How vulnerable are emerging markets? An expert discussion

Craig Botham, Emerging Markets Economist
James Barrineau, Co-Head of Emerging Markets Debt Relative
Allan Conway, Head of Emerging Market Equities
Guillermo Besaccia, Fund Manager, Emerging Market Debt
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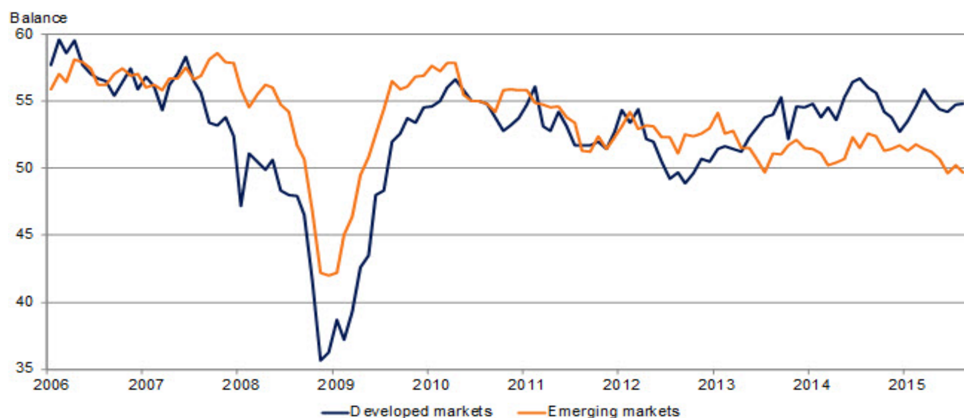
At the recent Schroders Webconference hosted by Craig Botham, Emerging Market Economist, three emerging market investors with different perspectives discussed the outlook for the region.

Craig Botham began by outlining the key issues facing emerging markets (EMs). He noted that the once strong relationship between EM and developed market (DM) growth had in recent years started to show signs of de-coupling, as illustrated by a divergence in EM and DM Purchasing Managers Index (PMI) surveys (see Chart 1).

He suggested that this is partly explained by stagnation in global trade volumes. Furthermore, he said: "this weaker growth outlook for EMs unfortunately coincides with some gathering global headwinds in the form of the potential US Federal Reserve (Fed) rate hike, slowing growth in China, weaker commodity prices and a set of domestic EM political issues."

Chart 1: DM versus EM PMI survey readings



Source: Thomson Datastream, Schroders Economic Group, Sept 2015

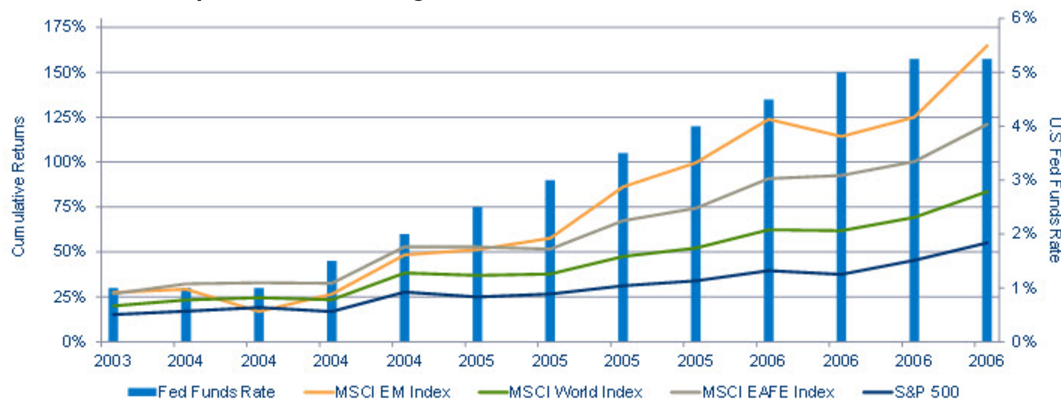
Does the Fed's "failure to launch" mean investors should re-enter emerging market assets?

