Schroders

Emerging markets:

road map to recovery

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Keith Wade
Chief Economist

Craig Botham
Emerging Markets Economist

One of the key investor questions for 2014 is whether to increase exposure to emerging markets. In this article Keith Wade, Chief Economist, and Craig Botham, Emerging Markets Economist, look at some of the key indicators that will drive asset allocation toward the region and which economies are best placed to make the adjustment toward economic recovery.

Executive summary

- Having withstood the initial impact of the Global Financial Crisis, emerging markets have struggled to maintain robust growth and when combined with the prospect of tighter monetary policy in the US, the region has experienced significant capital outflows since 2012.
- As a consequence, emerging market equities have underperformed their developed market counterparts by some 30% since October 2010. Valuations are now considerably more attractive, with the discount on emerging equities widening significantly as global fund managers have moved underweight.
- In looking for a trigger for this performance to reverse, we would identify three macro factors. First would be a recovery in emerging market growth, which has decoupled from the recovery in the developed world. Second would be evidence that China is successfully de-leveraging its financial sector, such that fears of a collapse in growth diminish. Third would be evidence that those countries with current account deficits, who have been in the eye of the emerging market storm, are successfully turning their deficits around and can re-embark on a stronger growth path.
- In focusing on the third factor we assess which of the emerging economies are best placed to adjust, drawing on evidence from the recent euro crisis where economies have experienced a sudden stop in capital flows.
- We look at a number of factors we deem important for adjustment, based on the empirical and theoretical evidence. Adjustment seems likely to be most rapid in open economies who are exporting to fast growing partners and undergoing deleveraging, undertaking unit labour cost adjustment and improving their competitiveness. Currency flexibility is also important. It is important though to note that rapid current account adjustment is not purely positive, and could entail significant economic pain.
- Of course it is easy to generalise but in reality, idiosyncratic issues will have a role to play as well. We consider some additional complications, such as a reliance on commodity exports and foreign exchange intervention by the monetary authorities, both of which could have negative effects.

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Global Financial Crisis reaches emerging markets

For a while it looked like emerging markets (EM) would withstand the Global Financial Crisis. After the initial shock in 2008 when global trade collapsed, growth bounced back in 2010 and 2011 and was close to pre-crisis levels, a more robust outcome than in the advanced economies. At the time it was not difficult to see why as the emerging economies seemed to be free of the drags affecting their more advanced counterparts.

Banking systems were on a solid footing; well capitalised with a strong deposit base and not infected with sub-prime mortgage debt. At the macro level, many countries had spent the past decade building foreign exchange reserves and strengthening external accounts; a response to the 1997-98 crisis which afflicted Asia and the wider emerging market universe. The position of the emerging economies contrasted favourably with the West where the collapse of the banks had sent the US and Europe into the deepest recession since the Great Depression.

The return of growth combined with ultra loose monetary policy in the US and Europe to draw capital into EM. Investors in the West became desperate for income as cash and bond yields fell to historic lows. The search for yield took them into EM, where growth and monetary policy had decoupled from the advanced world. In 2010 the flow turned into a torrent and the complaint from central banks in the region was that the quantitative easing (QE) policies of the US Federal Reserve (Fed) were creating too much liquidity in their economies and markets (chart 1).

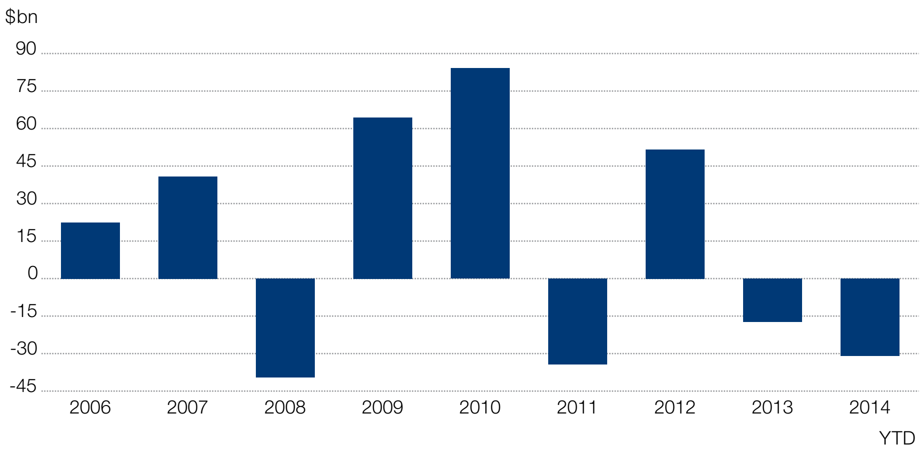
However, by 2012 EM growth began to fade and it became clear that emerging economies had not decoupled from the West. The strong rebound was attributed to stimulus policies by the EM authorities. For example, China implemented a massive fiscal boost funded by the banking system which took fixed investment as a share of GDP toward 50%, an unprecedented level. Yet as this faded and exports failed to pick up, growth slowed. In turn, weakness in China put downward pressure on commodity prices and hit other EM economies, particularly those in Latin America.

