Innealta
CAPITAL

Contact us:
consulting@innealtacapital.com
855.994.2326
innealtacapital.com

EMERGING MARKETS
TIME TO GO BACK

KEY TAKEAWAYS

- Emerging markets have been experiencing outflows during 2018.
- Corporate fundamentals do not come even close to explaining this phenomenon.
- The particular cases of Argentina and Turkey have created an image of trouble for emerging markets that is simply not supported by the data.
- Uncertainty, especially political, has had a tremendous impact.
- After examining these two cases closely, it is easy to see that they are outliers.

Investors in the U.S. have been worried about emerging markets throughout 2018, withdrawing funds and asking themselves whether they should continue decreasing their exposures to them. The spike in volatility in February, the rate policies of the Fed, and, more lately, the situation in Turkey and Argentina, have scared many advisors away from emerging economies. But the time has come to rethink that approach. Current data and historical events should drive advisors to, at least, keep a moderate exposure to developing economies. As we explain here, the main causes for concern have not come from changes in fundamental data, but from idiosyncratic macroeconomic factors, Fed policy, or uncertainty around the political process in some places.

1. The Fed

- The Fed has been increasing rates since 2015, putting an end to 7 years of an effectively zero rate.
- The Fed has increased rates 7 times since 2015, twice in 2018.
- This has led to an appreciation of the dollar and to the reallocation of capital from emerging economies to the U.S.
- Both developments have hurt the returns for U.S.-based investors in emerging markets.

Looking ahead

- The pace of future rate hikes will be much slower than what many analysts expected.
- First, the Fed decided not to raise rates in August.
- More importantly, Jerome Powell, the Fed chairman, said very clearly this month in Jackson Hole that future increases would follow a moderate path, taking into account economic output and employment data.
- Monetary policy will tighten if inflation is stable and unemployment falling.
- The fact that many analysts did not expect this flexible approach was corroborated when the dollar lost ground against major currencies immediately after Mr Powell's speech.

Our view

- Beyond the U.S., rates can be expected to remain very low in Europe (at least well into 2019) and Japan (for a long time).
- Consequently, monetary policy should not be much of a concern: rate increases for the U.S. were expected (nobody was expecting them to remain at near-zero levels forever), and they will follow a gradual upward path in the future.

2. Worrying case #1: Turkey

- It is very important, in our view, to realize that Turkey's troubles are very particular to Turkey, and mostly do not stem from anything that could affect other emerging economies.
- Under President Erdogan, the country has been veering towards autocracy, holding a presidential election this year where the result was known before a single ballot was cast.

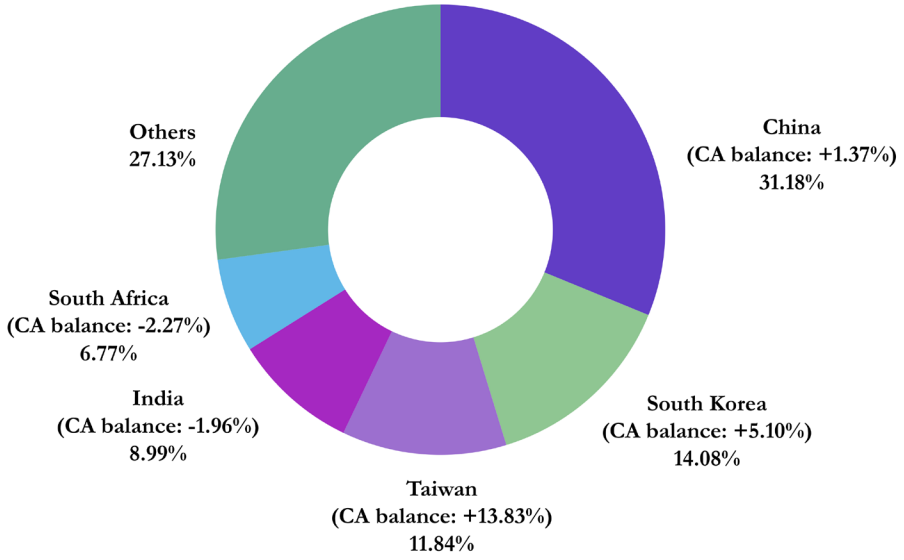
- The president has also put explicit pressure on the central bank to keep interest rates low, even as the currency was plummeting, going against the most basic economic orthodoxy.
- The high levels of dollar-denominated debt were one the main reasons cited by investors for leaving Turkey.
- Furthermore, Turkey's current-account deficit has led some analysts to wonder whether it could signal a broader problem for other emerging economies.

