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Emerging Market Turmoil Abating?

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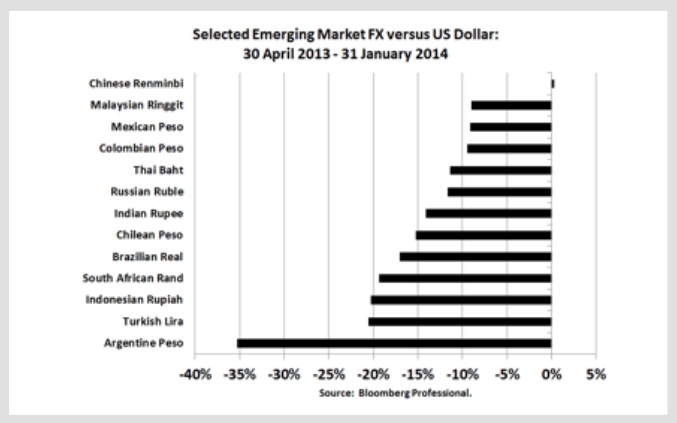
While it is easy to group Emerging Markets (EMs) into convenient and often catchy acronyms, and by extension into one broad asset class, it might not be wise. Just as in the developed countries of the US, UK, Japan and the European Union, structural issues, politics, and fundamental dynamics amongst all the countries are very distinct and differentiated. This differentiation is even more pronounced among EM countries. Yet, to some extent the securities related to EM sector exposures often do share a relative lack of liquidity when compared to developed countries, giving the generalization some credence, especially during market sell-off episodes where liquidity challenges exacerbate the market impacts and lead to the characterization as contagion. What this also means is that market developments that lead to improved liquidity may assist in deterring future episodes of contagion.

This report will examine the causes and mechanics of the recent market contagion regarding EM countries. Our key conclusion is that relative out-performance by the US equity market in 2013, economic growth deceleration in many EM countries, rising political risks, and the mechanics of asset allocation shifts in these less liquid markets were the four primary causes of the contagion episodes in the spring of 2013 and winter of 2013/14. We are not in the camp arguing that the tapering of quantitative easing by the US Federal Reserve was a primary cause of the EM currency market sell-offs. To illustrate the differences among EM countries, we will outline the issues facing Brazil, India, and China, as they manage their currencies in the face of contagion fears and in the context of their own economic and political evolution. We also argue that more active trading in non-deliverable forward agreements (NDFs) on EM FX, along with improved economic conditions in the US and some modest growth in Europe after years of stagnation, will help stabilize EM markets in 2014. This more optimistic market scenario based on an economic perspective, however, is dependent on how political risks evolve.

Causes of Recent EM Contagion

Market contagion often affects unsuspecting parties who have not necessarily done any wrong. In the context of the EM sell-offs in May-June of 2013 and January 2014, we can decompose its probable causes, starting first with a look-back at US markets.

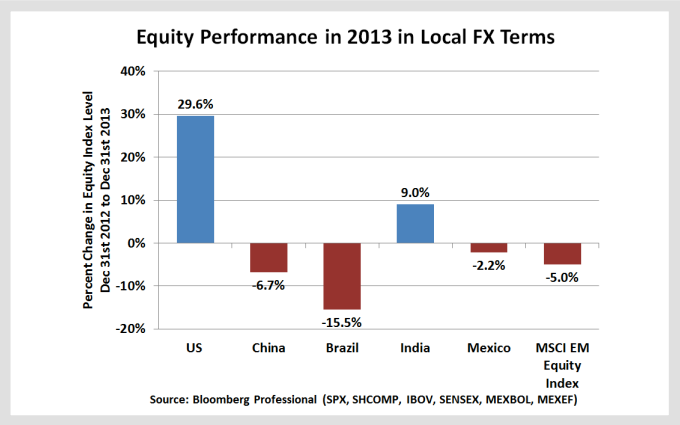
Figure 1.