As a result, capital flows became more volatile, with investors becoming net sellers in 2011 before returning in 2012. The turning point came last summer when Ben Bernanke, the chair of the Fed, signalled that QE would not last forever, thus triggering a rise in US Treasury yields and a reappraisal of the search for yield in more risky markets such as high yield and EM debt. Capital flows began to reverse, currencies fell sharply and it started to look like 1997-98 again. Pressure on Asian EM countries like Korea was increased by “Abenomics”, whereby the Bank of Japan began aggressive QE, which – in another echo of the 1997 Asia crisis – caused a significant fall in the Japanese yen. Investors who were only in EM to pick up yield began to head back home, often to US Treasuries and bunds.

From this perspective, the Global Financial Crisis which began with the sub-prime crisis in the US has found its way to EM. En route it stopped off in the eurozone, where the peripheral economies faced meltdown and potential exit from the single currency. Although no two crises are the same, the problem in each was one where a surge in investment created a bubble which subsequently reversed as credit conditions tightened. In the current episode this has played out in US mortgage-backed securities, peripheral eurozone sovereign debt and EM debt. Equity markets in each region have suffered as the bursting bubble infects the banking system and growth collapses.

However, as we have seen in the US and Europe, a combination of economic recovery and policy action has enabled equity markets to improve and, in the case of the US S&P500, move to new highs. The question for investors today is whether EM equity markets can follow this path, or if the investment story is now over and asset allocators should continue to look elsewhere.

Chart 1. Emerging markets net fund flows



Source: JP Morgan, EPFR Global, 27 April 2014.

Searching for a trigger

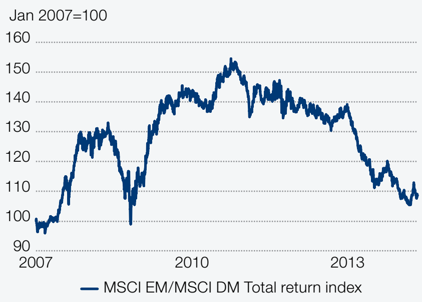
This is a complex issue and it is not possible to identify a single trigger which would turn the situation around for EM. In this section we look at a range of indicators that may signal a turning point, before going on to trace the adjustment process needed from a macro perspective to lift the region onto a stronger growth path.

Valuation and sentiment

First, the underperformance of EM against the developed markets has been severe (chart 2), amounting to nearly 30% since October 2010. Although there have been other periods of underperformance, this has been one of the most persistent. On a valuation basis the discount, as measured by the difference in the PE ratio, has increased significantly (chart 3). Clearly, EM valuations have become more attractive. However, on an 18-year basis the discount is only in line with its average and whilst that period contains a wide range in experience, arguably part of the problem for the EM equity market has been that it had been trading at too small a discount until recently.

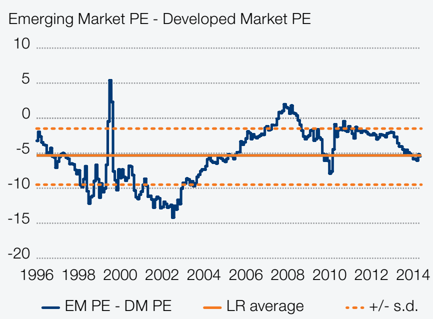
Second, there are signs that capital flows may be beginning to stabilise, judging from currency movements in the economies which have been the most vulnerable during the crisis. These are the so called “Fragile Five” consisting of Brazil, India, Indonesia, South Africa and Turkey; all economies that became significantly dependent on foreign capital inflows as a result of running current account deficits (chart 4). Currency stability suggests that capital has stopped

Chart 2. Relative performance



Source: Thomson Datastream, Schroders. 9 May 2014.

