PERSPECTIVES

November 2014

# Not all emerging markets are created equal: The case for Asia

**Change is in the air for the world's emerging markets. The surge of liquidity that flowed in when the Federal Reserve began its quantitative easing programme in 2008 has begun to reverse. Oil prices have plummeted, potentially leaving commodity-driven emerging markets with huge holes in their budgets. Meanwhile, a stronger dollar is sending shivers down the spines of some investors, especially in Asia, who recall the effect this had on the build up to the Asian Financial Crisis of 1997.**

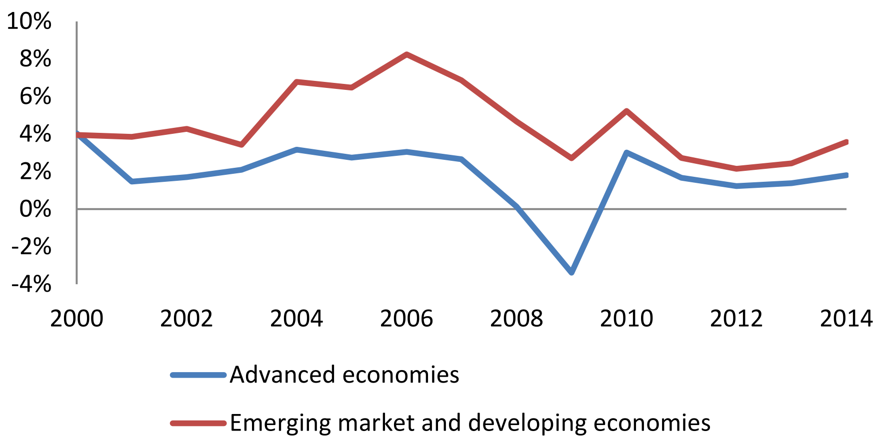
**In this Perspective, we argue that not all emerging markets are created equal. Whilst these issues will have a negative impact on a number of developing economies, in Asia today the stage is set very differently.**

Since the 1980s, the term "emerging markets" has been used as a convenient catch-all for those countries transitioning from developing to developed economies. Indeed, for much of that time these markets have appeared to move in tandem, with commodity exporters benefitting from growing demand and prices, and capital flows typically moving from the developed to much of the developing world in the search for higher returns (a dynamic that became exaggerated under the US quantitative easing programme).

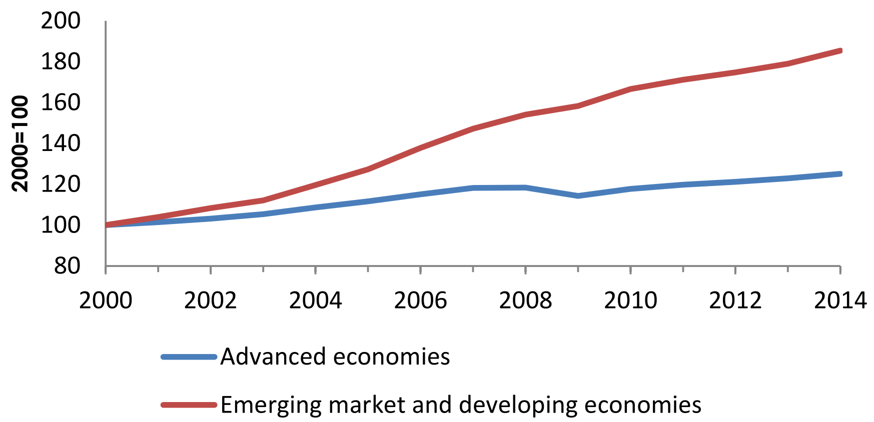
### AT A GLANCE

- A resurgent dollar, the end of US QE and falling oil prices are all impacting global emerging markets.
- But we can no longer view emerging markets as one homogenous group; they have each matured differently and each will be impacted individually.
- In Asia in particular, the stage is set very differently, with strong reform agendas, improved fiscal conditions and stronger current accounts.
- Asia's emerging markets may be best-placed to weather these structural changes.

