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CONTAINMENT OVER CONTAGION

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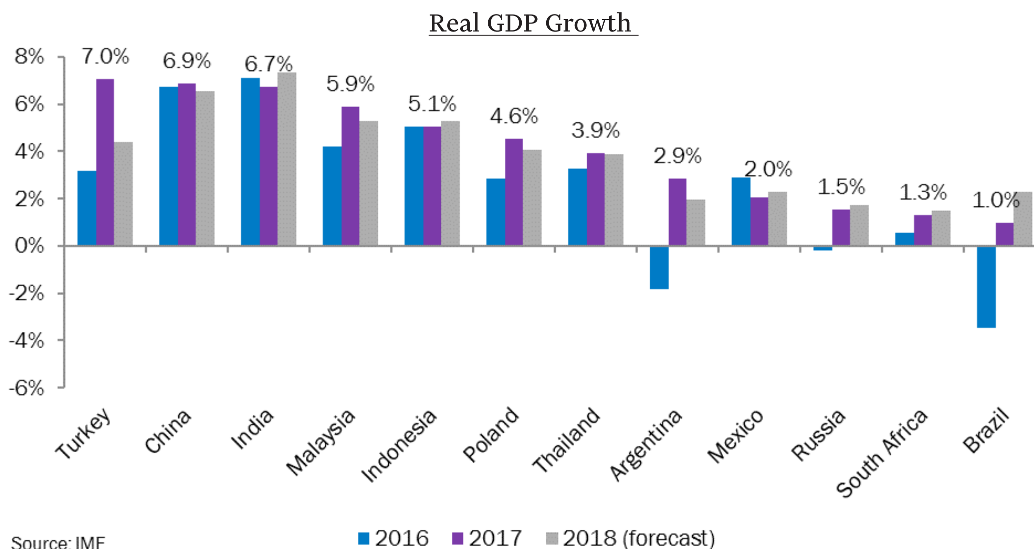
The recent volatility in Emerging Markets (EM) has raised question from investors about the potential for contagion. Recent headlines surrounding the IMF bailout of Argentina and sharp currency sell-off in the Turkish lira bring back memories of the EM crises of the 1990s. In our view the situation is more analogous to the high yield sector in 2015/2016, when cracks in the oil and commodity markets wreaked havoc on energy companies' balance sheets and drove up high-yield spreads. Ultimately, the credit deterioration in the energy sector didn't materially spread to other segments of the high yield market, although the reduction in capital spending led to a profit recession and a sizable market correction of ~15%. The environment looks similar in emerging markets today. The entire EM universe is under pressure from pronounced turmoil in specific countries and the recent strength of the dollar. Ultimately, we think the fundamentals are strong enough to avert a widespread meltdown across emerging markets.

As shown in the chart below, the slowdown in growth looks to be more of a secondary issue than the primary driver of the recent weakness. In Turkey and Argentina, 2017 growth was actually an improvement from the prior year. However, a combination of overheating economies, mismanaged monetary policy, current account deficits, and high short-term dollar debt balances set the conditions for pressure on their currencies and funding costs as global liquidity conditions tightened. In the case of Russia and Brazil, their economies are still recovering from their respective 2015/2016 recessions, with muted growth forecast in 2018. The South African economy contracted in Q1, though the IMF is forecasting a slight rebound in growth for the full year of 2018. Despite those pockets of weakness, other major EM economies such as China, Indonesia, India, Malaysia, Poland, and Thailand, all look to be healthy. The key question is, will the recent pressure from capital outflows and currency depreciation force EM central banks to raise rates materially and potentially act as a headwind for growth?



During periods of abundant liquidity, investors tend to allocate capital into developing markets with the promise of higher returns. Prior boom periods saw not only strong economic growth, but also the rapid accumulation of debt financed by eager foreign investors. A strengthening dollar and tightening Fed served as headwinds for emerging markets, with structural imbalances and shifts in global monetary conditions causing past market crises.

Historically, EM economies were characterized by monetary and fiscal mismanagement and unstable political regimes, forcing EM governments and corporations to finance themselves through short-term dollar debt. Countries that issued dollar denominated debt found themselves in an uncomfortable position as the dollar appreciated, liquidity tightened and capital flows retreated. They were then faced with the dilemma of defending their currency against a wave of capital outflows by raising short-term rates, but at the risk of weakening economic growth by raising the cost of borrowing. The outcome was often severe recessions, continued capital exodus and ultimately, in some cases corporate and sovereign defaults.

