in New York. Heightened turbulence is likely to continue because political uncertainty exists on many other fronts as well. Will European politicians endorse a Eurobond to stem the bloc’s debt crisis or bow to opposition in Germany and Finland? Will the U.S. let the Bush-era tax cuts expire next year?

“The markets are having a crisis of confidence,” says Kevin Parker, global head of Deutsche Asset

Management in New York. “The biggest factor is political risk. No one can calculate it. You can’t put it in a spreadsheet.”

Daniel Arbess, manager of the $3 billion Xerion hedge fund at Perella Weinberg Partners in New York, says investors are much more comfortable making bets on corporate managers than trying to figure out what politicians will do. “In 2008 you could identify the weak link — it was financial institutions with toxic debt,” he says. “In the current environment, where resolving public sector debt burdens requires government policy intervention, it’s challenging to position because investors are trying to exploit chronic policy weaknesses, but government has the power to make and change the rules of the game,” such as banning short-selling.

The U.S. government so far hasn’t paid a price for the S&P debt downgrade. The rating agency had signaled the likelihood of the move, if not its timing, well in advance. A similar downgrade of Japan in the 1990s had no real impact on rates there. More important, Treasuries remain the go-to asset in times of trouble by virtue of the market’s unparalleled depth and liquidity. Before the downgrade they accounted for 55 percent of all triple-A-rated sovereign bonds, making the U.S. Treasuries market more than five times the size of the German Bund market.

“U.S. Treasuries are still the instrument you are most likely to sell at the price you anticipate,” says Peter Fisher, head of fixed-income portfolio management at BlackRock in New York. But, he cautions, “the risk-free rate has never meant riskless. There’s plenty of interest rate volatility in Treasuries.”

Several factors could increase market perceptions of risk, driving up Treasury yields and potentially threatening the dollar’s status as the dominant reserve currency, analysts say. Sovereign wealth funds and central banks have been slowly diversifying away from the dollar in recent years by investing more of their fund inflows in the euro, emerging-markets securities and even private equity, and that trend could accelerate. In a telling move just before the U.S. debt ceiling deadline, the Central Bank of the United Arab Emirates announced that it did not hold any U.S. government securities because of their “very low return.”

Moody’s Investors Service and Fitch Ratings could follow S&P and cut their triple-A ratings on the U.S. if lawmakers fail to deliver the $1.2 billion in spending cuts called for under the debt ceiling agreement. Some analysts see a potentially bleak scenario in which slow growth aggravates the U.S.’s deficit and debt problems, sending the country’s fiscal condition into a downward spiral similar to that of Greece. J.P. Morgan’s Patterson estimates that if U.S. growth averages 2.5 percent a year through 2016, as her firm deems likely, rather than close to 3.5 percent, as the Congressional Budget Office assumes in its latest ten-year forecast, U.S. debt would grow by an additional $3.5 trillion this decade. “If we miss the mark on growth, we’re going to miss the mark on debt by a lot, and that is reason to be nervous about the rating for the U.S.,” she says.

In short, the challenge for U.S. policymakers is getting tougher than ever at a time when the political will to address fiscal and economic problems is lacking. “If we fail in Washington, we’re going to fail in the marketplace too,” says AllianceBernstein’s Carson. “Capital goes where it’s welcome. Unless we clear up this problem quickly, America is going to suffer.”

Europe faces an even tougher test. The euro zone has lower aggregate debt than the U.S., but the structure of monetary union threatens to turn problems in peripheral countries into a systemic crisis. Greece, Ireland

and Portugal can't devalue to ease their debt burdens or increase competitiveness. Instead, they will be obliged for years to implement tough austerity packages dictated by the European Union and the IMF, with the danger of prolonging their recessions, stirring up social protests and undermining public support for the euro.

The European Financial Stability Facility, the bloc's €440 billion ($625 billion) bailout fund, risks spreading the contagion instead of containing it. Euro area countries pool money to guarantee the EFSF, but if Spain and Italy have to draw on the fund, that would increase the burden on a shrinking number of guarantors. The EFSF could become a kind of financial doomsday machine, threatening the triple-A rating of France and potentially even that of Germany.

Ultimately, most analysts believe the EU will have to collectivize the debt to save the euro, but so far leaders are balking, with German Chancellor Angela Merkel flatly rejecting proposals for common euro area bond issuance combined with a new EU fiscal authority to enforce discipline. Indeed, Finland's recent demand for collateral to protect its share of a new loan package for Greece threatens to unravel that program.