Allan Conway noted the negative equity market reaction following the Fed's decision to leave rates unchanged. "The thing that markets absolutely hate is uncertainty and that's what we've got at the moment".

However, he explained that historically, equity markets have actually performed well in the early stages of interest rate hikes (see Chart 2). "This is usually because there is some growth in the economy coming through and earnings growth is doing well, which overrides the early interest rate rises".

Allan discussed the signs which would likely support performance in EM economies. Specifically, he pointed to the "extraordinary appreciation" in the US dollar in the last few years. Whilst rate hikes might ordinarily be expected to spur further strength in the currency, Allan made the point that the US dollar is, from its own historic perspective, almost as expensive as it has ever been. He did not believe dollar weakness is a necessary requirement but argued that "for EMs to look more attractive you are going to need some comfort that the dollar has at least peaked. Given where we are now, there is reason to believe that is possible."

Chart 2: Indices' performance during Federal Funds rate rise



Source: IntersecResearch, Investment Metrics, as at September 2015. Past performance is not a guide to future performance and may not be repeated.

Looking from an emerging market debt perspective, James Barrineau interpreted the recent market reaction as in part attributable to Fed messaging, given that the central bank has been "promising to hike rates for at least nine months". He suggested the fact rates remain unchanged has perhaps led markets to conclude that there must be something wrong with US and global growth.

James concurred with Allan Conway regarding the "sky-rocket" in the trade-weighted US dollar. If this becomes a factor in terms of the Fed tightening decision, then he believes there are implications for the hiking cycle, given the dampening effect this would likely have on US growth. As a result he looks at this in the context of "have we put a chink in the armour of the strong dollar story?" For EM currencies to at least stabilise, James believes we need to see some amelioration in the Fed hiking cycle.

Emerging market debt specialist Guillermo Besaccia contrasted the structural positioning of EMs today relative to 2008, when they were able to respond to the global DM crisis from a stronger footing. He noted their more limited ability today to conduct counter-cyclical measures . In particular he flagged how several large EM economies had been tested in recent years, one after another; initially India, then Russia and more recently China and Brazil. As a consequence these markets have suffered somewhat. Guillermo believes it is "the countries which have had less structural improvement, and consequently have not benefited from lower or declining yields, such as Brazil, that are under the most pressure".

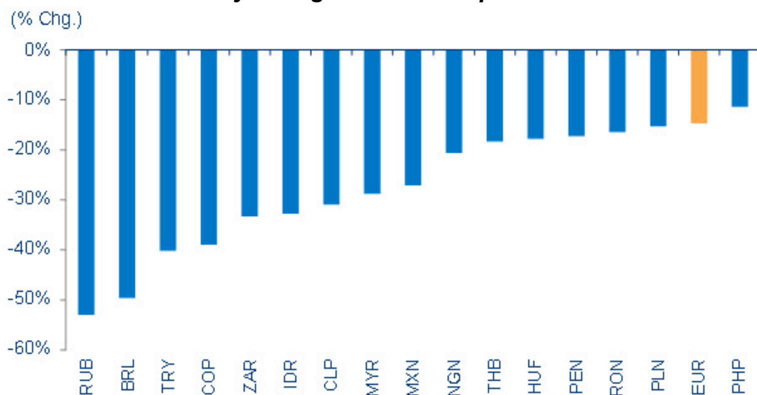
What are the implications of the collapse in commodity prices?

James Barrineau indicated that stability in commodity prices ought to be supportive of EMs. However, significant oversupply in a lot of commodities, a long supply response and slow global growth mean commodity prices will, in his view, take time to stabilise. He cited the most prominent implication for EMs was the currency response, considering there were several EMs which had soaring foreign exchange rates on the back of the super-cycle earlier this decade. Chart 3 highlights this point with the Russian rouble and Brazilian real both recording sharp declines relative to the US dollar.