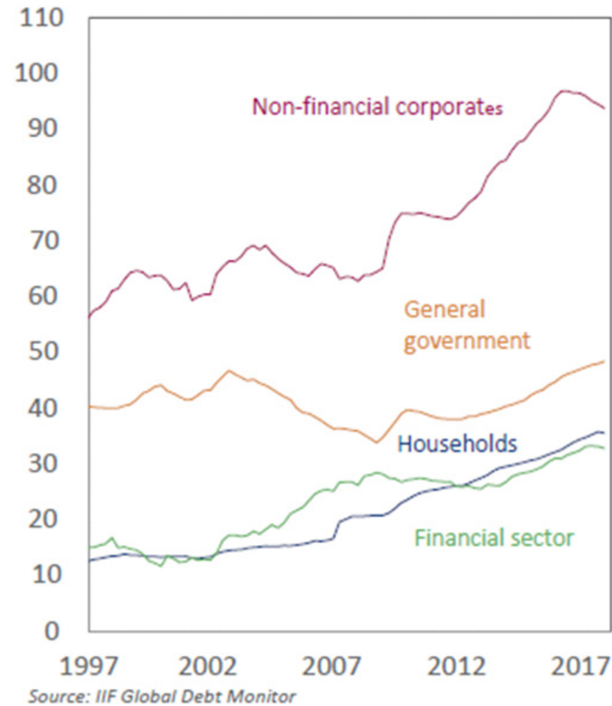
The recent cycle has many of the hallmarks of the prior era as easy monetary conditions in developed markets have fueled credit expansion and allowed debt issuance to outpace GDP growth in many cases. Total EM debt has increased by 50% to $63Tn in the past five years. Two things are different about this levering cycle:

1) China has accounted for the bulk of the debt increase, $17 of the $21Tn increase (81%). Debt levels across other EM economies are below historical thresholds, and based on debt-to-GDP ratios, it can be argued that emerging markets look less risky than developed markets.

2) The deepening of local debt markets has served to reduce the risk from a currency mismatch and thus a run on the banking system/sovereign debt market.

In totality, the credit issues facing EMs are somewhat different than those of the 1990s. Many countries have addressed the structural deficiencies of the past by reducing the reliance on short-term and dollar debt and by building reserve balances. However, this hasn't immunized them from the turning of the credit cycle or a shift in risk preferences from global investors. As we have seen with the sharp depreciation in the Brazilian real, Mexican peso, and South African rand over the past three months, it doesn't take a repeat of the Asian Financial Crisis to produce weakness across the EM spectrum. Due to the dominance of China, both in economic and market terms, any type of tail risk assessment requires a strong view on the direction of the Chinese economy and its ability to avoid a hard landing scenario. We are reminded that the market volatility in 2015 was due in large part to China's devaluation of the yuan and concerns over its ability to effectively manage a slowdown in growth.

Emerging Market Debt by Sector



The typical conditions that have plagued EM countries (currency mismatches, heavy reliance on short-term debt) and led to a series of balance of payment crises don't look to be present outside of Turkey and Argentina. Both countries stand out as economies with high inflation, large current account deficits, and insufficient reserves relative to their external debt balances. It is hard to group any of the other major EM economies in that category, with the possible exception of South Africa. As highlighted below, countries that both run large current account deficits and are net importers of oil are the most likely to face continued increased pressure on their currencies.[i]