Could there be contagion into other emerging economies?

- For those who fear a repeat of the Asian crisis of the late 1990s, no signs of anything similar have appeared so far.
- One of the main concerns for investors right now is the high current account deficits in emerging economies.
- However, the unsustainable current account deficits we saw at the end of the 90s do not bear any resemblance to today's.
- Turkey's current account deficit is definitely a cause for concern, but, amongst emerging-market economies, it is clearly an outlier.
- While Turkey ended 2017 with a current account deficit of 5.55% of GDP, the largest emerging economies in the MSCI Emerging Markets Index had current account surpluses or very manageable deficits.

Figure 1

THE MOST IMPORTANT COUNTRIES IN THE MSCI EM INDEX HAVE CURRENT ACCOUNT SURPLUSES OR MANAGEABLE DEFICITS



Source: Innealta Capital using data from MSCI and from the IMF's World Economic Outlook (April 2018 report). Data for current account balances is as of the end of 2017.

- A weighted average of current account balances across the countries in the MSCI Emerging Market Index yields a surplus of more than 2.5% of GDP.
- Turkey, although very large geographically, represents less than 1% of the index.
- Its annual GDP is not even $1 trillion (Italy, with roughly 3/4 of Turkey's population and feeble growth in the past two decades, is close to $2 trillion).
- As a reminder, in 1998 we saw economies shrinking by more than 10% in just one year (e.g., Thailand and Indonesia). Is anyone seriously predicting something like that today?

3. Worrying case #2: Argentina

- Before Turkey's economy became the center of attention for investors in emerging markets, Argentina was the main source of concern.
- The country had defaulted in 2001, and it was subsequently led by 3 administrations that embraced populist policies, doing very little to address the structural changes that were so badly needed.
- The Macri administration came into power at the end of 2015, and it sought to enact deep reforms and remove price distortions.
- Things looked promising as progress was being made: the economy grew 2.9% in 2017 and MSCI upgraded the country from frontier to emerging market in June of 2018.
- The government was able to secure access to international financial markets once again, which was capped with a 100-year bond issued in June of 2017.

Q2 marked the end of Argentina's smooth ride

- Uncertainty suddenly took hold of investors in May of 2018, mostly surrounding the country's ability to handle its debt: capitals started flowing rapidly out of the country, and the currency started losing value rapidly.
- The central bank was forced to raise interest rates to 40% in order to defend the currency.
- This did not appease investors, who were still concerned that the country would default.
- The Macri government saw no other way out than to ask for an IMF emergency package.
- When the $50 billion loan was approved, markets calmed down, but this would prove to be short-lived.

