September 2013

Emerging Markets Commentary

Are We Heading for an Emerging Markets Currency Crisis?

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Are We Heading for an Emerging Markets Currency Crisis?

- While recent currency weakness in emerging markets has echoes of the mid-1990s crises, today's dynamics are different.
- External debt is much lower today, exchange rates are floating, and currency reserves are large.
- The market has been punishing those countries with current account deficits (such as Brazil, India, Indonesia, Turkey, and South Africa), while other emerging markets currencies have held up relatively well.
- Even the countries with current account deficits have, for the most part, lower debt, smaller deficits, and more reserves than during previous crises. South Africa and Turkey appear most at risk.
- Eventual Federal Reserve tapering and the end of QE will continue to put pressure on emerging markets currencies and fixed income, given recent fund flows and a rising U.S. dollar, but an external debt crisis is not in the making.
- A Chinese hard landing remains the bigger risk for emerging markets today; this could trigger broader capital flight. China deleveraging needs to be monitored closely.
- Emerging markets equities have held up better to date than emerging markets debt, but there are wide divergences across markets and sectors, based on valuations and fundamentals.

Recent weakness in emerging markets currencies and asset classes has investors asking, "Are we heading for a repeat of the Asian financial crisis?" We are of the view that an emerging markets crisis similar to what occurred in the 1990s is not brewing. This short paper offers some thoughts on the prospects for an emerging markets crisis and the headwinds facing emerging markets assets in the near term.

To refresh, the previous Asian financial crisis developed amid a buildup of US$-denominated debt in Asian banking systems. This was especially the case in Southeast Asia (ASEAN), with many countries having pegged exchange rates to the U.S. dollar. Those US$ debts (often short-term loans) were lent long to local projects, creating both a currency and maturity mismatch between assets and liabilities. Most ASEAN countries were running current account deficits and had low FX reserves—a situation viewed as stable so long as the currency pegs held. However, once the currency pegs were broken, defaults rose given currency mismatch. While there were various catalysts for the devaluation of the Thai baht in the summer of 1997, the increase in the federal funds rate from 3% in early 1994 to 5.5% in 1997 played a part, as it helped strengthen the U.S. dollar and made maintaining the pegs more costly. Indeed, the rapid rise in the federal funds rate helped trigger the Mexican peso crisis in 1994, and a similar dynamic hit Russia in 1998 and Argentina and Brazil in 2001.

Today's situation is different in many respects. First, no major emerging markets country has a pegged exchange rate.[1] Second, external debt levels and current account deficits are smaller, while FX reserves are much larger and inflation much lower. While this is broadly true, there are regional differences (Pages 5–6).

Asia remains in the best shape with positive current accounts, large FX reserves, and much lower debts. This is especially the case for ASEAN, which has seen foreign bank claims as a percentage of GDP fall from 30% in 1997 to 14% today.

For Latin America, current accounts have slid back into deficit, similar to the late 1990s, but external debt is lower and reserves are much higher. For European, Middle Eastern, and African countries, the fundamentals look more troubling, with large current account deficits and high and rising external debt. Much of Eastern Europe had its own version of the Asian crisis in 2008 (given pegged rates and heavy borrowing in euros) and is still reeling from the broader Eurozone crisis. However, these currencies have already fallen substantially from their 2007–08 levels.

Still, overall emerging markets debt burdens appear manageable, with many countries maintaining FX reserves equal to or greater than external debt levels (Page 7). As such, capital outflows and falling currencies are unlikely to trigger defaults on external debt.

While outflows may raise the cost of borrowing in some countries, especially for corporates in the US$ market, risks do not seem to be systemic. In fact, the drawdown in currencies in 2008 was more severe and did not trigger a funding crisis.

Today, prolonged low interest rates and QE in developed markets have encouraged capital to flow into local emerging markets fixed income markets in search of yield, pushing up currencies. This tide of money is now starting to flow out, putting downward pressures on currencies.

So far, the markets have been discerning, hitting hardest those countries running current account deficits, such as Brazil, India, Indonesia, South Africa, and Turkey. While these currencies have seen double-digit declines, emerging markets currencies as a whole are down some 7% year-to-date. That is not much weaker than the median developed markets currency year-to-date amid a generally strong U.S. dollar (Page 8).

Page 9 is our attempt to group those currencies that are most vulnerable, based on the size of the current account balance and real exchange rate valuation. Countries with current account deficits and expensive currencies are most vulnerable, including Brazil and Indonesia. Most Asian currencies, which are either undervalued or have large current account surpluses, have held up rather well year-to-date, aided by large currency reserves that help buffer outflows.

[1] Hong Kong maintains a hard peg to the U.S. dollar, as does Saudi Arabia and other Gulf States. The Chinese renminbi is not pegged to the U.S. dollar and has been appreciating since 2005, although it is managed by the People's Bank of China. There are smaller frontier economies with pegged rates.

Looking forward, the eventual end of QE will see fund flows reverse and likely increase volatility as currency and bond markets adjust. As the Federal Reserve's recent decision to maintain its bond purchases highlights, actual interest rate hikes in the United States and other developed markets are unlikely until at least 2015, and then from a low base. Thus, emerging economies have time to adjust before pressures become too acute. Some countries will have to fight the currency weakness with higher interest rates, with Brazil, India, and Indonesia already doing so. These countries also face inflation pressures, which further necessitates rate hikes. Rising domestic rates will weigh on already slowing growth in these economies; some corporates may come under pressure in India and Indonesia given their larger share of US$ borrowing. Other countries with current account surpluses actually welcome the currency weakness as it may help exports, especially if U.S. and even European demand begins to recover.

In sum, while recent currency weakness has echoes of past crises, the dynamics today are not for a repeat of 1998 in Asia or 1994 in Mexico. Pages 10–14 show that for even the weaker group of emerging markets economies, their debt levels, reserves, and deficits are better today than in previous crisis periods,[2] save perhaps South Africa and Turkey.