Chart 3. Relative valuation



Source: Thomson Datastream, Schroders. 9 May 2014.
PE = Price Earnings Ratio.

leaving the economy. Although this may be temporary, positioning data indicates that many investors have already reacted to the downturn in the emerging world and are underweight.

Valuation and sentiment data are important but are not great tools for timing a turning point; markets can remain under- or overvalued for a considerable period, or as the economist Keynes famously observed "markets can remain irrational for longer than you can remain solvent". Consequently we would turn back to the macro in our search for a trigger.

Macro signals

The first of these would be a recovery in EM growth. Amongst the plethora of indicators available in this respect would be the Purchasing Managers Indices (PMIs) which provide a consistent basis of comparison. These currently show that the major EM economies continue to struggle to match their developed markets counterparts (chart 5).

In addition we would focus on export growth. Although in the long run we believe that the EM economies need to re-orientate their economies toward domestic rather than external demand, exports are, and will remain, an important source of growth. At this stage, like the PMI indices, EM exports have yet to show a clear sign of pick up (chart 6).

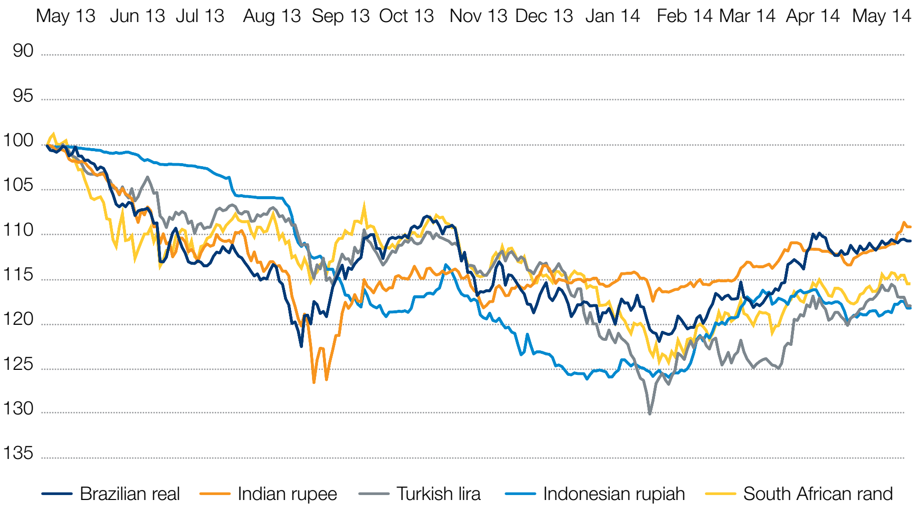
We discuss this adverse decoupling with reference to US trade performance in the April Schroders Economic and Strategy Viewpoint[1] where we highlight the weakness of US import growth relative to domestic demand. This may change if US demand becomes more orientated toward capital expenditure, but at present there has been little spillover from the US recovery to EM exports.

Tail risks

In addition to concerns about the near-term indicators, investors are also focused on the downside tail risks. One concern is China where the legacy of the stimulus programme has been an increase in non-performing loans in the banking and shadow banking systems. Like the US and Europe, parts of the Chinese economy need to de-leverage. The concern is that the authorities will lose control of the process, resulting in a sharp contraction of credit and a hard landing.

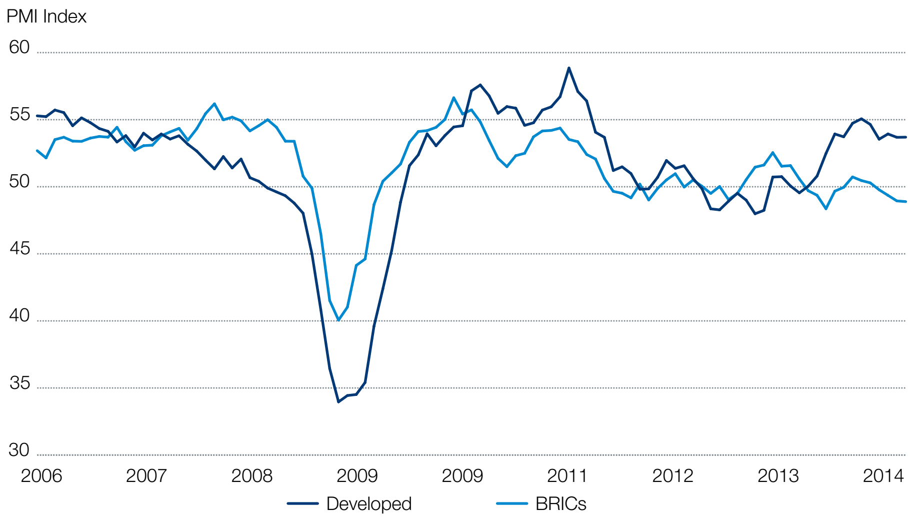
At one stage it looked as though the government would be relatively aggressive in restructuring, given its desire to bring market forces into the financial sector. However, after allowing a few defaults it now seems to have backed off and is going for a more extended and gradual adjustment process. Greater clarity and evidence that the system is robust enough to withstand restructuring is needed for these tail risks to fade. From a market perspective this is key as investors will recall that it was the reduction in tail risks which triggered the rally in eurozone assets ahead of the economic recovery.