The last days of August

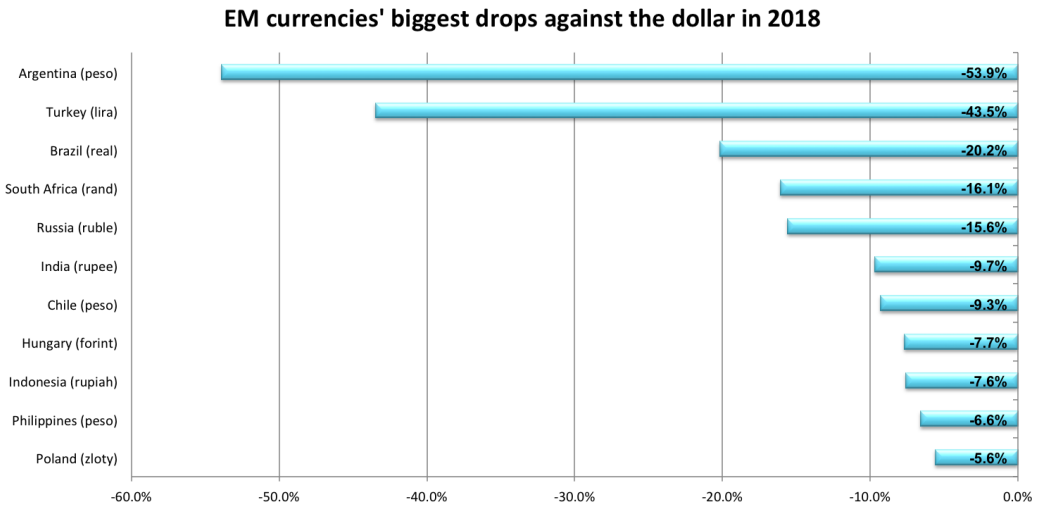
- Recently, doubts about the government's ability to rein in public spending and serve its debt have started to creep up again.
- Argentina's debt is estimated to be approximately 45% of GDP, with a significant portion in instruments like bonds set to expire soon.
- The peso has been losing more ground these past few days, and Argentina was forced to ask the IMF to start releasing part of the $35 billion it had not yet received with no strings attached (that is, without the examinations that the multilateral organization conducts periodically in these cases, looking at variables like inflation and fiscal deficit).
- The plan was to reassure markets that the debt will be served no matter what.
- At the time of this writing, the peso has lost more than 50% of its value in 2018 (the exchange rate went beyond 40 pesos per dollar, when it was 20 in April, and 1 before the 2001 crisis).
- The central bank reacted by raising interest rates to 60% (highest in the world), after a hike of 500 basis points in August proved insufficient.
- The monetary authority promised it would keep rates at those levels at least until December.
- It also increased reserve requirements for banks, seeking to drain pesos from the market.

- The end of the Argentine saga is very hard to predict at this moment.
- The government was counting on GDP growth of 3% and inflation of 15% in 2018, and now we expect a contraction of 1% and inflation of at least 30%.
- The key variable to watch is fiscal discipline: the fiscal deficit is more than 4% of GDP.
- The government has committed, as part of the deal with the IMF, to achieve a deficit of zero in 2020, and a surplus in 2021.
- This, of course, seems hard to envision today.
- Yet what investors should keep in mind, after assessing the evidence, is the degree to which Argentina (and Turkey, for that matter) is not representative of emerging economies in general.
- It is a country that has been following wrong economic policies for decades, and only very recently has sought to clean up its act.
- As an example, we can look at the largest depreciations within EM currencies in 2018: it becomes plainly obvious how exceptional the cases of Argentina and Turkey are.

Figure 2

MANY EM CURRENCIES HAVE LOST VALUE THIS YEAR, BUT THE CASES OF ARGENTINA AND TURKEY ARE CLEARLY NOT REPRESENTATIVE

Source: Innealta Capital using data from Bloomberg.



- The silver lining: although Argentina's troubles are much graver than Turkey's, it has at least a government that is keen on doing the right thing and that can count, unlike Turkey, on international support.
- In fact, we believe the IMF has given strong signals that it will do everything in its power to avoid a default like that of 2001.

4. Thinking long term

- One final issue to consider for those who are looking at long-term growth prospects: where will economic growth come from?
- Economists that have analyzed the data have a clear answer: it will come from developing nations, with Asia playing an outsized role.
- According to a study by economist Homi Kharas (Brookings Institution, formerly at the World Bank), more than half of the world's population will be middle class in 2020.

- In layman's terms, this group includes people who have disposable income after satisfying basic needs.
- He estimates that, of the next billion people that will join the middle class, 88% will come from Asia
- Although China and India are obviously the biggest contributors, countries like Thailand and Vietnam will also be adding many people.
- The global middle class could be spending $10 trillion more by 2022 (in 2011 PPP terms), with roughly 80% of that amount coming from Asia (60% just from China and India).
- By 2030, Asia should be responsible for more than half of the world's middle-class consumption.
- Countries in Latin America are also expected to contribute to the growing middle class, with Brazil and Mexico leading the way (each of them adding more than 100 million people).
- This matters because economic growth is tied to earnings growth.
- Regarding short-term volatility for the remainder of 2018, investors should acknowledge that this is certainly a possibility, but that developing economies, in a stark contrast with the situation at end of the 1990s, are much stronger: many have significant current account surpluses, as well as much more robust financial markets and larger amounts of foreign reserves.

Last revised: August 30th, 2018.

The Homi Kharas paper cited is "The unprecedented expansion of the global middle class: an update," Global Economy & Development, Brookings Institute, Working Paper 100 (2017).

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