The bigger risk for Asia and emerging markets in general is not default on external debt but a hard landing in China. Such an event could trigger wider capital flight from emerging markets, hit growth, and trigger corporate defaults. Recent data seem to imply the Chinese economy is stabilizing after slowing early this year. Eventual Fed tapering should have less impact on China, given the closed capital account and that China's debt accumulation is almost entirely domestic driven. The renminbi has actually appreciated this year. Still, we are concerned about the run-up in debt in China, the unwinding of which is likely to weigh on growth going forward. For emerging markets, watching how China manages its own deleveraging process is critical. Page 15 provides some insight into those emerging and developed markets economies most vulnerable via trade exposure to China—predominantly commodity exporters and export-oriented economies in Asia.

Still, Fed tightening and US$ strength have often been a headwind for emerging markets asset classes. Emerging markets debt appears most vulnerable, given the strong fund flows in recent years. Page 16 shows how over 2010–12, $122 billion flowed into emerging markets debt mutual funds, compared to only $84 billion for emerging markets equity funds. Recent outflows have been abrupt (roughly $25 billion), which has only served to reverse earlier inflows, leaving year-to-date net flows only modestly lower, implying there is potential for further pullback. While emerging markets debt bond yields (both local currency– and US$-denominated) have risen sharply recently, they are now only back to levels we would consider fairly valued, and not crisis-like levels. Emerging markets currencies on average are fairly valued, but this masks a wide range of fundamentals and few are cheap, especially compared to a decade ago (Pages 17–18).

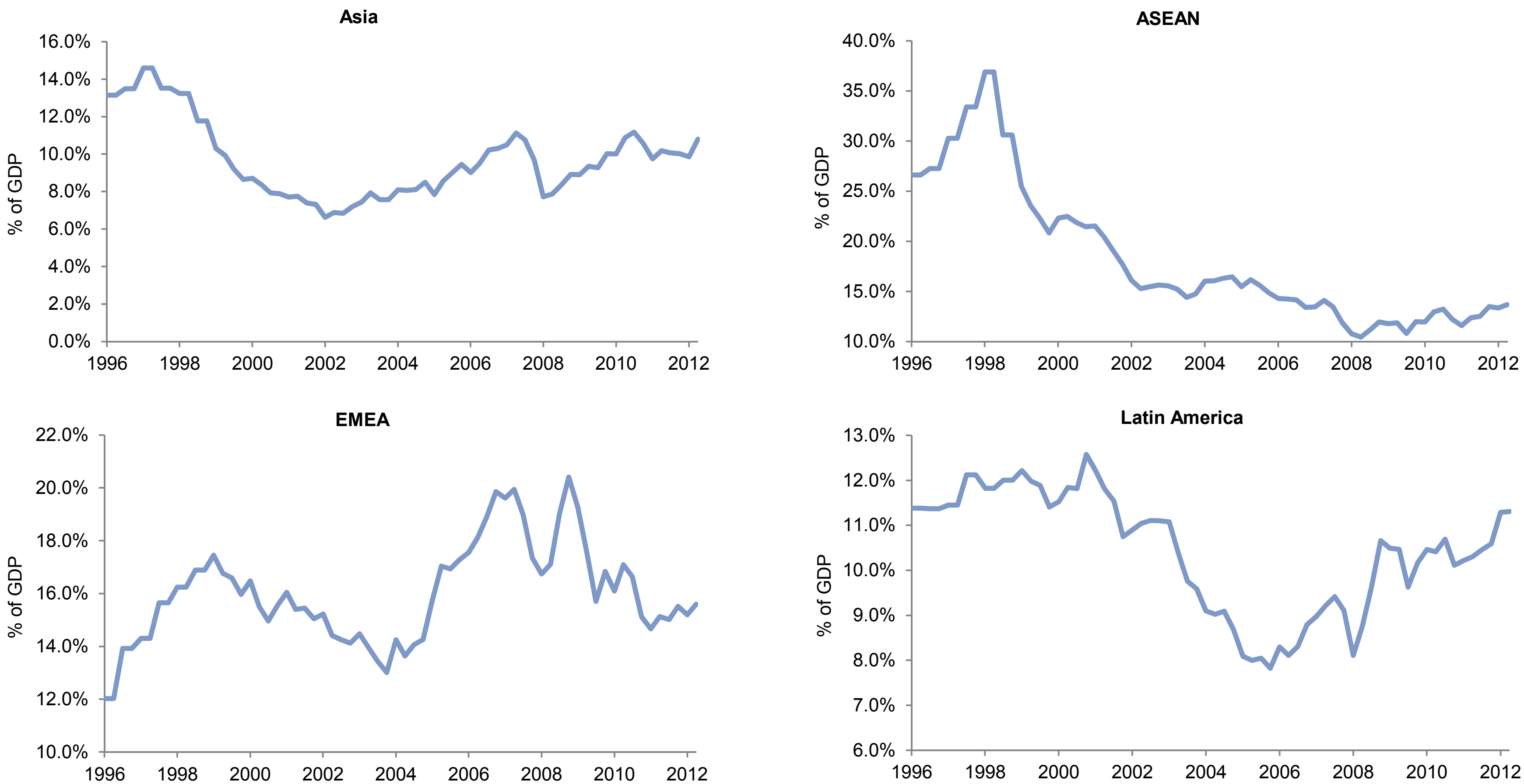
[2] Brazil had crises in the 1980s and 2001, India in 1991, Indonesia in 1998, and Turkey in 2001.

We do not yet see a compelling buying opportunity in emerging markets debt, although clearly lots of froth has been taken out of the market. Given the divergence in emerging markets fundamentals and performance recently, active management in emerging markets debt remains quite compelling today, and we still favor the broad, open mandate managers that can assess relative value across emerging markets fixed income segments and currencies.