Despite former Federal Reserve Chairman Ben Bernanke's "Taper Talk" in May 2013 and the official Federal Open Market Committee (FOMC) decision to start tapering asset purchases (QE) in December 2013, the US equity market powered on to new highs. The equity rally occurred even as the US 10-Year Treasury yield went from less than 1.7% at the end of April 2013 to a new range, 2.6% to 3.0%, a full 100 basis points higher than before the "Taper Talk." The ability of US equities in 2013 to effectively ignore the

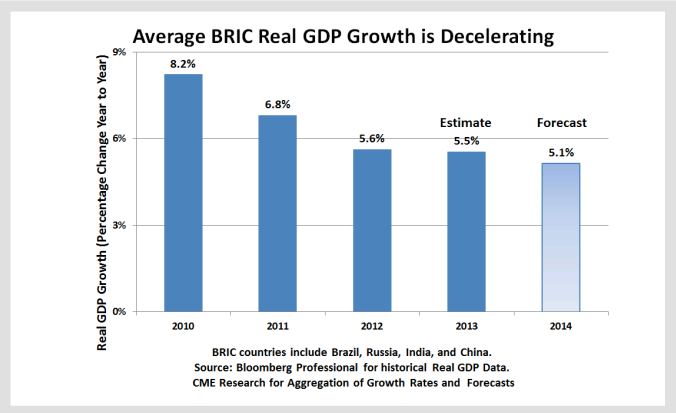
impending policy change at the Fed to taper QE while US bonds were selling-off aggressively strongly suggests to us that QE was not responsible for EM contagion. The buoyant performance of US equities, which were directly in the line of fire of rising US bond yields, leads us to conclude that one of the primary causes of these two episodes of EM contagion was US equity out-performance rather than tapering of QE. With EM equities lagging badly in 2013, it was only natural for asset allocators to shift away from them.

Figure 2.



Relative out-performance of US equities, in turn, was rooted not just in the strengthening of the US economy, but also in the combination of decelerating economic growth and rising political risk across a spectrum of EM countries. As examined in our previous report, "Decelerating BRICs Face Structural Challenges," from December 9, 2013, economic growth in the four largest EMs (Brazil, Russia, India, and China) has been slowing, with weighted average real GDP growth of 8.2% in 2010 declining to an estimated 5.5% in 2013 and a forecasted 5.1% for 2014.

Figure 3.



From a political risk perspective, challenges included the Syrian Civil War, which was complicated by the nerve gas attacks and related US-Russian diplomacy. There were demonstrations in the plazas of Turkey over development plans, as well as a scandal reaching high into the Government. Middle class residents took to the streets of Brazil to demand improved government services, even as the Government was spending generously on the infrastructure for the 2014 World Cup and 2016 Olympic Games. In Thailand, political unrest threatened the electoral process. India's election campaign was heating up with the possibility of a major change in political power. Argentina experienced significant inflation, a currency devaluation, and overall political confusion. Ukrainian political tensions became violent. Some of these tensions eased while others gained momentum over the year, and through it all the US equity market kept on rising to new record highs.

The juxtaposition of a powerful rally in US equities set against decelerating economic growth and rising political risks in many EM countries provided the foundation and incentives for many global asset allocators, such as pensions, endowments, sovereign wealth funds, etc., to shift their asset allocation policies in the direction of US equities and other mature industrial markets, and away from EM countries. This asset allocation shift hit both EM equities and currencies. With any asset allocation shift from a relatively less liquid set of exposures or markets to much more liquid markets brings with it another set of dynamics. When a growing consensus of market participants decide that they are "off" an asset class, the effects of a sell-off are exacerbated by limited liquidity, which heightens the appearance and reality of contagion.

That is, when investors feel the urge to take off risk in a specific asset class, or market conditions dictate a shift of investment climate, a first instinct is to cut positions across the board within the asset class in question. This often happens when large quantities of assets are managed by third parties for a larger fund or institutional investor.

