GUARDCAP

Emerging Markets Quarterly Outlook

SECOND QUARTER – 2018

A COUPLE OF BAD APPLES DON'T SPOIL THE WHOLE BUNCH

While 2017 was a year of robust and broad-based strength across Emerging Markets (EM) against the backdrop of historically (and uncharacteristically) low market volatility, 2018 has so far proven to be what looks like a return to old form for the less-developed parts of the world.

The first half of this year has seen a resurgence of volatility, not just in EM but globally, that has largely been a function of US monetary and trade policies. Indications of rising inflationary pressures at the start of the year spurred an aggressive repricing of the Fed which caused interest rates to spike and supported a concurrent firming in the US dollar. The addition of increased protectionist rhetoric from the White House further pushed up the cost of risk and underpinned an uptick in outflows from EM financial assets. This less benign market environment emphasized vulnerabilities in a few EM economies which were most exposed to changes in external conditions, namely Argentina and Turkey.

While it has been the case in the past that crisis in one EM economy quickly spreads to others, the current situation is not reminiscent of the environment around the turn of millennium nor is it even comparable to the fallout from the "taper tantrum" in 2013. The struggles in Argentina and Turkey appear idiosyncratic; a domino effect that will weigh down the broader outlook for EM has not been triggered, nor is it likely to be.

Built Up Immunities

The fear of contagion across EM always looms large on the regions financial assets. This explains the knee-jerk reaction to the crises in Argentina and Turkey transitioning into selling pressure across the broad EM spectrum, with 19 of the 24 regional markets that comprise the MSCI Emerging Markets Index posting negative returns in Q2 even as Developed Markets (DM) found their footing and commodity prices improved.

This largely appears to be a case of babies being dumped out with the bathwater, since the situation this time around is distinctly different from what prevailed 20 years ago (or even around the "taper tantrum" in 2013). The problems being experienced by Argentina and Turkey are not indicative of broader systematic issues across the EM landscape; these countries are more the exception than the rules this time around.

First and foremost, outside of Argentina and Turkey, the economic position of EM economies is markedly better than it was in 1997 thanks to increased foreign exchange reserves and diminished current account deficits — in the earlier period, 90% of the major EM economies were running current account deficits and half had them worth at least 3½% of GDP; now the share is down to less than 60% with a current account deficit and just four (Argentina and Turkey, as well as Egypt and Peru) have shortfalls at the extremes.

Moreover, the general dependence on foreign funds throughout EM has declined markedly over the last two decades, with the IMF estimating that external debt for the aggregated Emerging & Developing economies totalling less than 30% now compared to a peak of nearly 40% in 1998 — and the worst offenders in Emerging Asia have seen their ratios halved.

Even for the foreign debt that exists, both EM governments and companies have learned lessons from the late 1990s — when it was bullet payments coming due rather than the cost of capital that exacerbated the crises — and greatly lengthened the maturity profile of their external financial obligations. Moreover, EM corporations have made concerted efforts to match the currency of their income flows with debt service payments, mitigating the impact of currency swings on their ability to meet obligations.

Against this, a major crisis appears to be a low probability event, and with the exception of Argentina and Turkey, there are still few red flags waving from a macro standpoint. Overall, EM growth momentum remains in place supported by the continued expansion in DM and the broad firming in commodity prices — while increases in prices for raw materials (particularly crude oil) are negative for importers like China and India, they are a boon for the many net commodity exporters in EM with Brazil and Russia in particular on the positive side of that ledger.

Furthermore, while many DM central banks are moving toward policy normalization, the likelihood remains that the pace will continue to be very gradual which suggests that interest rates should not rise to an extent that it would threaten the growth trajectory in the EM. With respect to rates in the EM themselves, excluding a few outliers (again including Argentina and Turkey and to a lesser extent, Mexico), inflation in general remains benign, with expectations anchored and financial conditions still easy, which provides policymakers with some room to maneuver should it be warranted.

Finally, corporate profits in EM have shown no signs of decaying and earnings momentum, which was sorely missing in the region for most of the last decade, has held up. Accordingly, EM equities have generally weathered the recent more volatile market conditions well, all told, in part as a function of the grouping's relatively high exposure to the top-performing Tech sector. Valuations which were in middling territory have become even more compelling now, with no real signs of excesses at present.