Emerging markets equities, meanwhile, have held up relatively well amid the currency wobbles, especially those countries with current account surpluses and low valuations. This adds to the existing divergence across the emerging markets equity space among sectors and countries (Pages 19–20). ■

Foreign Bank Claims Are Lower Today, Especially for ASEAN

Emerging Markets Regions: International Bank Claims as a Percent GDP
Fourth Quarter 1996 – First Quarter 2013

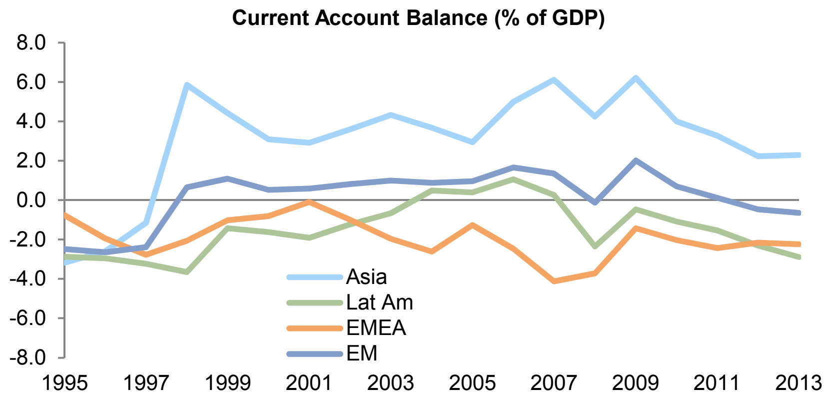


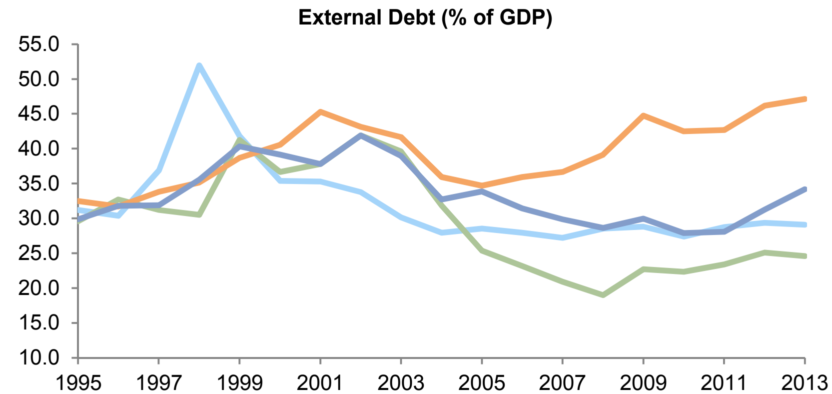
Sources: Bank for International Settlements, Oxford Economics, and Thomson Reuters Datastream.
Note: Asia and ASEAN exclude Singapore and Hong Kong.

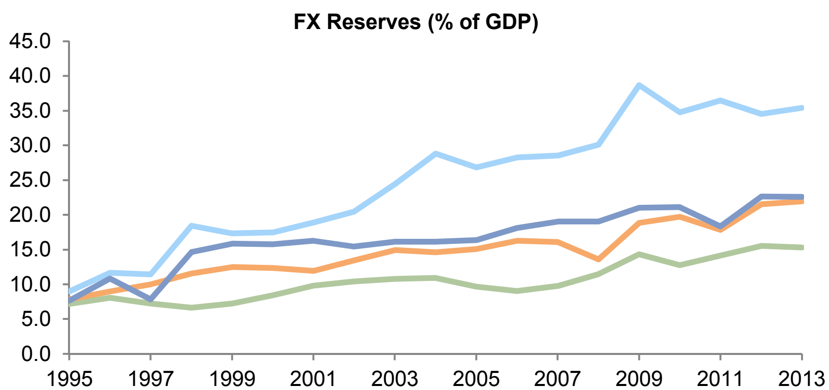
Current Account Deficits & External Debt Levels Lower; FX Reserves Much Higher