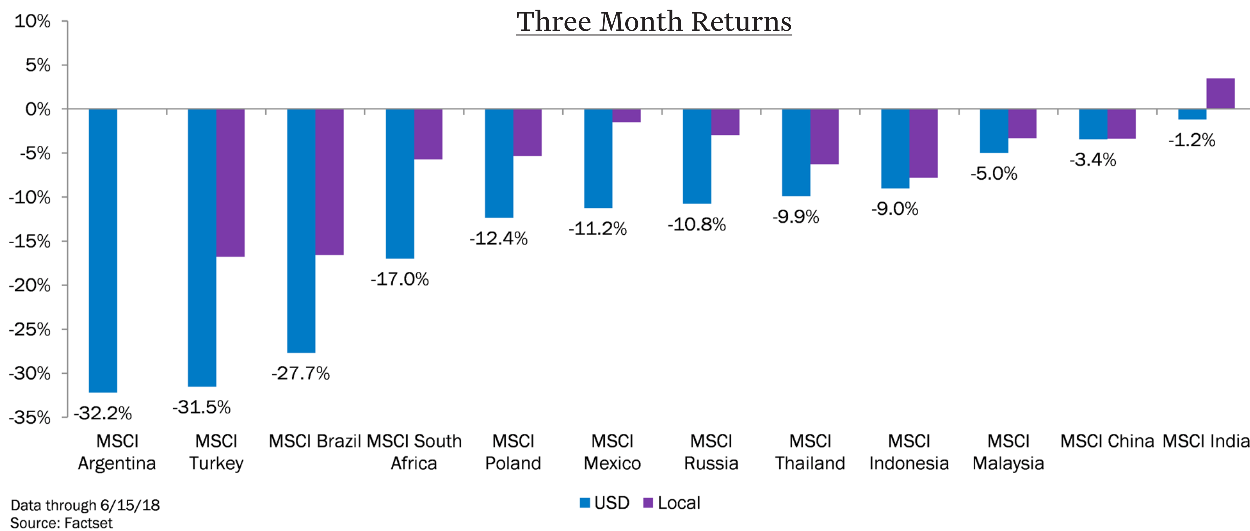
	Inflation (2017)	General government net lending/borrowing as a % of GDP (2017)	Current account balance as a % of GDP (2017)	Short-term debt as a % of total reserves (2016)	External debt stocks as a % of GNI (2016)
Argentina	24.8%	-6.5%	-4.8%	123.2%	35.7%
Brazil	2.9%	-7.8%	-0.5%	15.7%	30.9%
China	1.8%	-4.0%	1.4%	25.9%	12.8%
India	4.7%	-6.9%	-2.0%	23.2%	20.4%
Indonesia	3.6%	-2.5%	-1.7%	36.1%	35.1%
Malaysia	3.5%	-2.9%	3.0%	87.0%	69.6%
Mexico	6.8%	-1.1%	-1.6%	30.3%	40.7%
Poland	2.1%	-1.7%	0.0%	-	-
Russia	2.5%	-1.5%	2.6%	12.0%	42.0%
South Africa	4.7%	-4.5%	-2.3%	63.1%	50.9%
Thailand	0.8%	-0.6%	10.8%	30.7%	31.4%
Turkey	11.9%	-2.3%	-5.5%	92.5%	47.8%

Source: IMF, World Bank

* GNI = Gross National Income

Are EM assets cheap enough to warrant an increase in allocation? In our view, not at this time. Credit spreads (using the Bloomberg Barclays EM USD Aggregate index) have widened by ~78bps from their low in early February but are well below (by ~200bps) the level they reached during the 2015/2016 market selloff. Debt markets have been hit by the dual impact of rising rates and increased risk aversion. Unlike the 2015/2016 sell-off, EM debt is underperforming EM equities YTD. The current macro environment appears similar to the 2013 Taper Tantrum, when rising US rates pressured EM currencies.

On the equity side, the overall index (MSCI EM) is only down 3% YTD. Looking under the hood, a number of individual country equity markets have been pummeled in the past 3 months, particularly in dollar terms.



The good news is on the whole, emerging markets stocks look cheap (11.1x forward earnings vs. 15.9x on the S&P 500). Cheap valuations (relative to the US) reflect heightened risk aversion, concerns over the political conditions/fiscal monetary policies and the impact of any prolonged trade wars. In the short-term, political conditions like those in Brazil (elections scheduled for October), and Mexico (Presidential election on July 1st), the strength of the dollar, and changes to investor risk appetites are more likely to determine the direction of EM equities than valuations.

We think the shallowness of the current correction doesn't represent the buying opportunity that allocating to EM equities did in February 2016 (when EM equities decreased 30% peak to trough then). While we don't foresee contagion, we see enough short-term headwinds to maintain our current allocations to Emerging Markets and remain ready to act in the case of further non-fundamentally driven sell-offs.

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i For an in-depth analysis of relationship see the analysis from the Council on Foreign Relations, "Emerging Markets Under Pressure" by Brad Sester, https://www.cfr.org/blog/emerging-markets-under-pressure

Investment Publications Group: Ben Pace, Karim Ahamed, Patrick Murray and Tom Cohn

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