**Real GDP Growth (YoY)**




**GDP Divergence Since 2000**



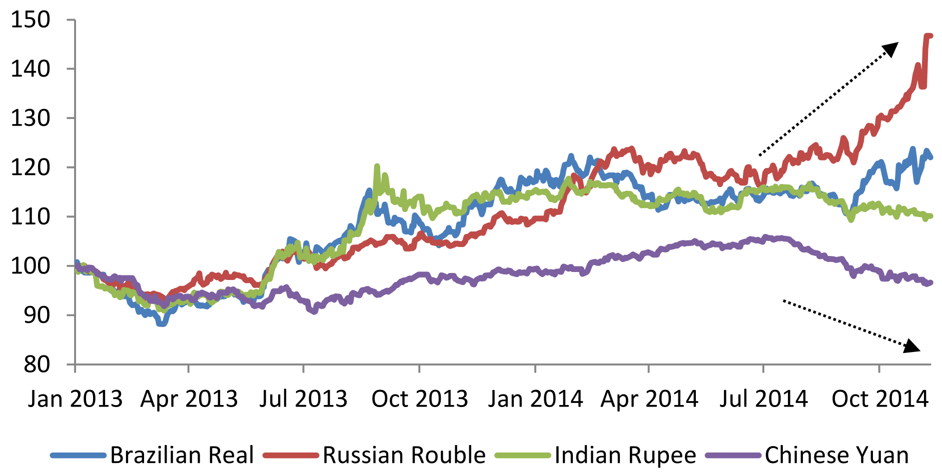

Source: Oxford Economics

**"Not all emerging markets are equal, and whilst a stronger dollar and weaker commodity prices do create headwinds in some markets, the reform agenda in Asia has been crucial. Politically, the structural reform impetus created by slowing growth in China and the reform-minded new administrations in India and Indonesia have seen the region make real progress."**

Timothy Orchard, Head of Equities, Asia ex-Japan

During that time however, as each market has matured, it has become harder to bundle them all into an homogenous “emerging markets” group. From an investment perspective, recent changes in developed markets and the individual characteristics of each emerging market will increasingly force investors to become more selective and alert to the idiosyncrasies of each economy. In Asia in particular, strong reform agendas, improved fiscal conditions and the fundamental transitions taking place in its biggest countries could help its emerging economies outperform others in the coming year.

**BRIC Currency Divergence (versus GBP)**




Source: Datastream

### THE BUCK IS BACK …

The recent relatively strong economic performance of the US economy has been reflected in the rise of the dollar, which has risen 6.3% on a trade-weighted basis over the past three months[1]. In the past, periods of sustained dollar strength have gone hand-in-hand with crises in Asian emerging markets. In the build up to the Asian Financial Crisis of 1997, the absence of decent local currency bond markets forced governments and companies to borrow from foreign banks in dollars. As the crisis bit, the dollar strengthened and the debt rapidly became untenable.

### … BUT THIS TIME IT’S DIFFERENT

In contrast to 1997, the situation in Asia today is very different. Asian emerging markets have largely weaned themselves off much of their dollar-denominated debt, with local markets maturing into a primary funding tool[2]. Many markets also have substantially more foreign currency reserves.

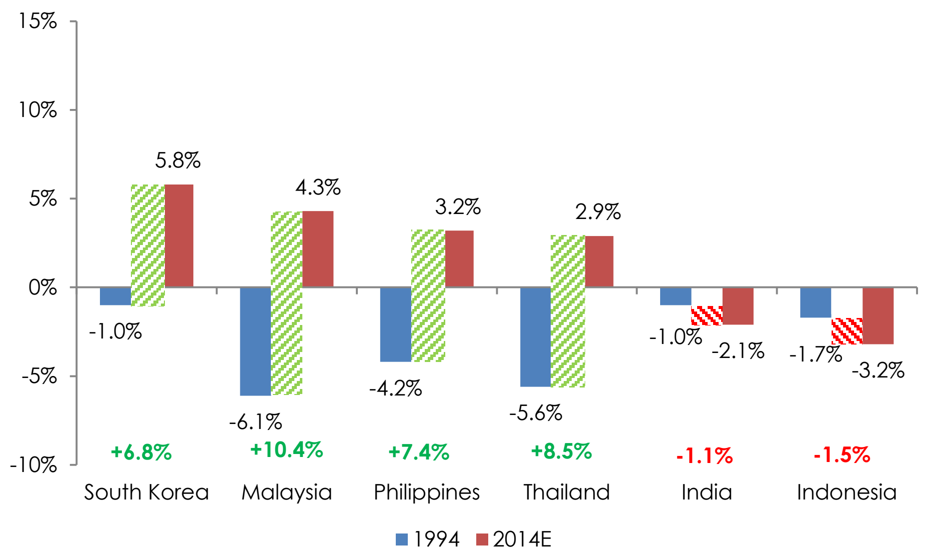
Overall, the developing world’s local currency bond markets have grown to around USD9.3 trillion[3]. The importance of this was highlighted when the 2008 crisis hit and these markets were able to borrow locally when international finance channels came to an abrupt halt. South Korea stands out as a country that now has a far bigger local debt market than in the lead up to the 1997 crisis.