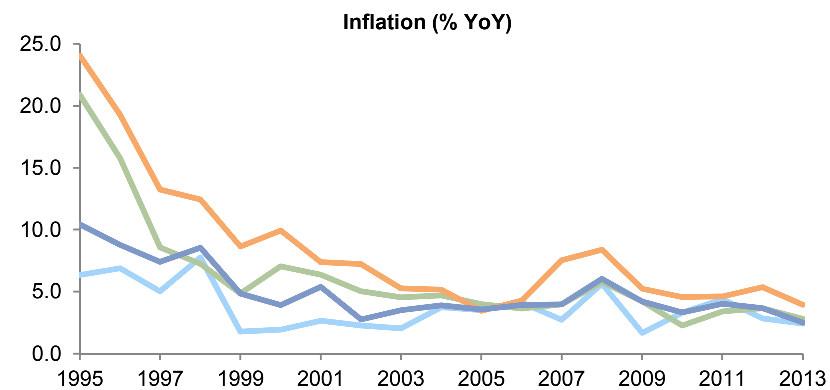
Emerging Markets Macro Indicators

1995–2013







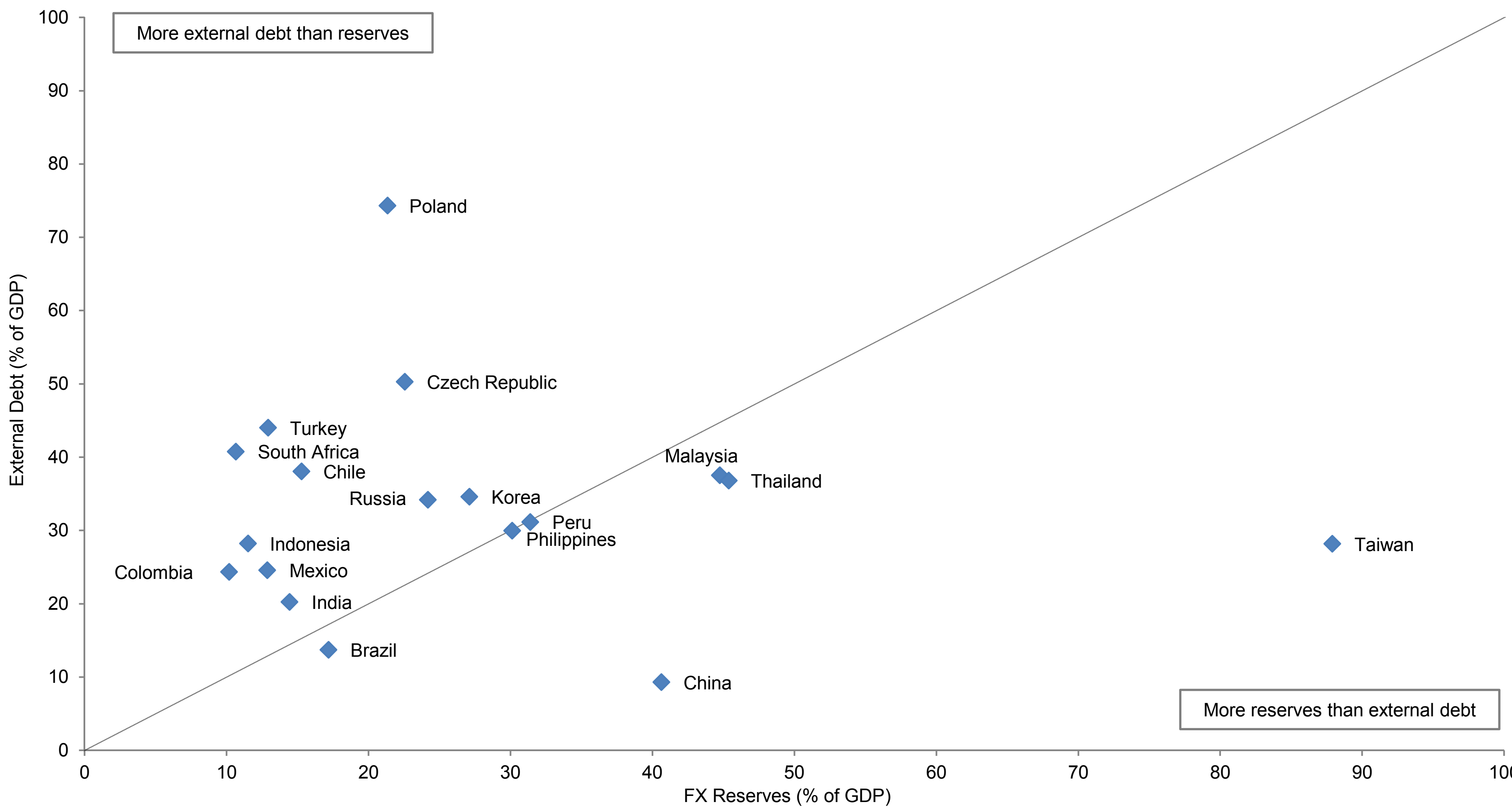


Source: Thomson Reuters Datastream.

Notes: The current account balance data is the average of countries in the respective regions while the external debt and FX reserves data are the median of countries in the respective regions. Forecasts for 2013 are from Oxford Economics.

External Debt Burdens Are Manageable for Most Countries

FX Reserves vs. External Debt Within Emerging Markets
As of 2013

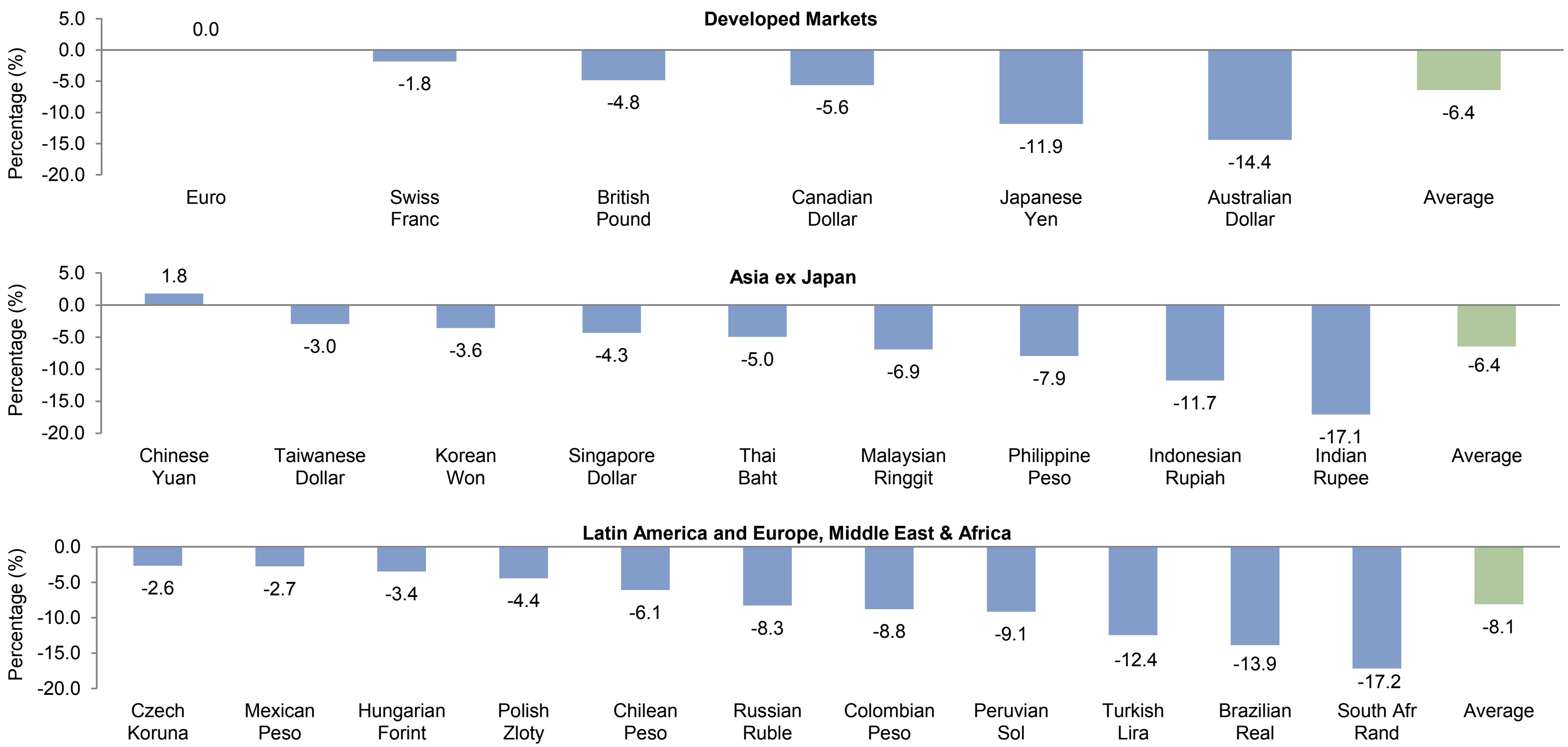


Sources: Oxford Economics and Thomson Reuters Datastream.
Note: Both external debt and FX reserve data are 2013 forecasts from Oxford Economics.

