Manuel Sánchez: The changing tide of financial markets

Remarks by Mr Manuel Sánchez, Deputy Governor of the Bank of Mexico, at the Latin America & Caribbean Government Funds Roundtable, Mexico City, 5 December 2014.

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It is an honor to speak at the close of this government funds roundtable, which has brought so many important international investors together. This seminar has provided us with insightful ideas on the progress made and challenges confronted by the government fund community in protecting and expanding capital.

I would like to organize my comments as follows, speaking first about the trade-offs investors may face as monetary policy normalization in advanced countries evolves. Second, I would like to examine the financial scenario from the point of view of authorities in emerging markets. Finally, I would like to touch briefly on the Mexican economy. As usual, my remarks are entirely my own and do not necessarily reflect the views of the Bank of Mexico or its Governing Board.

Investors amid U.S. monetary normalization

It is hardly an exaggeration to say that today's investment environment is unusually complex. Fund managers must factor in very low interest rates, many sovereign and corporate bond spreads at historically minimum levels relative to U.S. Treasuries, and possibly stretched stock market valuations. Generating continued profits in such a context is by nature difficult and potential upside in both fixed-income and equity markets could be limited.

Muddying the waters, the U.S. Federal Reserve will likely begin to reduce stimulus in the near future. Indeed, as monetary policy normalization in the United States has drawn nearer, volatility in international financial markets has increased.

Uncertainty on the pace of normalization still looms. Given recent forecasts and certain statements made by members of the Federal Open Market Committee, an eventual U.S. rate hike could come earlier than many market participants anticipate. Furthermore, exactly how markets will react to policy news as it arrives cannot be predicted.

In the last few years, most central banks and institutional investors have diversified their portfolios to enhance expected returns or to improve risk-return profiles. Many of them have invested in unconventional currencies or in less liquid and lower-rated fixed-income assets, such as mortgage, corporate, or emerging market bonds, among other types of assets.

Some sovereign wealth funds have pursued more aggressive strategies, engaging in real-sector asset purchases, such as infrastructure, commodities, real estate and equity. The overall results until now have been acceptable. But this could change as the global interest-rate scenario develops.

In this context, difficult investment decisions will need to be made. How to adjust asset allocations to evolving monetary normalization is a key question. Should investors prefer a more risk-off, conservative stance, or hold tight and take a longer view, in which they have to tolerate greater volatility? How can they become more agile in the way they incorporate new information, modify their expectations, and make decisions?

Related to these questions are the investment time horizon and the definition of an optimal portfolio. In general, asset managers attempt to use targeted optimization models based on historical data. But history is not necessarily a good predictor of the future.

A complicating issue is that in periods of stress, asset correlation is greater. Indeed, recently, the assets that appeared likely to offer the benefits of diversification have performed in a way similar to that of other instruments.[1]

These challenges are present in all economies. Long positions in fixed-income assets anywhere in the world are bound to result in losses for investors as yields in advanced economies normalize. Alternative strategies in equity or other real-sector assets could also suffer as financing costs increase worldwide. Finally, currency risk is also likely to rise in many countries.

Emerging economies may face particular difficulty given high weights for their assets in international portfolios. Currently, there is much discussion on whether it makes sense to participate or not in these countries from a risk-return perspective. In general, there are fears that eventual monetary normalization in the United States will affect all emerging economies as an asset class, but some nations are more prepared for the scenario than others, as always.[2]

The situation of emerging economies may become even more complicated in the face of possibly slower recovery in the Eurozone and lower growth in China, which might drag commodity prices down even further. This would be particularly daunting for many commodity-exporting countries.

The challenges for financial authorities in emerging markets

What should monetary and financial authorities in emerging markets do to prepare their economies for a rapidly complicating environment, given likely near-term gradual monetary normalization in advanced nations?

They have at least two complementary policy avenues. One is to pre-emptively make their economies more resilient to shocks by strengthening macroeconomic and financial fundamentals. Possible measures include improving the fiscal position, controlling inflation, and performing the delicate balancing act of bolstering financial regulatory and supervisory frameworks without limiting market development and innovation. Open, liquid, and transparent financial markets are beneficial in this aim. Structural reforms and healthy prospects for economic growth are also important.

A second strategy, which goes hand-in-hand with the first, is to monitor and manage risks in the aim of preserving financial stability. By financial stability, I mean the absence of interruptions and alterations that could impair the financial system's intermediation capacity.[3]

Risks to watch encompass significant overheating of the overall economy or crucial sectors, substantial misalignment of asset prices from long-term trends such as in the property market, excessive risk-taking and increasing corporate or household leverage, and extraordinary credit expansion, especially through nontraditional vehicles, including shadow banking. Timely corrective action at the detection of any systemic problem is essential.

Corrective action opens the debate as to what instruments to use to tackle specific complications. In addition to traditional measures such as fiscal, monetary, and bank

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[1] See, for instance, Scholes, M.S. (2000), "Crisis and Risk Management." *The American Economic Review*, 90(2); and Miyajima, K., et al. (2012), "Emerging market local currency bonds: diversification and stability." *BIS Working Papers* No 391.

[2] See, for example, Arslanalp, S. and T. Tsuda (2014), "Tracking Global Demand for Emerging Market Sovereign Debt." *IMF Working Paper* WP/14/39.