Chart 4. Fragile Five Currencies Stabilise



Source: Thomson Datastream, Schroders. 21 May 2014.

Chart 5. Decoupling: EM fail to track DM upswing



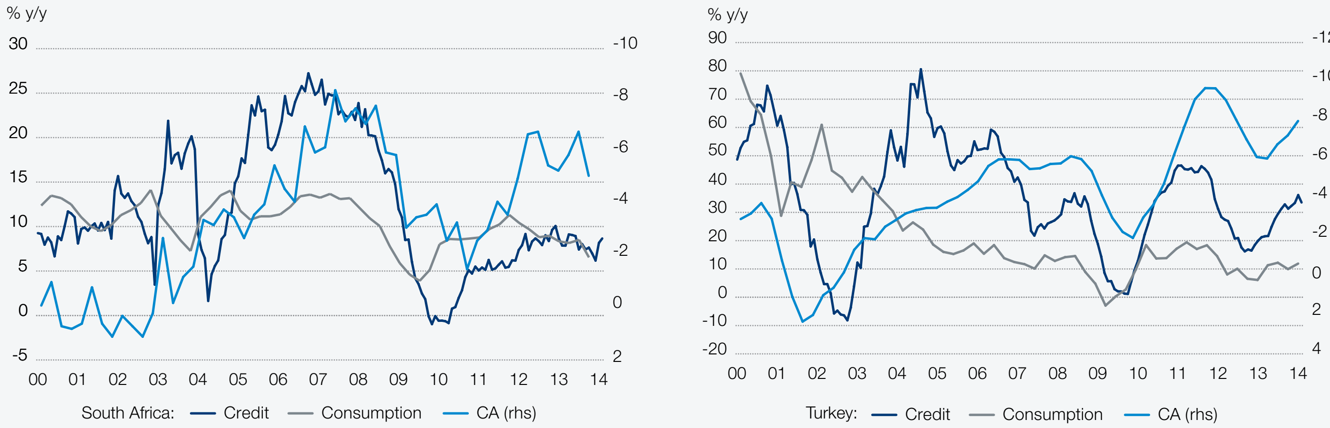
Source: Purchasing managers institute, Schroders, 5 May 2014.

Chart 6. EM export growth yet to recover

Source: Thomson Datastream, Schroders. 5 May 2014

1 'The US leads the recovery, but the world's locomotive is fading', April 29 2014. http://www.schroderstalkingpoint.com/tp/home/?id=a0j500000087jt0AAA

Chart 7: Some EM current account deficits have been fed by credit fuelled consumption



Source: Thomson Datastream, Bloomberg, Schroders. 12 May 2014

The second concern and a major source of capital outflows of late has been the Russia-Ukraine situation. At the time of writing, tensions have cooled a little after comments from President Putin. However, this remains a risk given the incentive for the Russian President to keep the pressure on Ukraine which seems to have contributed to a very strong approval rating.

Going beyond China and Russia there are a set of country problems which focus on the Fragile Five and the macro adjustment process. We turn to this issue in the next section which identifies those economies best placed to complete the adjustment and those that are likely to struggle.