EM Currency Weakness Reflects Fundamentals

Currency Movements Versus the U.S. Dollar

December 31, 2012 – August 31, 2013



Source: Thomson Reuters Datastream.

Note: We have excluded the Hong Kong dollar from the average calculations for Asia ex Japan given its hard peg to the U.S. dollar.

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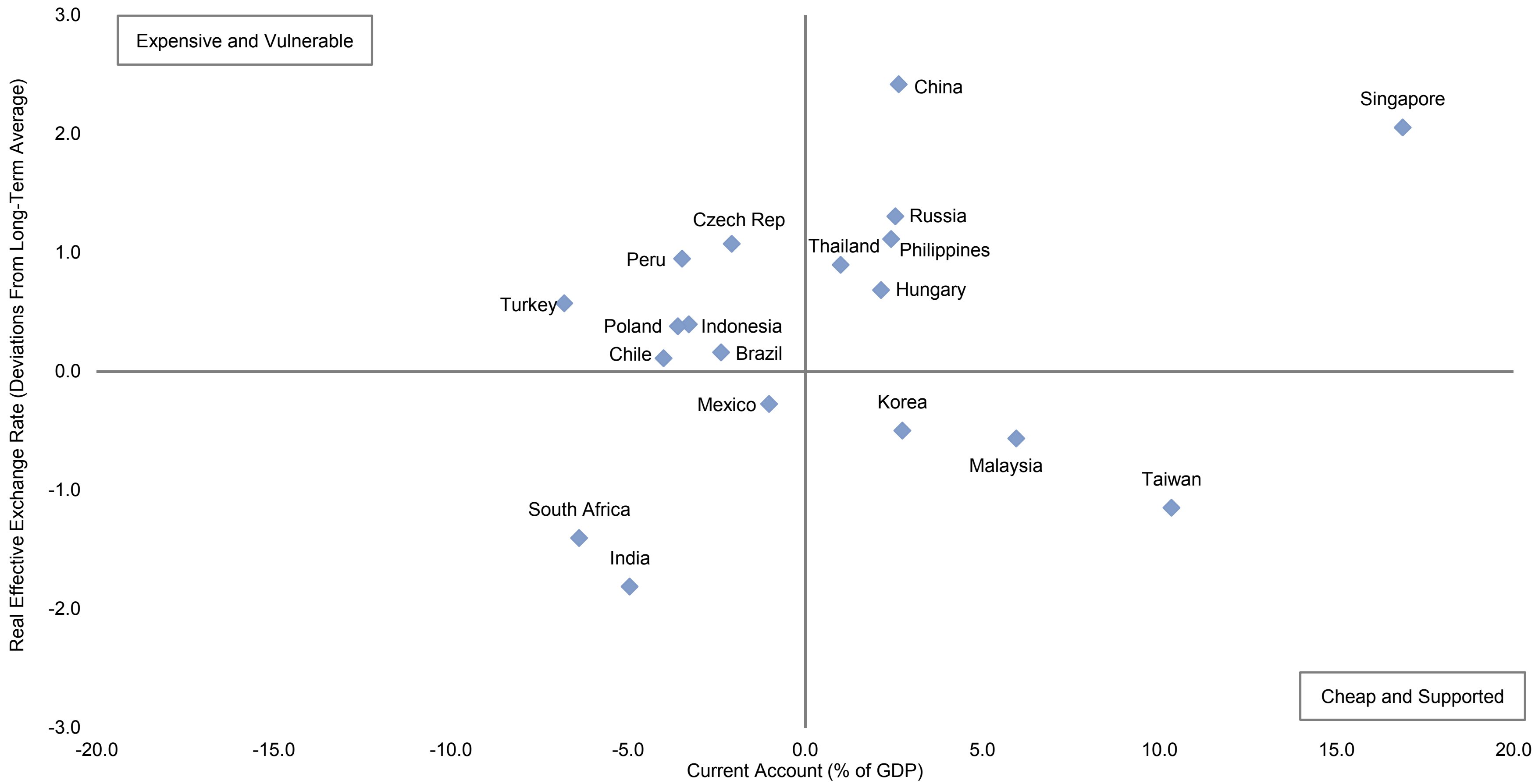
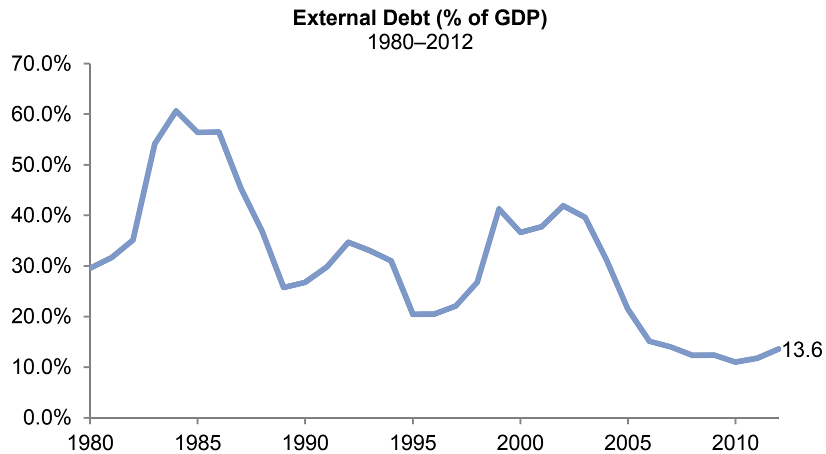
But Several EM Currencies Remain Vulnerable Due to Current Account Deficits

