Is “Euroglut” the next big problem for the Global Economy?

Cast your mind back to early 2004 when the Fed starting raising interest rates. Then as now the trade de jour was to cut bond portfolio durations in anticipation of rising rates. Fast forward to 2005 and everyone felt like an idiot because long-term rates didn’t budge. This was Greenspan’s ‘conundrum’ that he ruminated about for years to come. And because long-term rates drive mortgage rates, the Fed lost control of housing finance. Low mortgage rates plus serious regulatory fallings helped fuel a housing bubble, and the rest, as they say, is history.

But why didn’t long-term rates move higher in 2004 and 2005? A recent economist piece delved into the topic.

They argue there are three potential reasons:

> 1) Average short-term rates. Investors simply expect rates to stay low over a long period.
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> 2) Inflation expectations. Long-term bond yields might not increase during a rate hike cycle because investors start to price in lower inflation.
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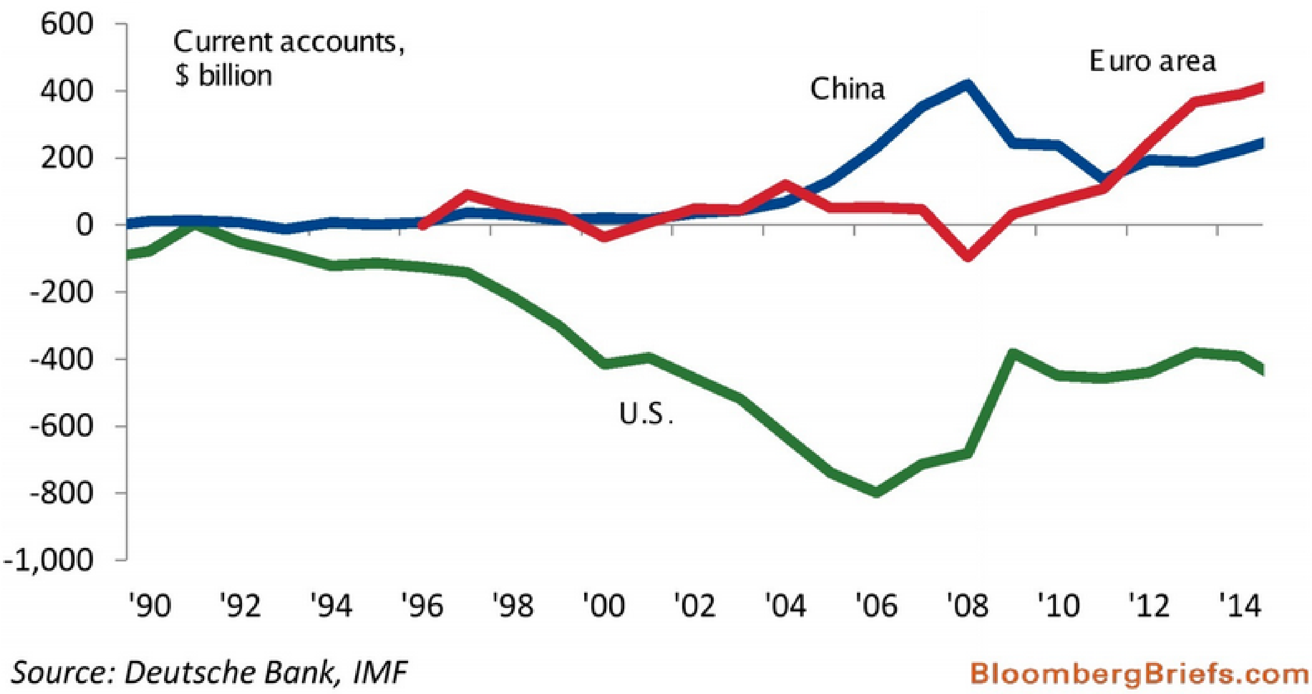
> 3) Falling term premiums. This is the compensation investors typically demand for owning long-term bonds. The Economist notes that term premiums have been in a secular decline, with the premium falling to zero during the Greenspan years. In recent years they have gone negative.