Looking at the current account balances in the region, China, Malaysia, Thailand, South Korea, the Philippines and Taiwan are now all comfortably positive.

**“A strong US dollar and its corollary, weak commodity prices, may well be negative for commodity-exporting emerging markets with a weak reform agenda, such as Russia, Brazil and South Africa. But it will not necessarily be negative for commodity-importing countries with a strong reform agenda, such as China and India.”**

Matthew Sutherland, Head of Product Management, Asia

## In a better place: current account balances 1994 and 2014E




Source: Thomson Reuters, Credit Suisse Research, February 2014

The deficits seen in Indonesia and India are still there, but as we shall discuss later, factors including the lower price of oil and the possible reduction of the huge fuel subsidies in those countries could help to turn their numbers positive.

Along with stronger current accounts and the relative weakness of Asian currencies (with more Asian economies now having floating exchange rates), Asian exports have become cheaper.

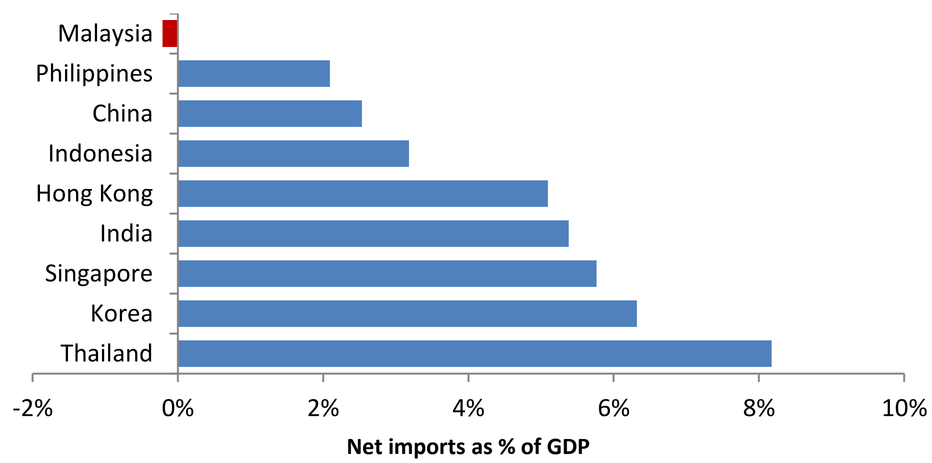
An improving US economy and stronger dollar will invariably lead to lower commodity prices and in particular, oil. It is in this space that the differences between Asian emerging markets and some of their western counterparts become most apparent.

### OIL: TIME TO DROP THE BRIC?

A combination of increased supply and decreased demand has led to a sharp drop in oil prices, with the decline since July being most stark: US WTI Crude has fallen to around US$78 (a 25% drop) with Brent Crude falling from US$115 in June to below US$82 in mid-November (more than a 28% decline).

The simple premise that lower prices are bad for producers and good for consumers holds well for oil. Asian economies, who with the exception of Malaysia are net importers of oil, stand to benefit. Four of the world's top five net oil importers are in Asia: China, Japan, India and South Korea.

## Asia is a net-importer of oil




Source: Macquarie, October 14th 2014

China, who after the US is the world's second-largest net importer of oil, stands to benefit considerably. Every US$1 drop in the price of oil saves China an annual US$2.1 billion[4]. Therefore, if the recent fall is sustained, US$60 billion (3%) could be taken off China's import bill. Despite slowing economic growth, latest data shows crude imports to China in September rose 7.8% compared to the same period last year, to 6.74 million barrels a day, the largest volume ever recorded for that time of year[5].