Riskless Abandoned

To the extent that the global economy remains on course, so too should EM be able to maintain their growth premium over DM which would be constructive for EM equities. The continued presence of risks on the horizon that could change the course, however, means that investor uncertainty will likely persist and costs of risk will remain high, which could prevent fundamentals from taking the wheel. As such, performance among EM assets is likely to be constrained until visibility on the outlook improves.

For starters, a strong US dollar is typically a drag for EM financial asset performance. The likelihood that the Fed will continue on its path to policy normalization means that American interest rates are likely to grind higher and continue to support the greenback, suggesting that this headwind should persist.

As well, while there have been some market-positive trends with respect to elections (including Iván Duque recently prevailing over leftist former guerrilla Gustavo Petro in Colombia's presidential election), political risks linger in EM. The recent election of Andrés Manuel López Obrador (or AMLO, as he is often called) in Mexico, the country's first leftist president in three decades, creates uncertainty as to the direction the populist leader will take Latin America's second largest economy. The upcoming election in Brazil (October 7) creates similar angst for markets as populist candidates continue to poll strongly — the recent protests over fuel prices in Brazil did no favours to incumbent Michel Temer's government's popularity.

Mexico is also one of the most exposed countries to the other key (and growing) risk of an all out trade war between the United States and the rest of the world. EM economies in general are more dependent on exports to and investment from the US as a driver of growth than their DM counterparts. This is especially the case with Mexico given that US imports of Mexico-produced goods account for nearly a third of the countries total output, leaving the economy highly geared to trade policy whims of the US Administration.

Of course, the main target of the White House's protectionist volleys is China and its $375 billion trade surplus with the US. Unlike Canada and Mexico, or the array of emerging Southeast Asian and Latin American nations that are most dependent on trade with the US, China actually does have leverage when it comes to negotiations — China holds a significant position at the centre of the global supply chain and thus it carries importance to American multinationals in addition to being the largest buyer of US sovereign debt (owning $1.2 trillion or 8% of all marketable Treasuries) at a time when the US is upping its bond issuance to fund its fiscal initiatives.

That said, while the US import tariffs that have been introduced so far are unlikely to have a direct material impact on the growth prospects in China given the increasing heft of its domestic economy, a prolonged and escalating dispute is not in the best interests of policymakers in Beijing as they work to push through major structural reforms in the economy. Although there is some scope for concessions from China surrounding the handling of intellectual property or market access to foreign investors, there is little reason to anticipate that Xi Jinping & Company will readily capitulate, which means the brinkmanship between the leaders of the world's two largest economies could continue for some time.

The Weighting Game

On the topic of China, one positive development for financial markets in the world's second largest economy is that MSCI began adding Chinese "A-Shares" to its Emerging Markets Index. These yuan-denominated and China-listed shares were previously only available to international investors under strict quotas set by the Chinese government. The market capitalization of these stocks alone represents the second biggest equity market in the world.

For now, the inclusion is small with just a 5% share of the A-Share market being implemented in two stages (half in June, the other half in September), which means that stocks for about 230 large Chinese-listed companies will be added to the benchmark index accounting for just 0.7% of the weight. Should China sufficiently liberalize its domestic equity markets, the inclusion has the potential to increase — should there be a full inclusion, A-shares would account for nearly 20% of the Emerging Markets index, which would bring China's overall weight in the index to more than 40% (MSCI already includes stocks of Chinese companies that are listed in Hong Kong, so-called "H-Shares", and ADRs in the Index).

The more prominent role in the benchmark stock index for EM, as well as the global benchmark MSCI World Index, is representative of China becoming a larger player on the global stage. From a more practical standpoint, the increased weight to Chinese stocks means that the countries equity markets should see an inflow of foreign funds — about $20 billion is expected to flow as a result of this initial move, with that increasing to $300 billion upon full inclusion — which would serve to help stabilize the country's capital account and also make domestic markets less speculative. Of course, plenty of hurdles still remain for investors to be fully comfortable with dipping their toes in the "A-Shares' market, namely concerns related to accounting practices and corporate governance.