For example, if a large global pension fund or sovereign wealth fund decides to allocate away from EM country exposures, this likely means that it will be withdrawing money from third-party EM asset product managers, who then must quickly raise cash to return to their investors. Often, this means there is little differentiation in what is

sold. Realistically, when a portfolio or fund manager is cutting positions, this is done in a sell-what-you-can and quickly-as-you-can format, with the liquid assets being the first to fly. Because the most liquid exposure in an emerging market is often the corresponding currency, and because sales of any locally-denominated securities will also involve a currency sale to convert the proceeds back to US dollars or some other major currency, the sell-off of EM currencies and assets often has the appearance of depreciation contagion. During this phase, correlations rise among pairs of exposures within the asset class.

Typically, the initial rush is followed by a more prolonged interval of nuanced adjustment. During this phase, EM fund managers move to re-balance exposures to optimize their portfolios for the change in environment and to take advantage of opportunities to purchase underpriced EM assets that may have been left in the wake of the initial flood of selling.

Indeed, it helps to look at the whole period between 30 April 2013 and 31 January 2014, as well as to separate the EM FX performance into three distinct periods. Among spot exchange rates for the EM nations shown in Figure 1, the representative move over this 9-month interval was a depreciation of between 9% and 21%, with Argentina being an outlier with significantly more depreciation (-35%), and the Chinese RMB representing the other extreme with a small appreciation (+0.3%).

A quantitative measure of dispersion over the whole period is to use the standard deviation of the percent changes in the EM spot FX. For this measure, a standard deviation of 0% would indicate perfect correlation – they all moved together and by the same amount. Higher standard deviations indicate more dispersion and less correlation in the movements. For the countries in our sample (See Figure 1) versus the US dollar, the dispersion measure was 8.4% for the whole period. If we take out our two outliers, Argentina and China, the dispersion measure falls to 4.5% for the "clustered" set of EM currencies. In the shorter contagion periods this measure of dispersion was even lower, reflecting a greater association of the EM FX movements and tighter correlations.

The first round of contagion was associated with the Fed's QE "Taper Talk" and ran from 30 April to 5 July 2013. During this period, the standard deviation of the EM FX movements was close to 3.0%, (excluding Argentina and China), which reflects the tight clustering of the EM currency movements that garnered the contagion label. As we have argued, though, the QE "Taper Talk" may have been a spurious association since there were also major political issues and disturbances around the EM world at the time.

The middle period, from 6 July through 31 December 2013, saw less association, with the dispersion measure rising to 5.4% (excluding Argentina and China). This was the interlude where country differences again mattered more than contagion. EM FX rate movements varied over a wider range, with some currencies stabilizing, such as the Russian ruble (+1.4%) and the Mexican peso (+0.3%), while other currencies depreciated significantly, such as the Indonesian rupiah (-18%).

Then, in January 2014, EM FX movements again saw strong associations. Our dispersion measure fell to a low of 2.1% (excluding Argentina and China), indicating a very tight clustering during this brief period.

Note that the contagion periods are relatively short, one or two months, and then country differences start to resurface quickly. While we will discuss this topic again in the final section, we believe that improvements in market liquidity and more active trading in EM currencies may help alleviate contagion episodes, although the situation may get more focused on the specific countries in the headlights of perceived increased political risks.

Three Case Studies

To highlight the differences among EM countries, we want to look at three of the largest – Brazil, India, and China. During our period of interest, 30 April 2013 through 31 January 2014, the Brazilian real fell 17%, and the Bovespa Index fell 15%. Similar to the Brazilian real, the Indian rupee depreciated 14%, but India's SENSEX Index gained 5%. In China, which limits currency volatility, the RMB appreciated nearly 2%, yet the Shanghai Composite Equity Index fell over 6% over the period. What happens to the currency does not necessarily happen to the equities, underscoring the need to analyze each country separately.