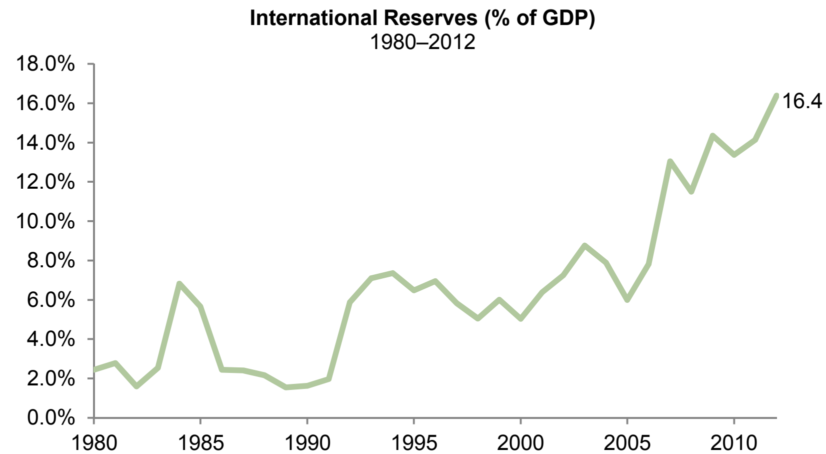
Emerging Markets Currency Vulnerability
As of August 31, 2013

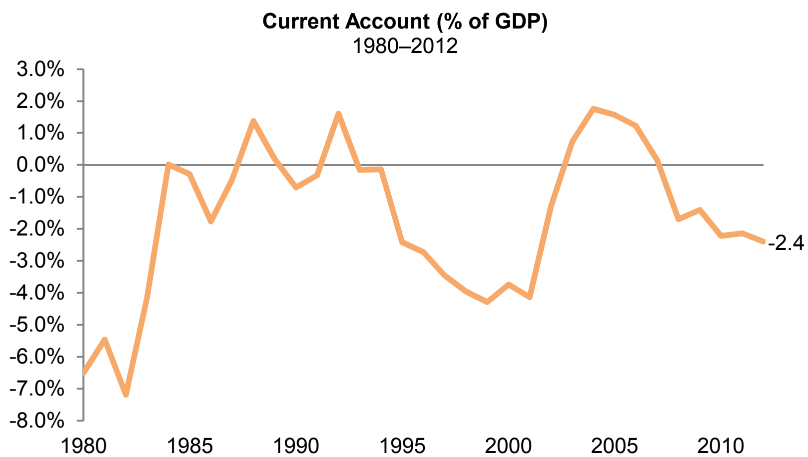


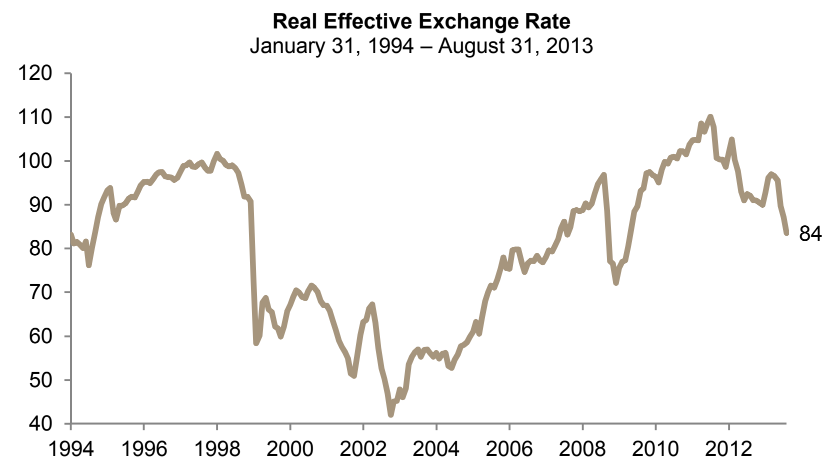
Sources: Bank for International Settlements, International Monetary Fund, and Thomson Reuters Datastream.
Notes: Current account data are 2013 forecasts from IMF World Economic Outlook publication. The data were last updated in April 2013.