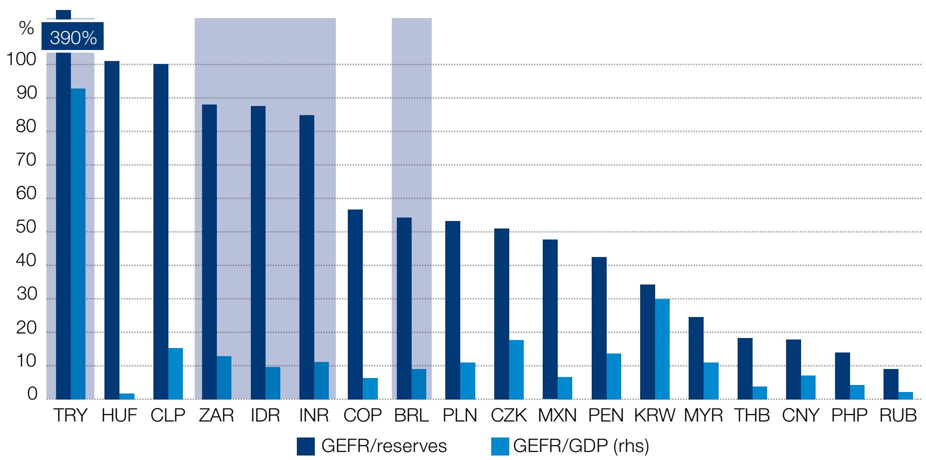
"I wouldn't start from here": the current state of emerging markets

Investor concerns around EM seem to have focused on a handful of metrics. The problem for EM in many cases has been the building up of large current account deficits, often through consumption fed by credit expansion (chart 7).

A second and related issue is the country's total exposure to overseas financing, particularly in the short term. Longer-term foreign financing is less of an issue; hopefully in a few years' time conditions will have calmed. But debt due within 12 months faces refinancing risk in a tightening environment. A good measure for this purpose is the gross external financing requirement (GEFR), the sum of any current account deficit and all short-term (<12 month maturity) foreign debt. A comparison of this figure to country FX reserves and GDP indicates, respectively, country capacity for funding itself in the event that foreign financing is withdrawn and the extent of economic activity reliant on that financing (chart 8).

Thirdly, a fiscal deficit indicates that a government's expenditures exceed its income. Large deficits imply a growing debt stock, and as with a large current account deficit, can lead to worries about the borrower's ability to repay. In the case of fiscal deficits, this can impact sovereign credit ratings and concerns over higher future taxation, dissuading investment flows. This can interact with, and worsen, the Capital account, making it harder to finance the current account deficit: Countries flagged by these metrics need to adjust. But in macro terms what will this look like, and how will we know when it is done?

Chart 8: Gross external financing requirement in EM



Source: Thomson Datastream, JEDH, Schroders. 12 May 2014
Shaded countries are the 'Fragile Five'

What does economic theory tell us? The adjustment process for Current Account Deficit countries

The theoretical adjustment is through a weaker currency. A current account deficit reflects that the country is borrowing from abroad, in effect selling the domestic currency to obtain foreign funds. This exerts a depreciation pressure on the currency. As the currency weakens, imports become more expensive and exports become cheaper, and more competitive, which improves the trade balance and hence the current account. This sounds simple, but in reality countries seem able to run persistent current account deficits even as their currencies weaken, as indeed many EM economies have done. To reduce the deficit, it seems some trigger event is also needed, such that foreign creditors become less willing to provide financing, and the economy is forced to adjust. Tapering by the US Fed seems to have been the trigger this time.

The adjustment will not be painless. For one, a weaker currency implies increased inflation. We have seen evidence of this in many EM economies, though the degree of exchange rate pass-through (the extent to which a depreciation of the currency feeds through to higher inflation) varies from country to country. Given the move towards inflation targeting by EM central banks in the past decade, this implies interest rate increases will follow. Within the Fragile Five of India, Indonesia, Turkey, South Africa and Brazil, all have now enacted rate increases in response to currency weakness and persistently high inflation.

The concern now is the impact this has on economic activity and debt service costs. Higher interest rates will likely reduce consumption and investment by increasing the cost of capital. Incomes will also be hit by the increased cost of servicing existing debt. Indebted households and corporates could be pushed to pay off debt rather than consuming or investing more to support growth. There is also a risk that rate hikes overstretch already strained corporates, resulting in a wave of defaults and endangering the financial sector. Either way, deleveraging is likely to lead to a period of slower growth, with the probability and impact of this risk highest in those countries that have experienced particularly rapid credit growth. Export growth is unlikely to offset this except in smaller, very open economies. We can turn to a recent example closer to our shores to see all of this in action.

What does real life tell us? Rebalancing in the eurozone

The era of the euro ushered in widening current account deficits in the eurozone periphery and in many emerging European economies, particularly those with fixed exchange rate regimes. There are certain parallels with the story for EM today: large scale foreign capital inflows drove a demand boom, both domestically and for imports, which widened current account deficits. Consequently, indebtedness rose, competitiveness fell, and governments indulged fiscally, leaving themselves little policy space. An IMF working paper[2] examines the causes and consequences of this, and traces the adjustment path for the affected economies.