The Global Savings Glut circa 2005

The third factor was a big deal in the 2000's, just as it is today. Central bank QE can push term premiums lower as there is no desire for higher returns from longer duration bonds. Their motives are really not economic. However, another factor is the so called 'global savings glut.' Bernanke coined the term in 2005.

Back in 2004/2005 emerging market central banks (China in particular) were building up huge war chests of dollar reserves. If you look at the chart below showing current account surpluses/deficits for China, Europe, and the U.S., you can see that starting in 2004 China's current account surplus began its inexorable march higher.



Large parts of this surplus flowed into Treasury bonds, this kept a lid on long-term interest rates, unusually low rates pumped credit into the U.S. economy (housing in particular), and what do you know, we saw a huge misallocation of capital because the price of debt was distorted.

From the Savings Glut to the Euroglut

So what is the problem today? Look again at the chart above. Prior to the crisis China and Europe were running a current account surplus of roughly $400 billion. Today the joint surpluses total approximately $600 billion – 50% higher than during the pre-crisis period.

A fascinating report from George Saravelos at Deutsche Bank explores this concept further. To quote his piece:

> "Euroglut is a global imbalances problem. It refers to the lack of European domestic demand caused by the Eurozone crisis. The clearest evidence of Euroglut is Europe's high unemployment rate combined with a record current account surplus. Both are a reflection of the same problem: an excess of savings over investment opportunities. Euroglut is special for one and only reason: it is very, very big. At around 400bn USD each year, Europe's current account surplus is bigger than China's in the 2000s. If sustained, it would be the largest surplus ever generated in the history of global financial markets.
>
> This matters."

He goes on to argue that the core problem in Europe (and Japan) is a lack of domestic demand. Europe cannot export their way out of their problems through a lower currency. After all, do they really need an even larger current account surplus? However, the odds of a massive increase in domestic spending are slim at best. Thus, surpluses are likely to build. Saravelos see's two key implications from this:

> 1) Currency weakness. The euro falls to 95cents by the end of 2017 as excess savings leave the region.
>
> 2) Very flat fixed income curves globally. European's chase yield, and long-term Treasury bonds are high on the list of things worth chasing. After all, 2.3% on the 10-year looks pretty good to German investors whose domestic yields are closing in on 0.7%. Plus you get a currency kicker!!

The Euroglut and Global Distortions

So this brings us to one of my favorite analysts. Michael Pettis is a Beijing-based economic theorist and strategist and one of the best writers on China today. [His October 19th blog post on "How to link Australian iron with Marine le Pen"] is a wonderful read, and he sees the Euroglut idea playing out in one of two ways:

> 1) If excess European savings flow primarily into developing countries with huge investment needs that have remained unfunded largely because of a lack of reasonably-priced domestic savings, and here India and parts of Africa immediately jump to mind, European savings exports will cause global GDP to grow and global unemployment to fall.

> 2) If excess European savings flow primarily into developed countries – the US being the most obvious candidate – or into developing countries with excess investment and savings – China, most obviously, not so much by flowing in as by preventing outflows – it will cause European unemployment to shift abroad to those countries. The net global impact – if there is no immediate response in the form of aggressive trade intervention and a sharp increase in beggar-thy-neighbor policies, of course – will be a potential shutting down of a US recovery, a virtual guarantee that Abenomics will fail (not that there was much hope for success anyway), and a brutal increase in the difficulty of a Chinese economic adjustment.

Powerful stuff.

However, we see a possible third way. Just as in the mid-2000's, if European buying sits on long-term Treasury yields for another few years, we are likely to once again experience a massive misallocation of capital. Where? That's anyone's guess at the moment. Maybe commercial real estate (a chasing yield play), maybe equities in general. Up until the recent break in oil prices you might have made the case for shale oil plays. High-yield credit could see (is seeing?) some crazy valuations that can only lead to long-term pain. But if the Euroglut thesis proves close to being true, Janet Yellen's job is going to get very tricky in the years to come.