Brazil Macro Data



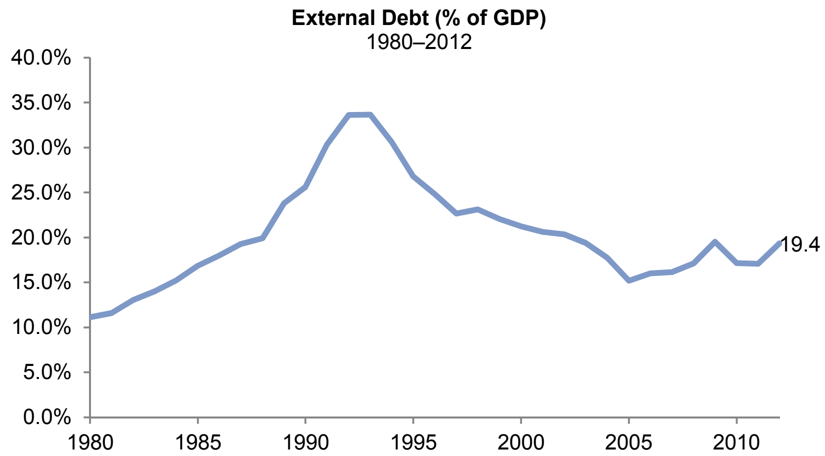


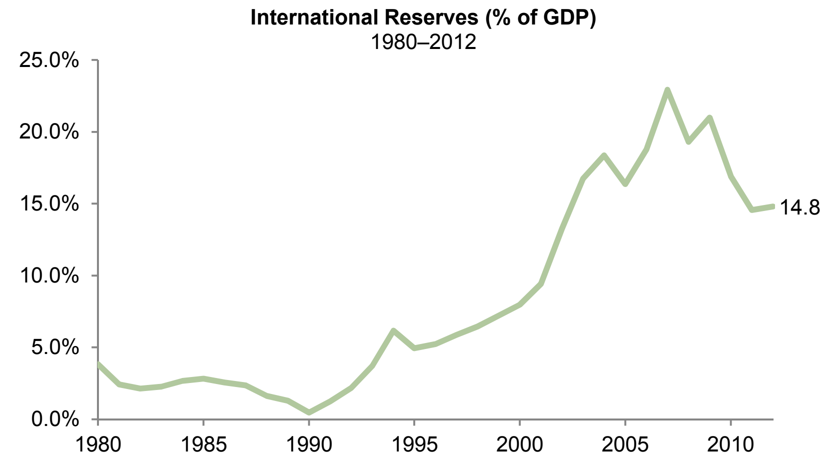


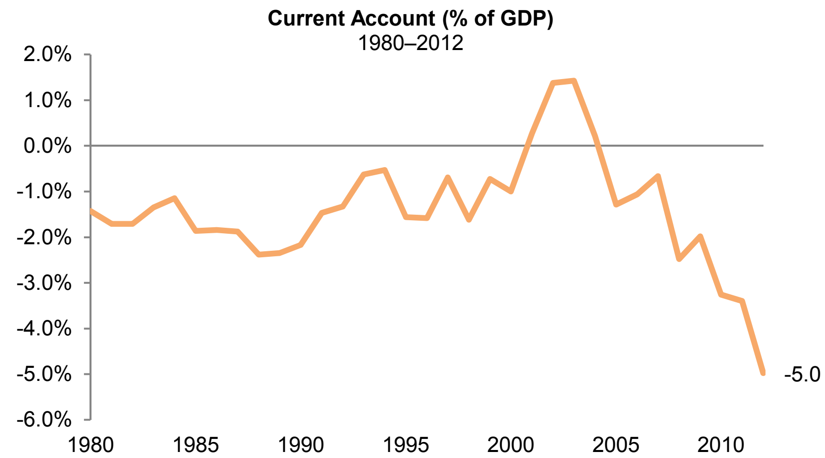


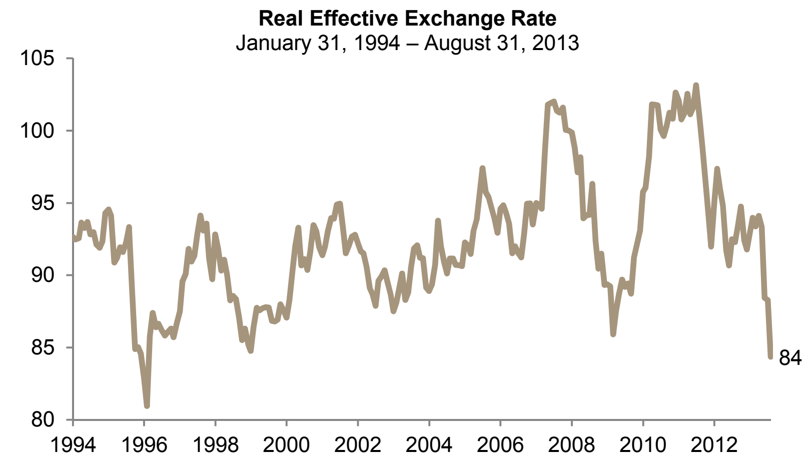
Sources: Bank for International Settlements, Oxford Economics, and Thomson Reuters Datastream.

India Macro Data





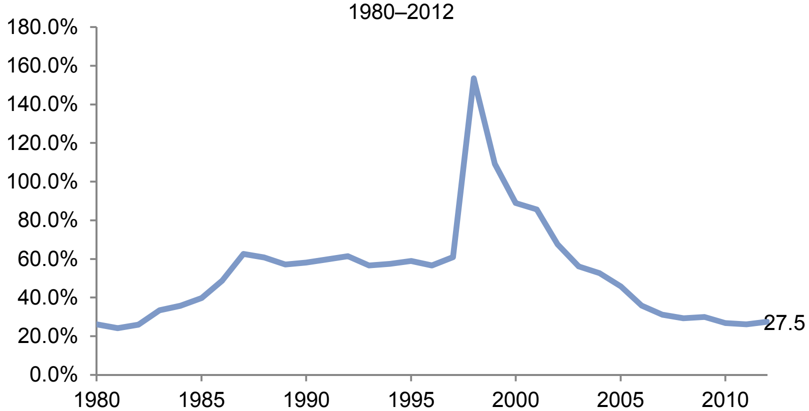




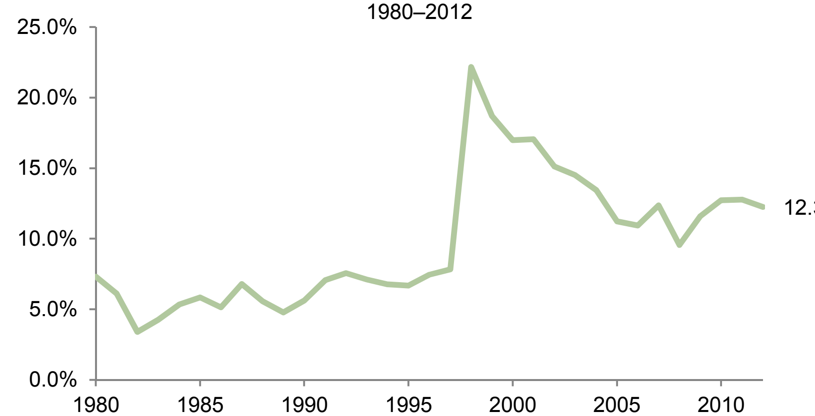
Sources: Bank for International Settlements, Oxford Economics, and Thomson Reuters Datastream.

