The Emerging Market Crisis:
Quantitative Easing Blowback

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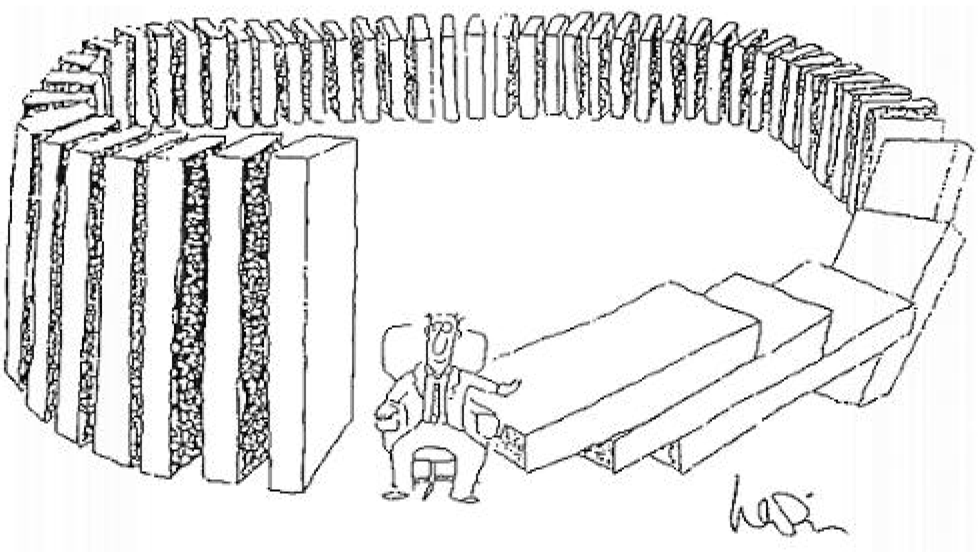

In a 16 January 2014 report I explored the law of adverse consequences, or blowback, in the context of the QE program of the Federal Reserve. Just a few weeks later we have been gifted with a perfect example of how QE creates blowback. This is a situation I must cover.

Walter Zimmermann
United ICAP

The Emerging Market Crisis as Quantitative Easing Blowback

Main Points

1. The tendency of Americans has been to think of QE solely in terms of its effects on America. That is when they think about QE at all. I add this last point because the last few times I was on CNBC I was told to not use the term 'quantitative easing'. Evidently CNBC was afraid that such a big word would confuse their viewing audience. If thinking about the effect of QE on the US economy is too confusing for CNBC viewers then forget about trying to understand its effects on the wider world.
2. The global problem with QE is that the world's leading economy, whose currency also happens to be the world's reserve currency, cannot explode its currency base without producing severe global consequences. The actions of the Fed have global repercussions.
3. There is no diplomatic way to say this - the emerging market crisis is blow-back from quantitative easing.
4. The clear number one goal of the QE program was to reignite inflation and thereby stave off deflation. How does one reignite inflation? Bernanke's theory was that pumping in massive liquidity and thereby weakening the US Dollar would reignite inflation, and at the same time spur a US export led economic recovery.
5. One big problem with this theory is that it presumes a weakening dollar causes inflation, and not visa versa. A second big problem with this theory is it presumed that in the face of rising US exports from a falling dollar the rest of the world would do nothing. It presumed that the rest of the world would take no counter-measures and make no efforts to engage in their own QE programs.
6. A third big problem with the Fed's theory is the situation we take up here. Bernanke's theory presumed that the inflation resulting from the QE program would occur here, within the borders of the USA, and so would be both contained and manageable. The Fed was very wrong.
7. Trillions in fresh, free, new money meant a big time 'risk on.' The search for risk was actually the search for higher returns. And since the onset of QE that search for higher returns has led to the emerging markets. As QE funds poured into EMs their markets soared higher along with their inflation rates. The US had exported its QE inflation.
8. Many outside the Fed knew this would end badly. But what could they do? And end badly it did. At the first hint of tapering a massive exodus from the EMs quickly ensued. The fund outflow from Emerging Markets reached 15 billion in 2013. And the outflow in January 2014 alone was over 12 billion US Dollars.
9. In terms of EM currencies the US Dollar is right back to where it was when Bernanke first announced QE. The DX Index is less than 6% below where it traded when QE1 was announced, and the DX is still headed higher. The unemployment rate in the US remains stubbornly high. The median real household income has fallen and can't get up. Guess four trillion dollars does not buy what it used to.
10. But what about the six billion human beings in the EM world? Where do they do now? Their markets have plunged along with their currencies, and their hopes of avoiding another phase as submerging markets. Many countries have been forced to raise interest rates to avoid an all out collapse - a terrible first step for growing a recovery.

