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A glimpse at emerging market stress

Written by: Bongani Mzimeli, Investment Analyst at Prowess Investment Managers

The current risk-off episode that has gripped the emerging market (EM) asset class in particular has caught the attention of many investors. Just five years ago, these markets experienced a boom that has now begun to unravel. After many developed economies contracted in 2008, emerging market economies attracted a large amount of investment capital due to their relatively strong growth rates. This capital was employed in various parts of the economy to enhance growth rates. In 2015, most of these markets experienced ongoing declines. They continued to rely on foreign investment to replenish their current account deficits. The 2013 "taper tantrum" - when the US Fed unexpectedly decided to start withdrawing monetary stimulus - proved to be damaging for many emerging markets. Likewise, the renewed economic worries in 2018 have seen currencies of these countries plummet against the US dollar.

According to the investment research firm MSCI, the Emerging Markets Index, which tracks large and mid-cap stocks in 24 countries, has fallen by more than 20% from its peak in January 2018. A cocktail of potential problems is confronting the world's emerging economies with many of them facing challenges such a global economic slowdown, rising interest rates, trade protectionism and geopolitical tensions. We have seen the emergence of credit stress for nations with macroeconomic imbalances or rising political risk - particularly those highly reliant on international financing.

Many market pundits point towards trade wars being the reason for the declines in the emerging market space but we contend that headwinds are likely the result of a readjustment to contracting global liquidity, a stronger US dollar and rising US interest rates as well as a slowing global economy.

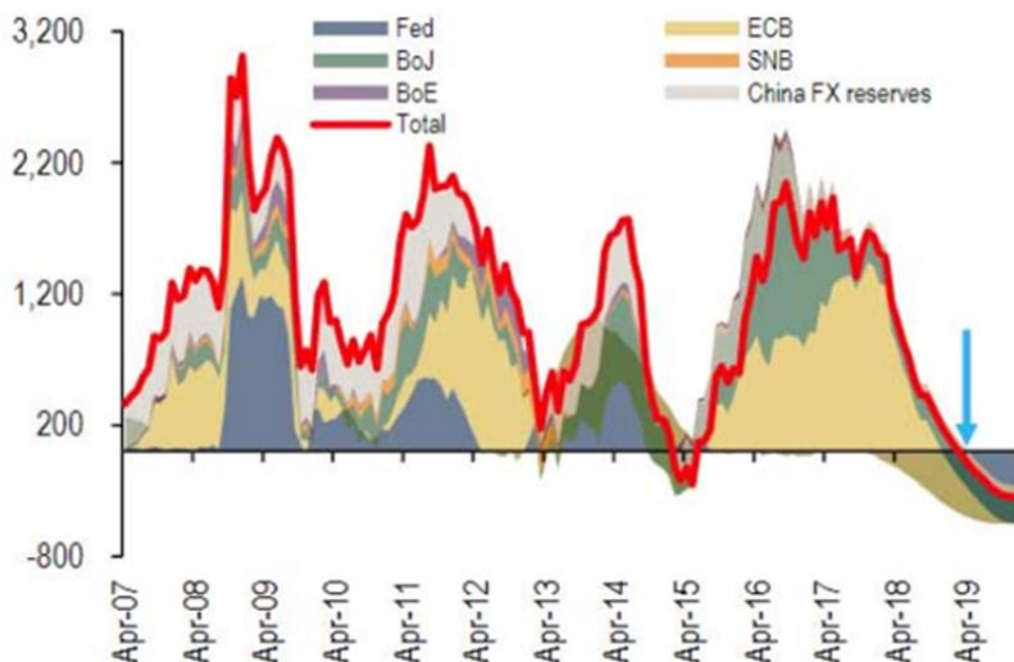
Contracting global liquidity

Most major central banks around the world have engaged in aggressive monetary easing which came with many different quantitative easing programs. The balance sheet and easing measures of the four major central banks (Fed, BoJ, ECB, BoE) can be looked at in aggregate to determine the thrust of global central bank policy as well as flows in global liquidity. As the Federal Reserve leads the way out of the era of central bank easing, markets have had to adjust to the first real test of central bank tightening. Fed policy has a broad reach and ultimately determines world dollar liquidity. That liquidity is profoundly shrinking around the world. The symptoms can be seen in emerging markets with declining equity prices and in economies where the cheap money policy of the past has encouraged dollar borrowing. These markets are now facing rising interest costs and a more expensive dollar, making repayment difficult.

Tightening from the Federal Reserve is felt in emerging market countries before it becomes worrisome in the US. This has to do with massive US dollar-denominated debt that was issued in the past. According to the Financial Times, the world saw a massive $2-trillion increase in central bank induced liquidity in 2017. By 2019, that will reverse to an $800 billion drain in global liquidity. That change will be massive and has tremendous implications for risk assets around the world.

The chart below shows early 2019 being the start of the liquidity drain on the global financial system.

In early 2019, global year-on-year "Quantitative Easing" is likely to turn negative (12-month changes in balance sheets, in $billion)



Source: BofA Merrill Lynch Global Research, Bloomberg

Liquidity has not gone negative year-on-year and is not expected to turn negative until early 2019. The slowdown in liquidity by central banks in 2018 has caused an almost 20% decline in emerging markets and led to the collapse of some local currencies. An outright contraction will certainly be a harbinger for risk assets (emerging markets).

