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Featured G

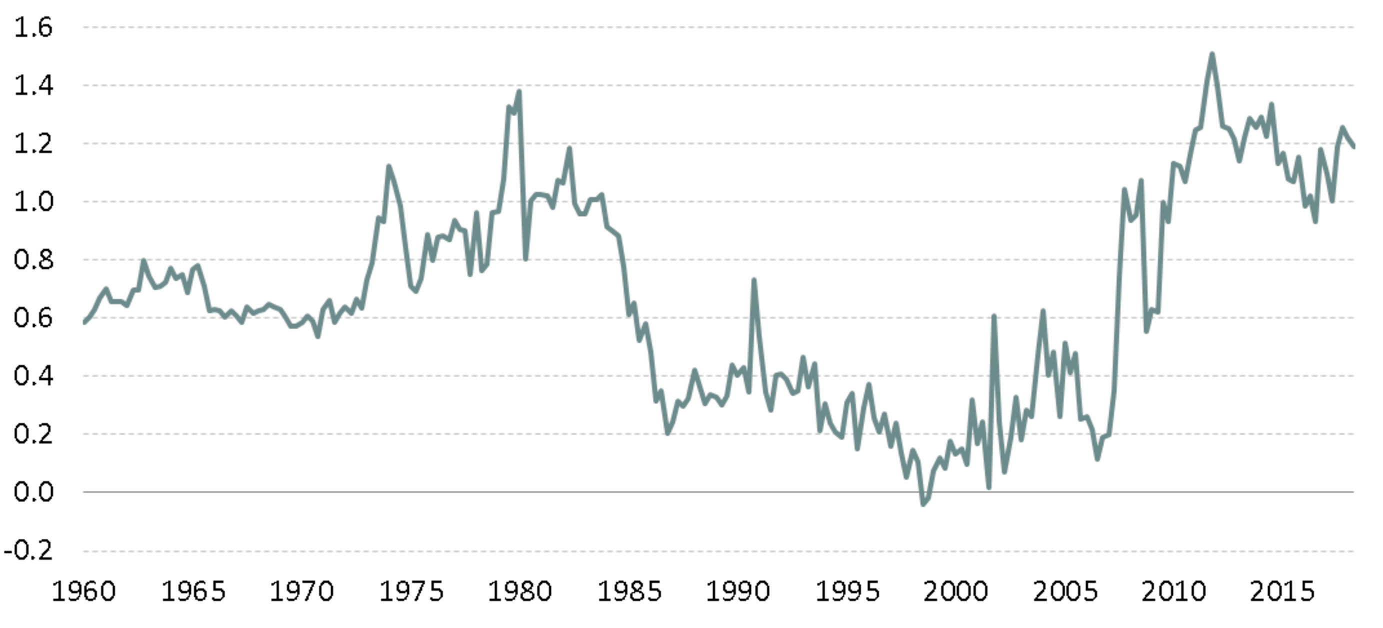
My Coupon, Our Problem

When the Federal Reserve unleashed quantitative easing (QE) on the world, investors responded by searching for yield abroad. Foreign ownership of domestic bonds rose significantly across most major emerging markets. While foreign ownership has leveled off, the world may now be dealing with QE's unintended consequences. As foreign investors clip their coupons, this counts as an outflow within the balance of payments equation that must be offset elsewhere. Even if foreign investors never exit these emerging markets en masse, coupon clipping could serve as a drag on currencies for years to come.

To work our way through this, it helps to start with the United States. The net income line of the current account measures the income received by U.S. residents minus income paid to foreigners. This includes income and price appreciation from equities, bonds, and direct investments. The U.S. runs a net income surplus (Chart 1), meaning the U.S. makes more from its investment than what it pays out to foreign holders. You can see from the chart that this series really took off around 2010 when Americans ramped up their foreign purchases.