The paper notes that emerging European economies saw a quicker adjustment in their current account deficits than those countries in the periphery[3]. In emerging Europe, it seems, there were more forces driving a current account improvement: export recovery, import compression, withdrawal of foreign capital, wage adjustment in the tradable sector and growth in trading partners. By contrast, the periphery had little trade improvement, as they were slower to make necessary wage and price adjustments, had weaker import demand in partner countries, and were less open economies. The wage adjustments are of particular importance; the paper found that improving competitiveness this way (measured by the real effective exchange rate, based on unit labour costs) was key to the adjustment process. The authors point out that the periphery also experienced a lesser withdrawal of financing, with TARGET2* funding filling some of the gap left by private sector funds and so reducing the need for import contraction.

While eurozone countries have been constrained by a fixed exchange rate, the authors found that a flexible exchange rate is not necessary for a successful adjustment as long as supportive policies allow for wage and price adjustment. This doesn't just mean "austerity"; flexible labour markets aid wage adjustment rather than placing the burden fully on unemployment. Of course, one implication of this is that a flexible exchange rate can take some of the burden away from labour markets altogether, and so allow for a less painful transition process; EM economies should not have to endure quite as much pain as the European periphery.

Another relevant finding for EM was that the adjustment process is influenced by the sources of any pre-crisis boom. Specifically, "if a particular sector played a disproportionately large role in pre-crisis growth and employment, post-crisis adjustment may have unfavourably large consequences for growth and unemployment." This seems particularly pertinent for the big commodity exporters. The problem is apparently exacerbated if an economy is less open and has an impaired public sector (i.e. high fiscal debt), where neither the state nor an external impulse is able to mitigate the effects.

Theory meets reality: implications for EM

Drawing on the theory outlined above and the experience of the eurozone, we can piece together a likely roadmap for EM adjustment.

The most rapid adjustment, in terms of reducing the current account deficit, will be in EM economies that are:

- Open (trade is a large share of GDP so an export recovery has a bigger impact)
- Undergoing deleveraging
- Undertaking ULC adjustment and improving their competitiveness
- Exporting to fast growing partners
- Allowing their currency to adjust

Some of these, though, imply a degree of pain to be endured; deleveraging, unit labour cost adjustment (e.g. real wage decreases) and currency adjustment all bear economic costs which will complicate the economic trajectory.

The fewer of these paths to adjustment are available, the heavier will be the reliance on the remainder. That is, very closed economies determined to defend their currency could face more painful deleveraging and ULC adjustments; what we might call the "Greek route".

Splitting EM into open deficit countries and closed deficit countries is not simple as there is not really a level at which a country is defined as "closed" or "open"; it is a sliding scale rather

Table 1: Assessing likely adjustment speed

	2012 trade openness (Trade as % of GDP)	Credit growth (3mma as of Jan 2014, %)	Credit growth acceleration, year-year, ppts	Wage growth (3mma, latest available, %)	Wage growth acceleration, year-year, ppts	Change in REER since May 2013 (%)	Average forecast change in GDP growth of trade partners, 2014 vs 2013 (trade weighted, ppts)	Change in gross FX reserves since May 2013 (%)	Overall rank
Turkey	49.7	33.9	16.1	16.3	2.3	-14.2	0.4	-1.9	
Peru	39.3	17.0	4.1	6.9	3.2	-3.4	0.3	-2.7	
Poland	77.3	3.6	2.3	4.8	2.7	2.7	1.0	-6.7	
Thailand	136.5	12.2	-6.5	7.3	-1.5	-7.8	0.2	-4.5	
Brazil	29.0	14.0	-1.0	3.0	-0.2	-9.3	0.2	-2.8	
Chile	68.3	13.8	-0.5	5.8	-0.3	-11.0	0.2	2.0	
India	36.9	14.7	0.2	-2.9	-6.9	-9.3	0.3	13.7	
Indonesia	59.8	20.6	-2.0	12.4	-7.6	-13.0	0.2	-2.4	
Colombia	35.9	13.1	-0.2	1.7	-1.5	-9.9	0.4	8.7	
Mexico	53.9	10.1	-2.1	3.8	-0.5	-5.0	0.9	11.5	
S Africa	53.1	7.1	-0.5	4.3	-3.8	-12.6	0.0	10.0	

Data is sorted by quartiles. Green denotes data lies in first quartile, yellow the second, amber the third, and red the fourth. Source: Thomson Datastream, Bloomberg, IMF, Schroders. 14 April 2014.