Brazil. Brazil is an interesting case in the EM FX and equity turmoil because they had started their interest rate tightening cycle just ahead of the contagion episode. Even so, the Brazilian real was hit fairly hard, as noted, falling sharply over the period in question. The central bank commenced tightening short-term rates in April of 2013, and overall, the SELIC base overnight rate has been raised seven consecutive times, from 7.25% to 10.5%, which is an aggressive move by the central bank. The original rate moves may have been motivated more by inflation fears, while subsequent rate moves were more motivated by the currency decline, which was also perceived as raising potential inflation pressures down the road. Also, and by way of contrast, while Brazil saw its short-term interest rate rise, during the same period, Mexico actually made a small cut in rates. Yet, the Mexican peso was modestly more stable, falling a little less than half of the ground lost by the Brazilian real.

EM economies are typically not as interest rate sensitive as mature industrial economies. Still, the tightening of rates came at a time of challenges for economic growth. Brazilian GDP year-over-year growth is estimate in the 2.0% to 2.5% range for 2013, which is down from 7% during 2010. The slower economic growth, which started well before the currency turmoil, was likely part of the cause for the poor equity performance last year, made worse by the currency sell-off associated with asset allocation shifts away from EM.

Figure 4.

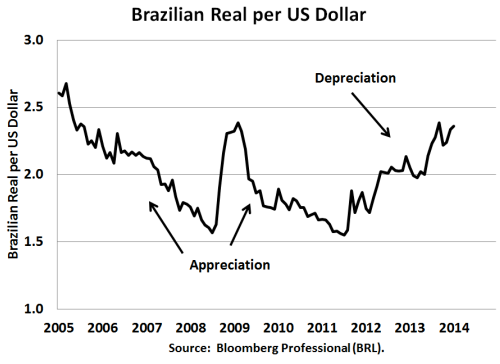
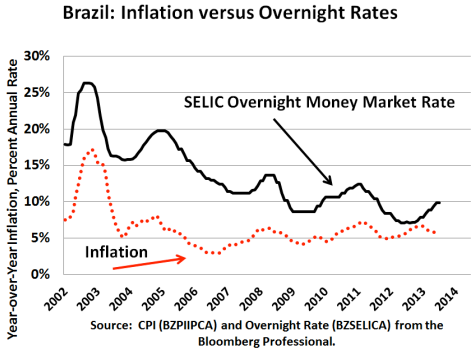


Figure 5.

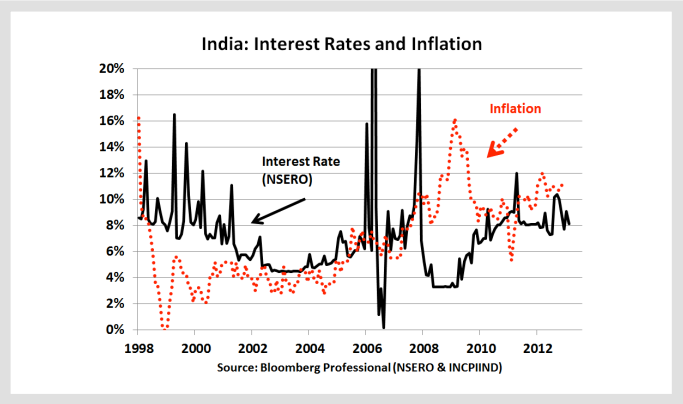


India. India has difficult underlying structural issues. The magnitude and continued growth of subsidies in India are concerning for the government's fiscal health. Oil subsidies in particular are one of the culprits of a widening current account deficit. Currently, India imports a staggering 80% of its oil, which is then heavily subsidized for its citizens. Gold imports are also a factor in the current account deficit even though the tariffs on gold imports have been raised. The Indian current account deficit has been getting larger, with the red ink around 5.8% of GDP.

The role of the current account in currency determination is given added importance by the relatively strict currency and capital controls that India has in place. When countries restrict capital flows, it is much more of a challenge to attract the offsetting capital flows when deficits grow in the current account. For example, India is highly dependent on Foreign Direct Investment (FDI). FDI flow can be temperamental with regards to market participant's preferences and appetite for risk, especially regarding the government's attitude towards foreign ownership of businesses operating inside India. Shorter-term capital flows fill the gap when FDI slows, but only at the price of a lower rupee, which has the potential to push inflation pressures higher down the road. Meanwhile though, Indian equities rose modestly in local currency

terms. The perceived benefits of a depreciated rupee as a longer-term positive factor for earnings of many companies involved in the export sector were not offset as they were in Brazil with rising fears of political risks.