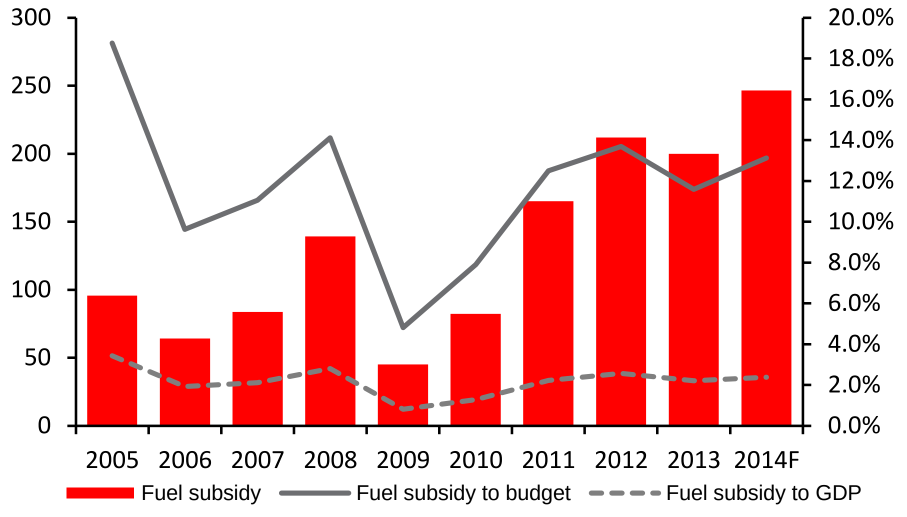
In India, cheaper oil could lead to a reduction in its budget deficit, which is now at 4.5% of GDP, by reducing fuel and fertiliser subsidies[6]. These subsidies make up around 14% of public spending, or around US$41 billion, and the Indian government already scrapped diesel subsidies last month. As a major agricultural economy, reduced fertiliser prices and subsidies will also stand the country in good stead. For Indian consumers, for whom energy makes up a large part of the cost of living, lower fuel costs are in effect a tax cut, leaving them with more money to save or spend elsewhere in the economy.

Likewise in Indonesia, its huge fuel subsidies (around a fifth of its budget) could be cut on the back of cheaper import costs. Cutting the fuel subsidy would give more fiscal room for the government to spend on infrastructure and rejuvenate the economy.

**"In India, much needed reform and cutting of bureaucracy looks set to gather pace and this will lay the foundations for high quality infrastructure spending and renewal of consumption. Now that diesel prices are subsidy-free, this frees up government spending into more productive infrastructure projects. The low oil price is good for consumption and helps reduce the current account deficit."**

Teera Chanpongsang, Portfolio Manager, FF Emerging Asia Fund

**Indonesia's fuel subsidies are unsustainable**




Source: Ministry of Finance, Indonesia, CIMB, September 2014

Elsewhere in Asia, a 10% decline in oil prices would have the biggest net impact on Thailand's current account balance (increasing it by 0.9percentage points relative to GDP) followed by Taiwan (0.8ppts), and Korea (0.6ppts)[7].

In contrast to Asian markets, governments of emerging markets that are net exporters of oil could face declining revenues, which could trigger sovereign credit events for those that are already running sizeable budget deficits – Venezuela, Brazil and potentially Russia are three such countries.

## THE END OF EASY MONEY

In May last year, the Fed hinted that it would begin to taper its purchasing programme, sending out a shockwave and outflow of capital from emerging markets. This "taper tantrum" highlighted how dependent foreign flows into emerging markets were on US monetary policy.

Compared to last year, the Fed's announcement in October that it would end its asset buying programme did not come as a surprise. It was also accompanied by clear guidance from Fed Chairwoman Janet Yellen, that any subsequent rise in interest rates would be entirely data driven – in other words, only when the Fed truly believed that the US economy had reached a sustainable escape velocity would they raise rates.

It is important to also note that the liquidity taps have not all been turned off. Major central banks including the ECB and Bank of Japan continue to keep their taps firmly switched on. This is conducive to further asset price inflation globally. The more liquidity there is, the more likely it is that riskier assets such as emerging market equities will outperform.

Whilst the end of US QE and the possibility of rising US interest rates in 2015 could create bumps in the road for Asia, its largest emerging markets could be resilient to these headwinds while reaping the benefits of their own strong domestic reform agendas.