2 Atoyan, R., Manning, J., and Rahman, J. "Rebalancing: Evidence from Current Account Adjustment in Europe" IMF Working Paper 13/74, 2013.
3 The periphery countries were identified as Greece, Ireland, Portugal and Spain, in the IMF paper. Emerging European economies were Bulgaria, Latvia, Estonia and Lithuania.
*A settlement system owned and operated by the EuroSystem. (Trans-European Automated Real Time Gross settlement Express Transfer system).

than a binary state. The greater trade (imports + exports) as a share of GDP, the more open is an economy. In our sample (table 1), Brazil is the most closed economy and Thailand the most open. Still, in what follows we attempt to draw out the adjustment path dependent on openness to trade.

Who will adjust fastest?

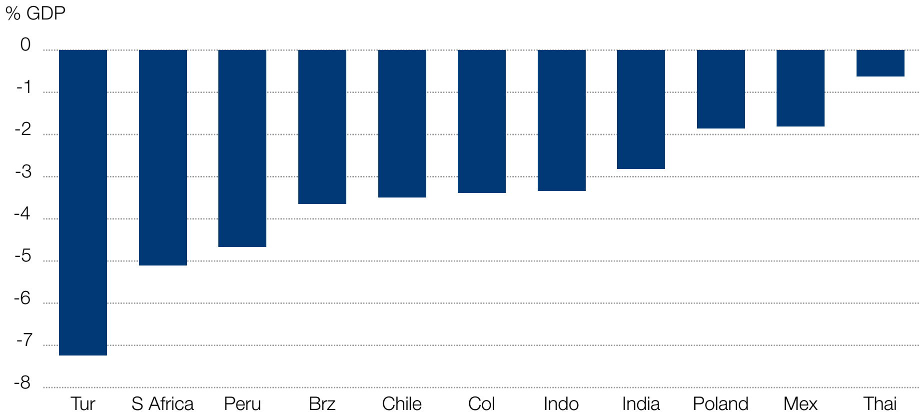
While we do not have a model to predict adjustment speed, we can make an educated guess how the deficit economies will fare on a relative basis. The table below examines the criteria laid out above for the EM current account deficit countries.

Overall, countries towards the bottom of the table, particularly ranked as green, should see a more rapid current account deficit improvement and pick-up in market sentiment. Essentially, they are further along the adjustment path than those further up the table and should return to growth sooner. This should not, however, be seen as a signal that they have no problems; we are attempting to measure current account adjustment, not overall macroeconomic health.

One particularly surprising result thrown up here is the good position of South Africa, given its membership of the Fragile Five and the fact that it has not made the same external macroeconomic adjustments as already seen in India. South Africa's green ranking reflects its relatively slow credit growth, contracting wage growth, expansion of reserves and the depreciation of its currency. These factors will limit domestic demand, particularly for imports, and improve the competitiveness of their exports; the current account should benefit.

At the opposite end of the scale, also in the Fragile Five, is Turkey. Here it looks like adjustment has barely begun. Recent aggressive rate hikes have yet to fully feed through and the pain of deleveraging lies ahead. Again, as with South Africa, we also have political risk adding to the mix.

Chart 9: Current account deficits



Source: Bloomberg, Schroders. 12 May 2014

What next?

Combining the table above with the present current account position of the deficit countries (chart 4), we can hazard a few guesses about what happens next.

Smaller deficits exert less rebalancing pressure. Of the Fragile Five, India looks like it should almost be completed. Coupled with a relatively favourable position in table 1, we could be moving into an upswing for the Indian economy soon. The remaining adjustment is obviously much larger in Turkey, Peru and South Africa. The first two are also flagged up in red on table 1. In essence, they have lots of adjustment to do and have barely begun. Both seem likely to face strong deleveraging and real rebalancing (i.e. wage cuts and/or increases in unemployment, weaker consumption and investment) and sustained FX pressure. Trade does offer a slight release valve but we would still expect a marked growth slowdown. It seems likely that import contraction will play a large role in the adjustment story given only a limited uptick in trade partner growth reducing the scope for an export-led move.