"It is all wrapped up in a large adjustment response, but the thing is these currencies tend to overshoot and in some countries this appears to be happening to a level which is more significant than the drop in commodity prices," he said.

In response to Craig Botham's point about why commodity importer countries have not benefited from the situation, James highlighted a "feedback mechanism" whereby large commodity exporters, which had been importers of manufactured goods, have slowed their imports as their currencies adjusted to the commodity cycle. The result is that commodity importer countries have been unable to grow their own external accounts, the impact of which has been exacerbated by weaker global growth.

Chart 3: EM currency changes since 30 April 2013



Source: Schroders, as at 21 September 2015

Guillermo Besaccia talked about the impact from a decade of expansion in many EM credit cycles. Similar to the de-leveraging process which has taken place in DMs, he sees a correction phase at play in some EMs and views this as an additional drag on these economies. Guillermo took the view that investors should "focus on the big player in the house, China, given that it is the consumer of over 50% of global supply in some commodities. We need to figure out how far along the adjustment path China is".

Allan Conway emphasised that today "more EM countries benefit from commodity weakness than suffer from it". He highlighted that the structure of EMs (and the MSCI EM index) has changed and it is no longer necessary for commodity prices to be rising for EM equities to perform, as perhaps it was 25 to 30 years ago. Indeed he referenced weaker global demand as the reason why countries such as India, China, Korea and Taiwan, net beneficiaries of lower commodity prices, have not performed better. Allan indicated that an improvement in the global growth environment, in which the exporters of manufactured goods can perform, would be another positive sign for EM equities.

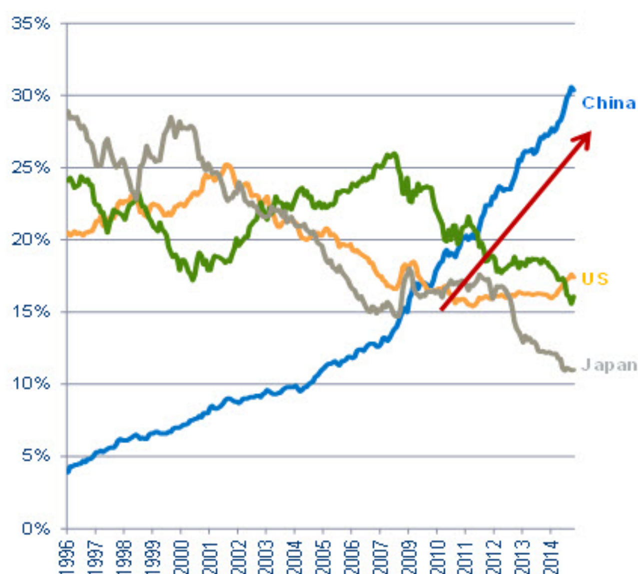
Is China's slowdown going to spread across emerging markets? What are you hoping for as a policy response?

Guillermo Besaccia discussed the shifts in the Chinese economy since 2008, highlighting the political changes, and what he regards as a backward step to more inward facing, conservative interventionist policies.

"Since then we have actually seen just about every type of liquidity bubble possible created, and then corrected afterwards," he said.

He believes China needs to go though an adjustment process to rebalance its economy. Since China has been the provider of around 30% of global liquidity (see chart 4), this adjustment is also likely to have an impact on the global economy as well as domestic China. Turning to policy responses, Guillermo suggested that depreciation of the currency may be part of the solution, as well as a reversal of the excessive expansion in credit.