"We are heading toward an endgame," says Thomas Bossert, a senior portfolio manager at Union Investment in Frankfurt. "You have this monetary union without a fiscal or political union. As long as this isn't solved, you will have problems." Srinivas Thiruvadanthai, director of research at the Jerome Levy Forecasting Center in Mount Kisco, New York, predicts that one or more euro members will have to quit the currency zone to stem the crisis. "We would bet on it not surviving this decade," he says. "The current arrangement is not sustainable."

"People are going to have to face up to the reality of the world they live in, in which there is no risk-free rate," says Jerome Booth, director of research at Ashmore Investment Management in London. "There is no substitute for thinking. The risks you care about most are the really big ones. You have to start pricing in sovereign risk and exchange rate risk."

In Booth's view those risks are arguably much higher in the U.S. and other developed economies than in emerging markets. Not only do many emerging markets enjoy better economic fundamentals than most advanced economies, their sovereign wealth funds and central banks are among the world's biggest and fastest-growing investors. These funds have few liabilities in the U.S. and Europe, and therefore have little incentive to keep investing the bulk of their assets in those markets. The growing interest of these funds in investing in emerging markets may explain why Sri Lanka, a country that only two years ago ended a decades-long war with Tamil separatists, was able to sell $1 billion in ten-year bonds at 6.25 percent in July, while Spain and Italy needed intervention by the European Central Bank to maintain their access to markets.

To facilitate a shift in allocations, Booth favors weighting benchmarks by GDP, which would reflect the growing size of emerging-markets economies, rather than by market capitalization, which gives a bias to established markets. "What investors want ultimately is future income," he says. "The best indicator of future income is GDP."

Goldman's O'Neill also advocates increasing allocations to emerging markets — not surprising for the man who coined the term "BRIC" a decade ago. On the question of risk, he notes that only three of the 17 euro members — Estonia, Finland and Luxembourg — currently comply with the Stability Pact rules stipulating that deficits be kept below 3 percent of GDP and debt below 60 percent. By contrast, Brazil, China, Indonesia, Mexico and South Korea are well below those thresholds. As for reward, O'Neill cites Goldman estimates that emerging markets will contribute much more to global growth this decade than the developed markets will. The BRICs alone — Brazil, Russia, India and China — will generate nearly $13 trillion in growth over the period, compared with a little more than $3 trillion for the U.S. and barely $2 trillion for the euro area.

GSAM is developing a new asset allocation model that combines three elements: consensus earnings estimates as a gauge of growth, valuation metrics such as price-to-book ratios and a ceiling on volatility to protect against market instability. "Growth isn't a guarantee of return," O'Neill says. "But if you combine it with volatility and valuation, it gives you a portfolio with better risk characteristics." The new model, which GSAM expects to begin marketing to clients in the autumn, isn't a panacea. Whatever approach they take, investors need to be more nimble and adjust their weightings to reflect changes in valuations, volatility and managers' views on the markets. "Your benchmark approach has to be more dynamic," says O'Neill.

Perella Weinberg's Arbess takes a different approach to the developed-emerging divide. He regards the distinction between the two as obsolete from a risk perspective. Instead, he contends that investors need to take a credit approach in deciding their asset allocation. "In the new investment framework, balance sheets matter most," he says. "Governments and companies with weak balance sheets should be avoided, and those with strong balance sheets should be bought. Thinking about debtors and creditors instead of emerging and developed leads us to a different understanding of risky and riskless investments."

Russell Investments, a management and advisory firm that runs $163 billion in assets, is discussing with clients ways to take a basket approach to portfolio management, says Cynthia Steer, New York–based head of investment strategy for the Americas. Instead of using U.S. Treasuries as the risk-free benchmark, clients would invest in a basket of securities from as many as ten countries. The consequences of such an approach could be far-reaching. Using a basket instead of the ultraliquid U.S. Treasury market would constrain a manager's ability to trade in and out of positions. Turnover in a fixed-income portfolio might fall to as low as 75 percent a year from an average of about 200 percent currently, she says. "This will change the way bond managers operate," Steer says.

Even as investors continue to diversify globally, some continue to find ways to maintain returns at home. J.P. Morgan's Patterson likes U.S. companies with strong overseas earnings that pay solid dividends. Companies in the S&P 500 index get an average of 30 percent of sales from overseas, giving them good exposure to growth in emerging markets, and their average dividend yield stands at just under 2 percent, rivaling the yield on ten-year Treasuries.

Schroders' Brown notes that U.K. blue chips like retailer Marks & Spencer and supermarket operator J. Sainsbury have strong balance sheets, offer dividend yields of more than 5 percent and have earnings that are at least two times the dividend payout. "I see high-quality, high-yield equities being closer to a risk-free asset than government bonds," says Brown.

Our debt-constrained world may need new investing models, but the ability to identify value is as important as ever. • •