[3] For a discussion of the concept of financial stability, see Tucker, P. (2011), "Macroprudential policy: building financial stability institutions." *Speech given at the 20th Annual Hyman P. Minsky Conference*, April.

regulatory actions, market interference in the wake of the big financial crisis has been invoked under the rubric of macroprudential policies.

Some countries have opted for active FX intervention or direct management of capital flows. Although these measures may have resulted in short-term benefits, especially in emergency situations, their costs in terms of market distortions and disincentives for sustainable long-term flows may be high.

Emerging economies suffering from high inflation, excessive fiscal disequilibria, and large current account deficits were hit by severe volatility at the end of last year and beginning of this year, underscoring the importance of the task of preparing for financial turmoil. In short, authorities should take advantage of the potential of both fortifying fundamentals and managing risks in order to waterproof against financial storms.

The Mexican economy

Mexico's economy has weathered volatility relatively well during the last two years. For example, currency depreciation has been lower than that observed in many other emerging economies. Orderly market conditions have prevailed, with bid-ask spreads remaining tight and operating volumes high.

This strength likely reflects a set of sound economic policies, including moderate and relatively stable public debt ratios, low inflation and a well-capitalized and liquid banking system. Furthermore, Mexico's flexible exchange rate regime has served as a buffer against turbulence, become a mechanism of self-discipline for authorities and market participants, and resulted in less pass-through to inflation. The Mexican peso sees more trade than many advanced-nation currencies, and it is the most traded among those of emerging economies.[4]

Additionally, the local debt market has become attractive to foreign holders, and this is beginning to be the case for foreign issuers as well. Foreign holdings of local-currency government bonds, as a percentage of total domestic public debt outstanding, have run at around 37 percent. This share has remained relatively stable in the wake of brusque market reactions to talk of eventual tapering of Federal Reserve asset purchases last year and so far continues to do so.

A high concentration of these holdings in long tranches of the yield curve provides some basis for believing that many investors see their positions as a long-term bet. In other words, perhaps they are here to stay. However, as we are in unchartered waters, we cannot rule out the possibility of significant downward adjustments in these holdings, amid changing market sentiment or shrinking carry-trade opportunities as U.S. monetary normalization proceeds, among other possible causes.

After a year and a half of weakness, Mexico's economy started to rebound during 2014, notwithstanding some lower growth in the third quarter reflecting, in part, temporary factors. The main impulse has come from consolidation of U.S. economic activity and associated higher demand for Mexican exports.

Domestic spending has also gained some steam, mainly through private investment and, to a lesser extent, from consumption. Consumer confidence has been at somewhat low levels but appears on the mend according to evidence from November data.

The growth outlook is one of gradual improvement. A close economic relationship with the United States is a positive factor for Mexico. Before the U.S. recovery took off, it was a

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[4] See Bank for International Settlements (2013), *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity in 2013*, April.

disadvantage vis-à-vis many commodity-exporting countries, which enjoyed the benefits of high and ascending commodity prices. The tables, however, now appear to have turned.[5]

Monetary policy in the last two years became more accommodative in the context of lower economic growth. Rate cuts from March 2013 to June 2014 totaled 150 basis points, and the policy interest rate is currently at 3 percent.

Since July 2014, annual inflation has surpassed the upper limit of the variability interval around the permanent 3 percent target, due mainly to transitory factors. Pressures from the effect over the year of tax hikes, and from the noncore component of the National Consumer Price Index, especially livestock prices, have made themselves felt.

Inflation is expected to be lower in 2015, on a path of convergence to the permanent target. This development would be extremely timely as it would contribute to increasing the economy's resilience to a possibly more difficult international financial environment. But convergence implies not only achieving but also maintaining the target level.

Upside inflation risks should be carefully monitored. One may come from substantial hikes in minimum wages. Others are a prolonged weaker currency due in part to financial market stress, and renewed pressures from noncore inflation. Analysts' inflation expectations for all periods, although stable, remain above the Bank of Mexico's permanent target.

Concluding remarks

Approaching monetary normalization in advanced countries will make life more complicated for fund managers, especially in light of very low global interest rates, historical minimums for bond spreads, and record highs in many stock markets. Beset by heightened uncertainty, emerging markets will see added challenges. Portfolio weights are already heavy with their assets, a stumbling Eurozone recovery could derail some of them, and lower growth in China could further dent demand for commodities, on which many emerging economies depend as exporters.

Financial authorities need to work hard to underpin macroeconomic fundamentals by focusing on how to strengthen fiscal and monetary policies, as well as regulatory and supervisory frameworks in the financial system. They should also remain fully alert to financial risks and keep stability at the fore of their concerns.

After some fragility, Mexico's economy appears to be on an upturn, pulled by a stronger recovery in the United States, as well as more momentum from domestic demand. The expected approach of inflation to the permanent target is a welcome development, particularly given the need to shield the economy against what could be rocky times ahead in the global marketplace. Especially in light of this possibility, any warning sign in the financial markets that would indicate serious future systemic instability must be heeded in a timely and decisive manner.

[5] Analysts estimate that GDP for Mexico will grow 2.2 percent in 2014, 3.5 percent in 2015 and 4.0 percent in 2016. See Banco de México (2014), *Encuesta sobre las Expectativas de los Especialistas en Economía del Sector Privado: Noviembre de 2014*, December.