Figure 6.



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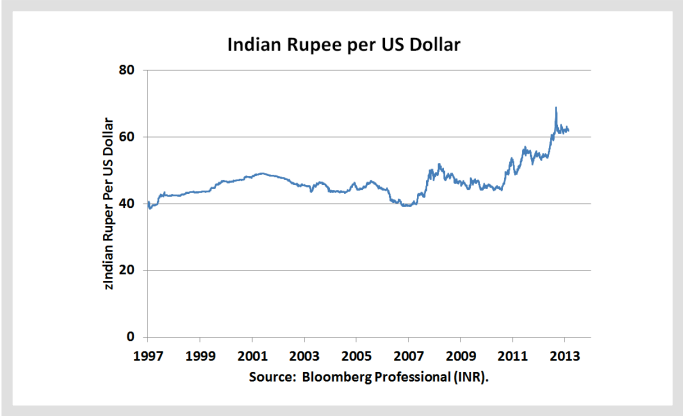


The role of political risk is also rising in India. With only two months to go before the next general election, opinion polls suggest that the Indian National Congress party – the party of Sonia Gandhi and Rahul Gandhi – may suffer a major defeat at the hands of the Bharatiya Janata Party. This may still leave the choice of new Prime Minister up in the air, since it is extremely difficult to amass an outright parliamentary majority. That has not happened since 1989.

China. The previous economic growth model in China was dominated by large-scale infrastructure building with the state playing a key role in many aspects of the economy. As the Chinese economy has grown and modernized, there has been a natural evolution towards diminishing economic benefits from additional large scale, state-directed infrastructure projects. Moving forward, China will likely aim to modernize its services sector and liberalize factor prices including the currency, interest rates and energy prices. For now though, China still has relatively restrictive currency controls and typically limits currency moves in a tight range.

Figure 8.

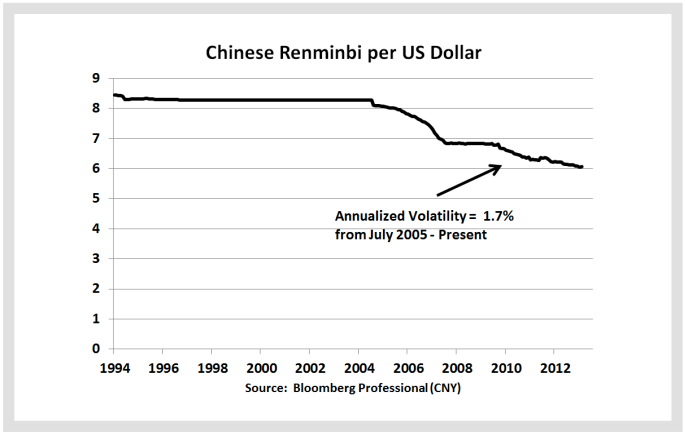
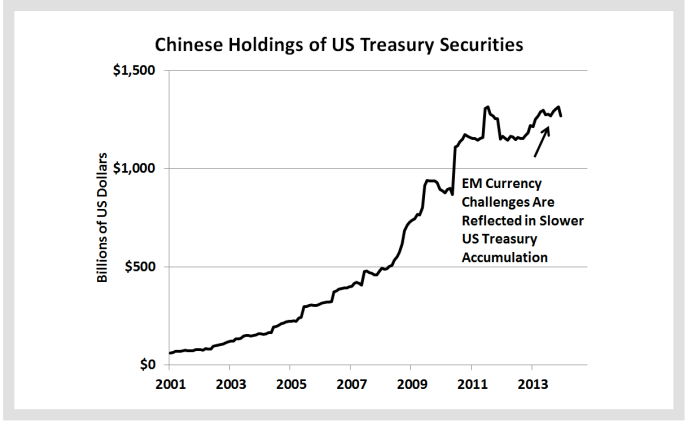


Figure 9.