## REFORM RULES

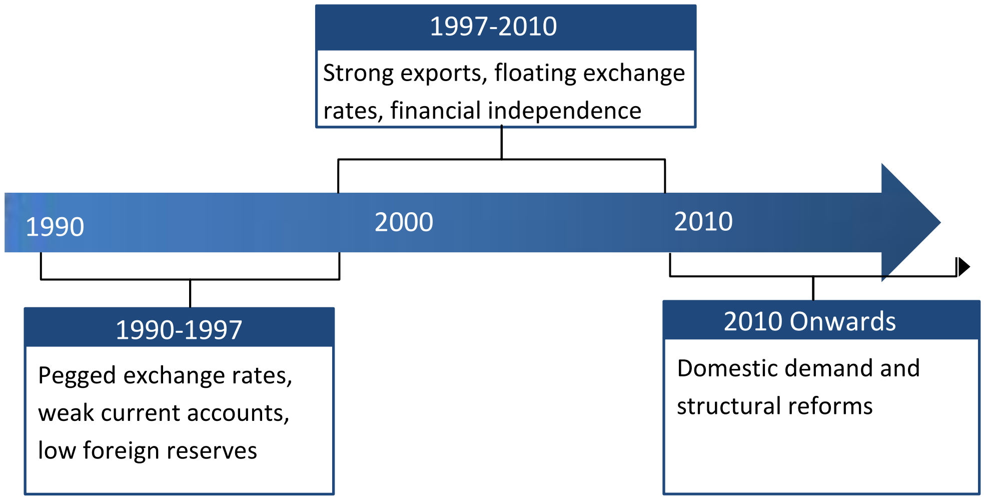
For the past decade, investors have primarily looked at emerging Asia as an engine of growth. Today, the focus is firmly on reform. Those countries that have lacked the necessary structural reforms over the past decade or more could suffer in the current climate, whilst those that are reforming could be rerated by investors.

Across Asia, economies have moved from the pre-1997 crisis Washington consensus period of artificially pegged exchange rates, weak current accounts and low foreign reserves, through to an export period between 2000 and 2010 where economies became financially independent, exchange rates floated and exports were strong. Now these economies are shifting from the export driven model to a more domestic demand driven model.

**"Although Asia has slowed down in line with the rest of the world from the levels seen before the financial crisis, the region's domestic fundamentals and structural growth story remains intact and it should continue to be one of the fastest growing in the world."**

Allan Liu, Portfolio Manager, FF South East Asia Fund

**Asia now focused on domestic demand and reform**




Source: FIL Limited

China, India and Indonesia, three of the top four most populous countries in the world, stand out as countries who have committed strongly to reform. In China, the focus on quality of growth rather than quantity of growth, along with its ongoing judicial and SOE reform, are key to its successful transition to a consumer-led economy.

New leaders in India and Indonesia are expected to be market friendly and reform led. Coupled with the fall in oil prices, strong domestic consumption growth and a growing middle class, these countries could be well-positioned to mitigate much of the forces that are buffeting emerging markets globally at present. This is in direct contrast to markets such as Brazil and Russia, which have ultimately lacked the willingness to undertake necessary structural reforms seen in Asia over the past decade.

## CONCLUSION

Whilst it has been convenient to group developing economies under the catch all "emerging markets" label, changes in developed markets and divergent policies in individual emerging markets make it essential for investors to be more selective.

A rising dollar, the end of US QE and falling oil prices will certainly cause headwinds for the coming year, but those emerging markets that are net importers of oil, which have implemented strong reform agendas and that have improved fiscal conditions, could have a smoother ride that is increasingly recognised by more discriminating investors.

## References

[1] Bloomberg, November 2013
[2] Macquarie, October 22, 2014
[3] G20 report, *2nd Annual Note on Recent Developments in Local Currency Bond Markets (LCBMs),* August 2014
[4] *Cheaper oil: Winners and losers,* The Economist (October 2014)
[5] *China scores cheap oil 14,000 miles away as glut deepens,* Bloomberg (October 2014)
[6] Trading Economics (www.tradingeconomics.com) (November 2014)
[7] *Asia Macro and Strategy Outlook*, Citi Research (October 2014)
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