Chart 1: U.S. Net Income Balance

% GDP, As of 6/30/2018



Source: Haver Analytics

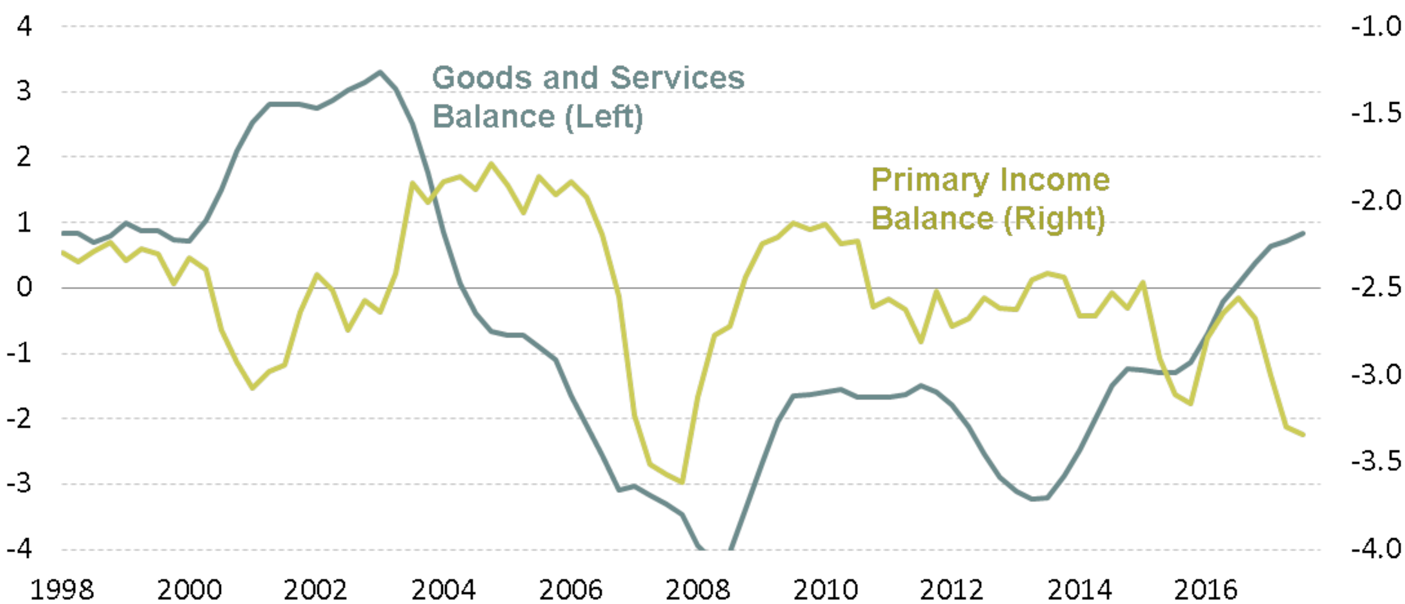
The flip side of every surplus is a deficit elsewhere. In this case, the deficits can be found in many emerging markets (EM). Let's use South Africa as an example. If you look at the goods and services lines in the current account the country is running a surplus, which reflects:

1. The stage of the business cycle,
2. Higher metals prices over the last few years, and
3. A more competitive currency.

If you look at the income balance, the deficit is striking (Chart 2). South Africa has run persistent current account deficits over the last decade and 70% of those deficits have been due to the income component. The income component is a function of several things, but in the case of South Africa it's mostly attributable to foreign holdings of local currency debt. In other words, as U.S. investors clip and repatriate their South African government bond coupon, this translates into a significant demand for hard currency.

Chart 2: South Africa Current Account by Select Components

% GDP, As of 9/30/2018



Source: Haver Analytics

Markets are self-correcting mechanisms and there are a few ways this income imbalance currently present in many emerging markets (EMs) can be corrected over time:

1. Reduced rate differentials between U.S. and EMs,
2. Higher relative asset returns for investors residing in EMs relative to investors residing in U.S.
3. An offsetting improvement in other current account components such as merchandise trade
4. A reduction in foreign holdings of the debt stock
5. A stronger U.S. dollar

We are positioned for mechanisms 1-3 which we expect to occur as a by-product of EMs that run responsible fiscal and monetary policies. Mechanisms 4-5 would correct the income imbalance as well, but likely at the expense of bond holder returns. For the income hurdle to be cleared, EMs need to reengage in the development model that we saw prior to the global financial crisis. One would want to see policy that leads to sustainably lower domestic rates, export competitiveness that takes advantage of cheap currencies, and higher growth performance that in turn boosts asset performance. These policies are self-reinforcing and can each feed off each other, thereby creating a virtuous cycle that resolves the income deficit issue along with other obstacles.

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