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Emerging Market Crisis as QE Blowback

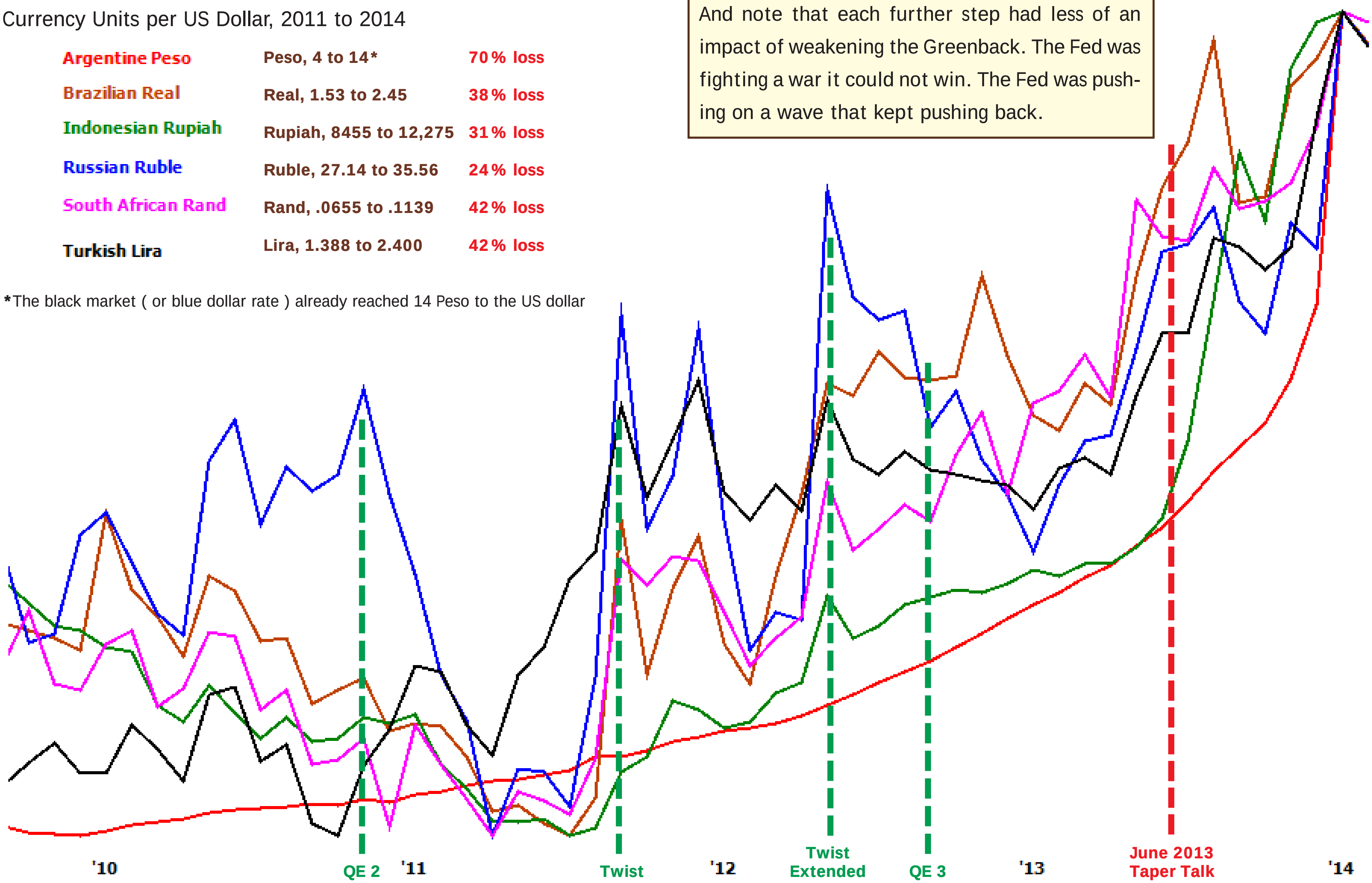
QE Strategy: Keep the US Dollar Weak

Note the timing of each step of QE escalation. And note that each further step had less of an impact of weakening the Greenback. The Fed was fighting a war it could not win. The Fed was pushing on a wave that kept pushing back.