Chart 4: Key contributors to global money supply M2 1996-205



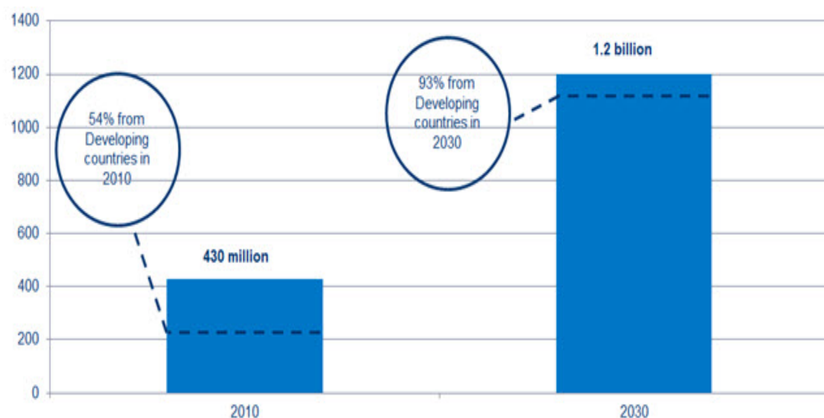
Source: Schroders, 30 June 2015

James Barrineau focused on the need to take a balanced view on China. He believes there will "be a long adjustment process but unlikely a hard landing", emphasising the authorities' range of policy tools still available. From a policy perspective he does not believe major stimulus offers a sustainable resolution, but is encouraged by rationalisation of provincial and local government debt. He also cited positive developments happening away from the headlines, for example property companies accessing local currency borrowing at lower rates than those offered in US dollar markets, thus mitigating default risk. He believes the currency needs to be more flexible and that depreciation appears to be at an early stage, but takes the view that the authorities are addressing these issues and "there are some glimmers that the economy is actually starting to improve."

Responding to Craig Botham's question on the recent changes to China's currency fixing, which spurred an initial 2% depreciation in the renminbi, Allan Conway concurred with the rest of the panel that further depreciation in time is likely. However, he noted that since the policy change the authorities had ensured further depreciation did not occur, and so recent a recent bounce back is deceptive.

With regards the equity market, Allan emphasised that despite a lot of bearishness, the MSCI China has outperformed the MSCI EM year-to-date and remains attractively valued at around a 20% discount to the MSCI EM on a price-to-earnings basis. He drew attention to the changing structure of the Chinese economy, with more growth now coming from services than manufacturing or construction. This, he signalled, was a reminder of the very strong underlying domestic demand story, not just in China but also in wider EMs. Allan illustrated this (see Chart 5), indicating that between 2010-2030 the global middle class (whose disposable incomes can drive consumption) is forecast to more than treble. He indicated that in 2010 half of this population category were in the developed world, but by 2030 the majority are expected to live in the emerging world. "That is a massive source of domestic demand in the global economy, and a good chunk of that is in China and the other part of that is in India".

Chart 5: Estimate of middle class growth



Source: World Bank. "Global middle class defined as individuals earning an income falling between capita income of Brazil and Italy. Data as of January 2015.

What are your main concerns and positives regarding the outlook for EM?

Allan Conway highlighted the significant bearishness in EMs as a positive, indicating it would be “almost impossible today to give you a bear argument in EM which is not already out there”. This was underscored by record net capital outflows from EM equities this year, which now exceed the previous record in 2008. Allan also emphasised that the long-term underlying strategic case for EMs lies in the domestic demand story, supported by a strong valuation case. His main concern is the US dollar, which if it continues to strengthen could be a major headwind.

James Barrineau cited getting through the Fed interest rate conundrum and the path to a stable US dollar which he believes would allow EM currencies to stabilise. From a growth perspective, he believes that some of the large countries in EM, such as Brazil and Russia, still face challenges but that there remain many other economies which are in reasonably good shape such as Peru and Chile in Latin America, and Poland and Hungary in Eastern Europe.

Guillermo Besaccia pointed to China as the key concern and specifically the degree to which rebalancing and adjustment of the economy takes place. That will be important in finding the bottom in commodity prices which can support stability in EMs and provide comfort to invest in currencies and EM local debt, an area which he believes could bring some interesting opportunities.

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