Capital controls and currency policies, however, may result in a misleading picture of the impact of global asset allocation shifts on Chinese markets. With economic growth in China on a slowly decelerating path from the 10% real GDP of past decades to around 7.7% for 2013, and perhaps only 6.5% to 7.0% in 2014, Chinese equities were not shielded from the general sell-off in EM equities. The Shanghai composite index lost 6.7% for all of 2013 and fell a further 4% in January 2014.

Also, we note that countries that seek to limit exchange rate volatility will tend to see that volatility re-channeled into variations in foreign reserves – the basic tool for containing currency movements. Indeed, China was actually a net seller of US Treasuries in December 2013, suggesting there was implicit downward pressure on the RMB.

Scenarios Going Forward

We see Emerging Markets as becoming more positive on economic grounds while remaining risky on political grounds. We draw several conclusions from our overall EM analysis as well as our three case studies.

First, the EM currency sell-off in 2013 and early 2014 was driven by the combination of relative out-performance in US equities, decelerating economic growth in many EM countries, and rising EM political risks, and was exacerbated by the relative lack of liquidity in EM currency and equity markets. Notably absent from this explanation of EM FX contagion is the cause cited by many market analysts, namely that the Fed tapering of QE was mostly to blame for creating an EM risk-off market environment.

Second, although commentators frequently characterize this episode as "EM sector contagion," in fact there were large and striking differences in FX and equity market performances among EM countries. The most volatile currencies were those for which home-country political risk raised its head, such as the Argentine peso and Turkish lira. Moreover, countries with relatively stringent currency controls were not immune. The Indian rupee depreciated sharply while China shifted to being a net seller of US Treasuries to keep its currency in the desired range in the face of implied downward market pressures.

Third, following any storm in the markets, two competing scenarios for the future typically emerge: (a) the storm will abate and leave selected buying opportunities in its wake, or (b) the storm will intensify, with yet further FX and equity depreciation. For the present, in our view, the probabilities of the storm abating have the upper hand. This is because more robust growth in the US, and even some modest economic improvement in Europe, will provide a solid foundation for global trade flows on which EM FX can stabilize. From a political perspective, however, we see a continuation of relatively high risks in many countries. This leads us to expect potentially wide divergence in FX and equity market performance among EM countries in 2014, depending on the evolution of local political risks.

Fourth, and encouraging for the more optimistic scenario, is the continuing development of more EM currency trading activity in London, on CME Group global electronic platforms, and in regional off-shore centers and exchanges. Moreover, there is more trading activity even in the NDF currencies where there are exchange rate controls and other capital flow restrictions for domestic purposes. More active currency trading is a sign of incremental improvements in global economic integration, and it means that markets are developing to provide needed liquidity. This trend helps establish stronger linkages such that EM countries can benefit more quickly from any improvement in economic conditions in the mature industrial world.

Moreover, because of contagion episodes, there are EM countries and central banks that often feel that their currencies are victims of the speculative element in the markets. We take a different view that is heavily influenced by the degree of liquidity available in a currency. Where liquidity is lacking, global asset allocation shifts are likely to be more violent and feed contagion. Where liquidity is seen as relatively good and trading activity is more active, contagion is less likely. There is a parallel with capital controls and flows. Countries that restrict capital flows make it hard to take money out so foreign investors are circumspect about investing – putting capital into the country. By contrast, countries that allow a freer flow of capital and currency movements actually have a relative

advantage in attracting capital. Put another way, if one tells me I can take money out, I will put it in, and if one tells me I cannot take money out, I will not put it in.

Thus, improvements in liquidity and trading activity have the potential to allow for country differences to shine through and to reduce the probabilities of future contagion. There are encouraging signs that even amidst the current contagion liquidity is likely to improve over the next few years, making future contagion less likely or possibly less severe.

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