Currency Units per US Dollar, 2011 to 2014

Argentine Peso	Peso, 4 to 14*	70% loss
Brazilian Real	Real, 1.53 to 2.45	38% loss
Indonesian Rupiah	Rupiah, 8455 to 12,275	31% loss
Russian Ruble	Ruble, 27.14 to 35.56	24% loss
South African Rand	Rand, .0655 to .1139	42% loss
Turkish Lira	Lira, 1.388 to 2.400	42% loss

*The black market (or blue dollar rate) already reached 14 Peso to the US dollar



World Markets: Emerging or Submerging - why it matters

Who really cares whether the so called emerging markets are actually emerging from poverty of submerging back into poverty? Why does it matter? Why should we be concerned?

- The first point to make is that the uncontrolled collapse of a nation's currency is never, ever a bullish development.
- The second point is that this issue of emerging versus submerging matters deeply to the 85% of the world's population that lives in what are euphemistically called the emerging markets. We are speaking here of over 6 billion human beings.
- And this issue matters deeply to anyone concerned about the world economy, as the emerging markets contribute almost 75% of global GDP growth. Or at least they used to.
- And this issue matters very much to the Euro-zone. Not exactly a bastion of financial strength to begin with, Euro-zone banks are on the hook for over 3.5 trillion in emerging market loans.
- And this issue matters very much to the Federal Reserve, who have been trying to keep the US Dollar weak so the US can export its way out of its economic doldrums - exports to emerging markets.

Why the recent collapse in EM currency values?

- The Fed cannot create four trillion in new money in the world's reserve currency without consequences, even if almost half of that new money is sitting in private banks as excess reserves.
- Trillions in fresh, free, new money meant 'risk on' big time. The search for risk was really the search for higher returns. And since the onset of QE that search has led to emerging markets. And this meant that the inflation effects of QE were exported to the EMs.
- As QE funds poured into EMs their markets soared. The US had inadvertantly exported its inflation.
- And what happened with the first hint of tapering? A big time tidal wave of 'risk off.' There was a panic exodus from EMs. The fund outflow from Emerging Markets was 15 billion in 2013, and had already reached 12 billion in January 2014 alone.
- This massive evacuation collapsed both EM stock markets and their currencies. In a bid to staunch the bleeding EM countries jacked up interest rates - also a great way to quash any nascent recovery.
- What will the effect be on world trade? How will the Fed engineer an export led recovery now?

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from Walter J. Zimmermann Jr.