Note, however, that a large current account deficit does not automatically imply a large depreciation is still needed. We have seen considerable moves in the South African rand and Turkish lira already. Typically there is a lag before a weaker currency helps reduce the current account deficit. In the interim it can even increase it – a phenomenon known as the "J curve" effect. Still, depreciation pressures will remain until current account deficits are reduced, as will inflationary pressures. A result of this is that monetary policy will have to remain tight until the current account deficit is reduced.

The adjustment process: summary

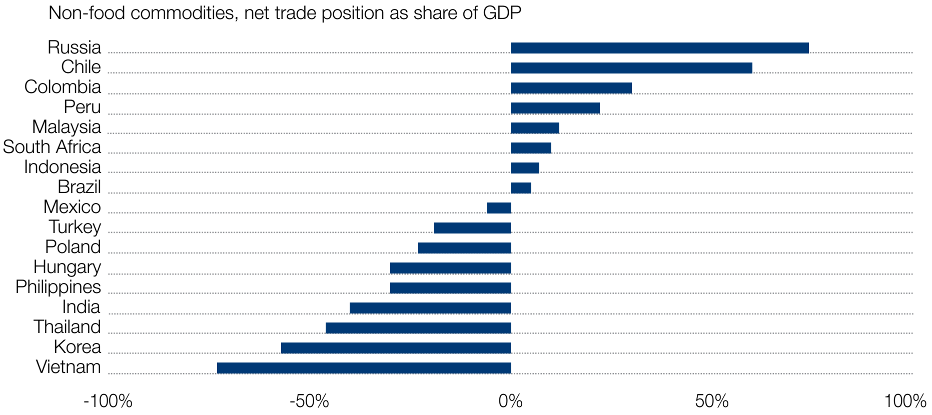
In brief, we need to see a strong net export recovery. Where this cannot happen via exports, it must happen through a domestic slowdown and import contraction. Until the adjustment is completed and the currency is safe, monetary policy will likely remain tight. A domestic slowdown will involve real wage and price adjustment (as in Greece, in the worst case) and deleveraging, particularly in economies where credit growth is still roaring along. The degree of domestic adjustment required will vary somewhat according to a country's degree of trade openness[4].

Open vs closed deficit economies

With recourse to trade as both a growth stimulus and source of FX inflows, open countries will be better positioned to avoid the more painful aspects of adjustment. This is not to say there will be no pain, only that the extent will be less than in closed deficit economies who will likely face a more painful adjustment process. It need not be as bad as in peripheral Europe; currency adjustment can take some of the strain. However, complications could arise.

4 By "open" here we refer to the degree of trade openness, shown in the second column of table 1. Of course, all the economies shown have some degree of openness. However, when trade is small relative to GDP we often say the economy is "closed". The US, with trade equivalent to around 24% of GDP, is a good example. Ultimately though the judgment is a subjective and relative one; economies in green in the second column of table 1 are the most open, those in red are the least open. The arguments laid out below will apply with varying strength depending on the degree of openness.

Chart 10: Net trade position in non-food commodities as a share of GDP[5]



Source: UN Comtrade, IMF, Schroders calculations. Updated 12 May 2014. A negative figure means the country is a net importer.

Complication 1: The outlook for commodities

With China slowing and rebalancing, commodity prices will be softer and net exporters (see chart 10) of non-food commodities will see less "trade beta" with global growth than historically. So when considering the capacity of countries to use trade as a means of adjustment, bear in mind it will be tougher where commodities are a sizeable export, no matter how open the economy is. South Africa's position is consequently less strong than table 1 alone would indicate.

Complication 2: The impact of FX intervention

Recent work by the Bank for International Settlements (BIS) explored the relationship between central bank FX intervention and the banking system in EM economies. The BIS found that for well capitalised banking systems, FX purchases aimed at resisting appreciation led, over time, to an expansion of credit to the private sector. Assuming a symmetrical effect then, attempts by central banks to resist currency depreciation will have negative consequences for credit growth, and consequently GDP growth. Again, this implies that attempts to fight depreciation will have growth costs beyond the impact on employment, competitiveness and trade performance. The BIS found that the increase in credit from FX purchases occurred with a two year lag. Again, assuming symmetry, FX sales could hit credit growth in two years' time; the adjustment process could be extremely protracted.

5 We have used UN Comtrade data, grouped by SITC (revision 1) categories. Chemicals, crude materials, manufactured goods classified chiefly by material, and mineral fuels were combined to create "non-food commodities". Data is for 2012.