It is therefore our considered view that as the liquidity contractions intensify, global risk assets will decline and the global economy will slow, led first by emerging markets. With the Federal Reserve set to raise interest rates in December, and few more hikes in 2019 (median forecast is 3 rate hikes), along with a continued reduction in the balance sheet, world dollar liquidity and banking liquidity will continue to contract. Further contractions in global liquidity will cause more pain in emerging market economies.

Rising US dollar will continue

The US dollar could be an important factor for global markets in the months ahead. Any further dollar gains could easily tip markets over towards bear market territory. A stronger US dollar is undoubtedly a negative for emerging markets. Over the past two years, the US dollar has increased in value and emerging market currencies as a whole have declined. Given the expected trends in US dollar liquidity, we believe the US dollar will continue to rise, which will further pressure emerging markets.

As dollar liquidity contracts, fewer dollars are available. This supply shortage drives up the value of the dollar. With dollar liquidity expected to continue declining with the outlined pace of monetary tightening, there is no reason for the declines in emerging market currencies to reverse and move higher. The outperformance of America's economy and markets, coupled with the underperformance of Europe and emerging markets, suggests that the rally in the US dollar has further to run.

Slowing global economy

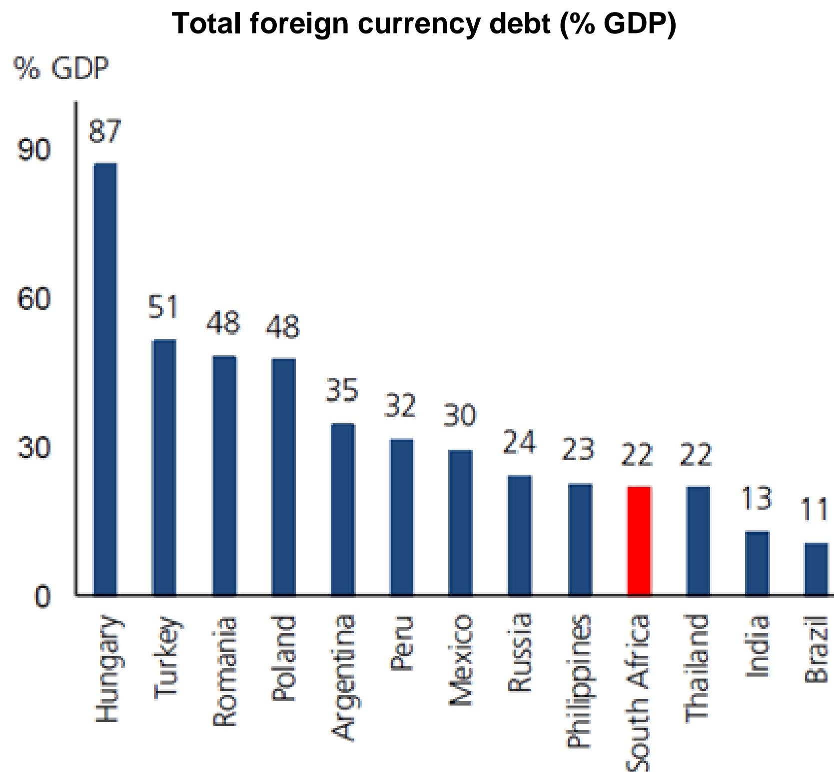
A material economic slowdown is causing most of the emerging market stress. Most of the declines in the emerging markets EM are attributed to trade wars/tariffs but there has been a broad-based collapse of economic data outside of the US. The economic weakness is simply a result of reduced global liquidity, a stronger US dollar, and a normal business cycle slowdown - rather than as a result of the current trade tensions. As many emerging market economies start to contract, the value of their local currency should be expected to decline.

The bottom line

The rush for the exit has created interesting buying opportunities. Investors have tarred all the emerging markets with the same brush, yet their individual situations differ widely. In a moment of panic, all emerging markets have moved the same way, but over time capital will return to the solid, well-managed, growing economies.

It is true that rising US rates are likely to present specific challenges to emerging markets, especially those with external financing vulnerabilities or governments, companies and banks with large amounts of dollar-denominated debt that could become more expensive to service. In assessing emerging market vulnerability arising from risks associated with US Fed monetary policy normalisation, one can get a better understanding of the level of risk exposure. For example, South Africa's macro imbalances are far less extreme than those of Turkey and Mexico. According to the chart below, South Africa is the fourth least vulnerable country in terms of foreign currency debt and Hungary, Turkey and Romania are the most vulnerable.

Total foreign currency debt (% GDP)



Source: iress, Macrobond, World Bank, IMF, Bloomberg, Moody's, BIS, RMB Global Markets

Meanwhile, on the other hand, the assertion that emerging markets with stronger fundamentals are better insulated, could be missing a very important point. Sentiment towards emerging markets is deteriorating – and the scope for financial contagion increasing – because of technical factors stemming from a surge in capital inflows over the past two years, especially last year. It remains to be seen whether emerging markets are perceived as strong enough to adjust to the rate of policy normalisation.

Glacier Research would like to thank Bongani Mzimeli for his contribution to this week's Funds on Friday.

Bongani Mzimeli – BCom (Economics)

Bongani Mzimeli is an Investment Analyst who supports the investment process through research and investment analysis. He formed part of the Prowess internship/skills transfer programme which started in 2010. The objective of the programme is to offer matric students, university students and graduates an opportunity to be exposed to the investment management Industry through skills transfer.