walterz@united-icap.com

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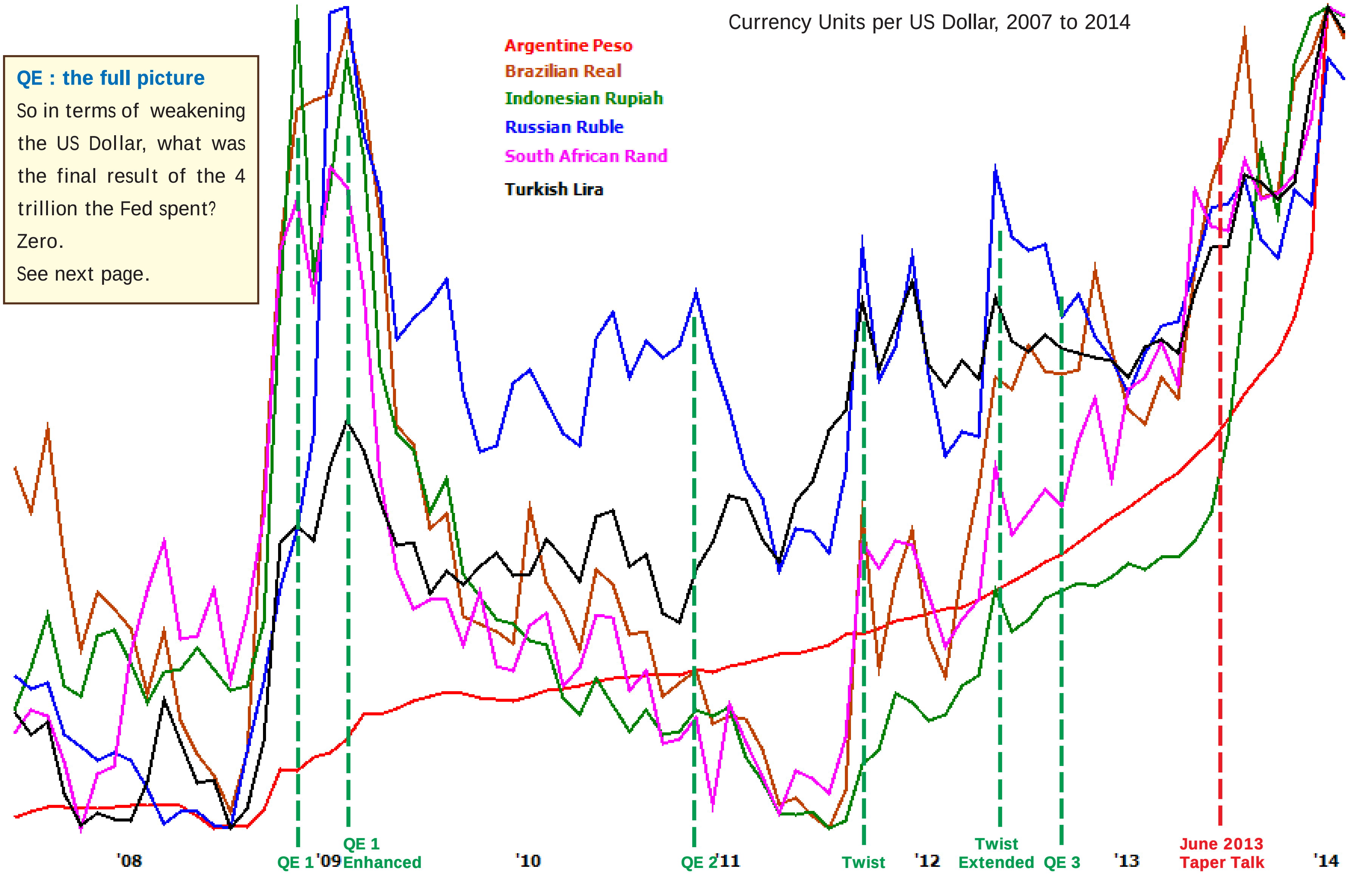
QE : the full picture

So in terms of weakening the US Dollar, what was the final result of the 4 trillion the Fed spent? Zero.

See next page.



Why the Fed failed to weaken the US Dollar

From the chart on the previous page, at first glance one might think that the timing of every new QE was decided by the price action of the Russian Ruble. Every time the US Dollar rose dramatically against the Ruble, we got a new QE escalation. But eventually the QE stopped working against all currencies, even as the US dollar amounts being created continued to rise. So what prevented QE from crushing the Greenback? This was certainly the outcome that everyone expected was certain to occur.

What the world is facing is a debt crisis. And if inflation withers and dies during a debt crisis you get a deflationary depression. Without inflation everyone is under intense pressure to pay down their debts. And because the US Dollar is the world's reserve currency, everyone needs dollars to reduce their debt load. Now stir in the fact that the major money center banks that were recipients of the freshly minted QE funds desperately needed lowly Greenbacks to rebuild their shattered balance sheets.

Half the four trillion dollars of QE is locked up supporting bank balance sheets. The other half went off in search of high enough returns to counterbalance the costs of carrying high debt loads. And because higher returns entailed the higher risks of EMs, an unhappy ending was all but ensured.

Human Nature and Market Analysis

In general, fundamental analysts tend to subscribe to the view that economic activity improves as the function of a sloped straight line, and that deviations from that path are unpredictable acts of deviant behavior. In general, technical analysts are not encumbered with that delusion. When you have studied market price action long enough you come to expect cyclical behavior, not eternal straight line growth.

You come to realize that cyclical behavior arises from the nature of human nature. You eventually realize that, under the pressure of events and circumstances, very bright people are capable of making really stupid decisions. Technical analysis can aid in the forecasting of the timing of those stupid decisions, and the duration and extent of the repercussions of those decisions. How can this be?

Decisions at the top are merely the innocent reflections of the collective mood of a nation. Economics is not the study of supply and demand, but the study of the nature and effects of collective human behavior. One expression of the content of the collective consciousness of a nation are price trends. Another expression are the decisions made at the top. The government is always an innocent reflection of the mood of a nation. That is why it is said that we get the government that we deserve. And that is why technical analysis will always have a significant value.