Indonesia Macro Data

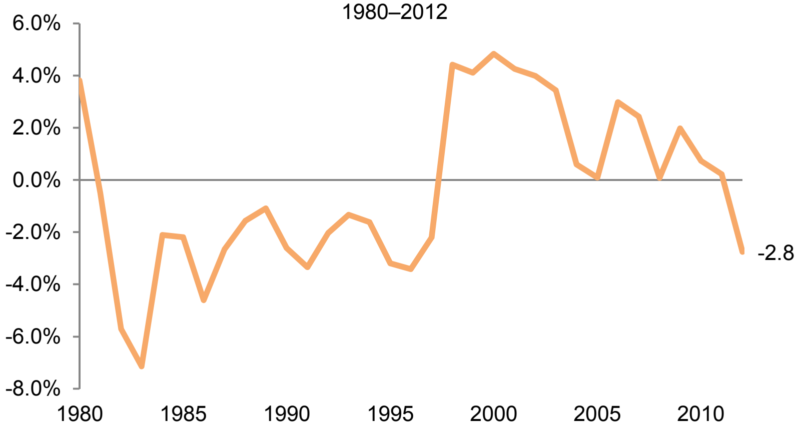
External Debt (% of GDP)
1980–2012



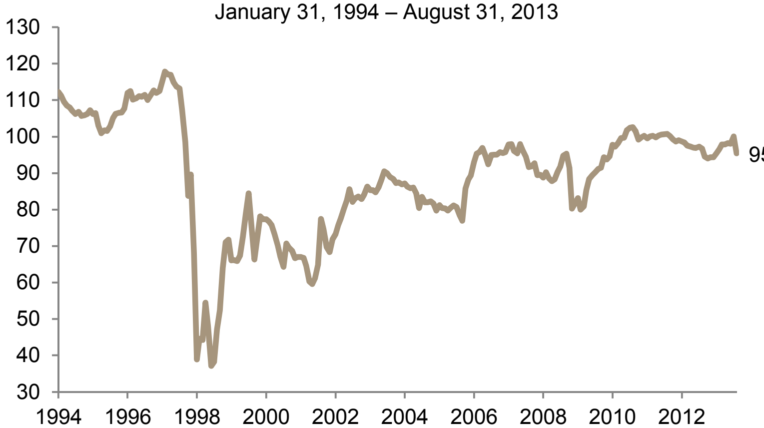
International Reserves (% of GDP)
1980–2012



Current Account (% of GDP)
1980–2012



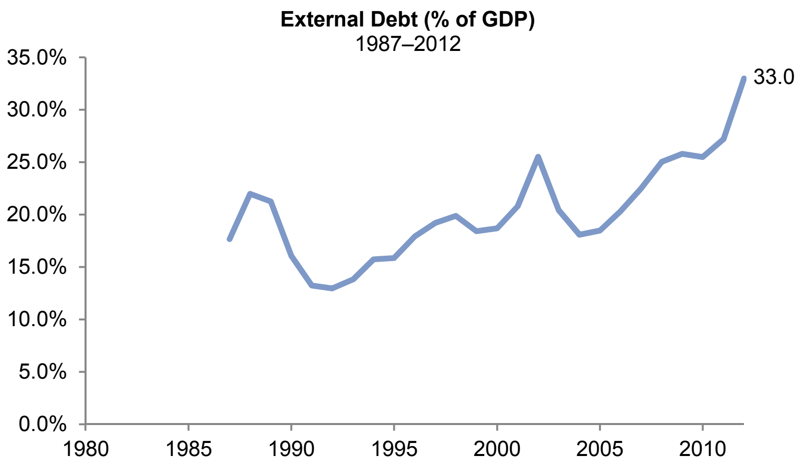
Real Effective Exchange Rate
January 31, 1994 – August 31, 2013

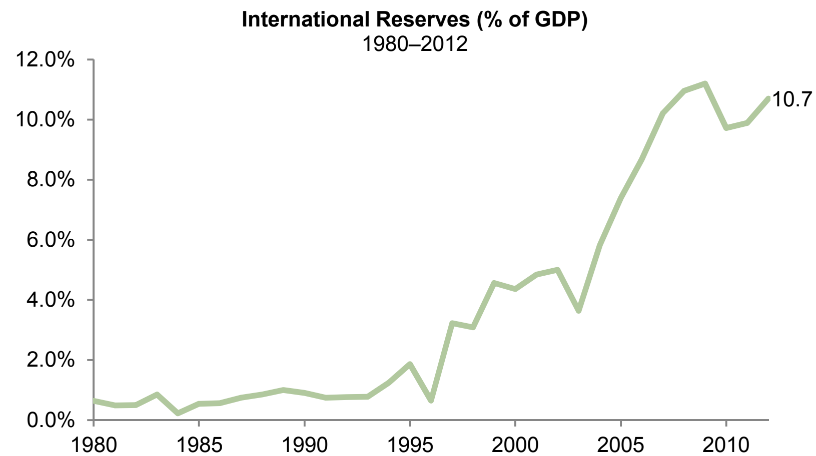


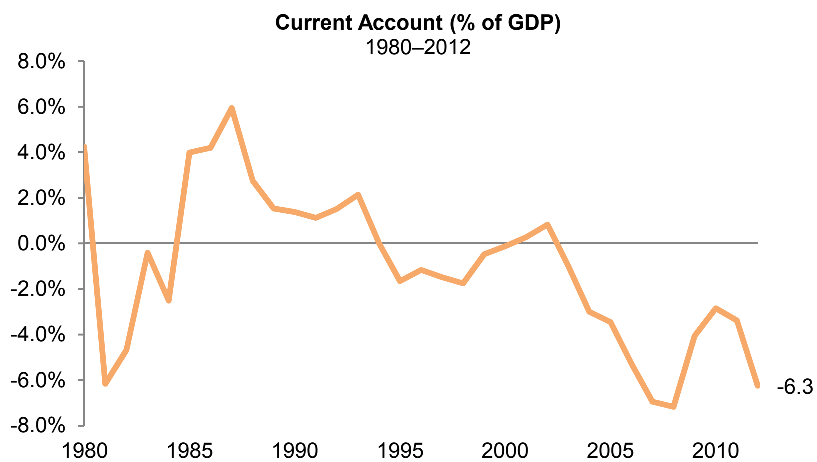
Sources: Bank for International Settlements, Oxford Economics, and Thomson Reuters Datastream.

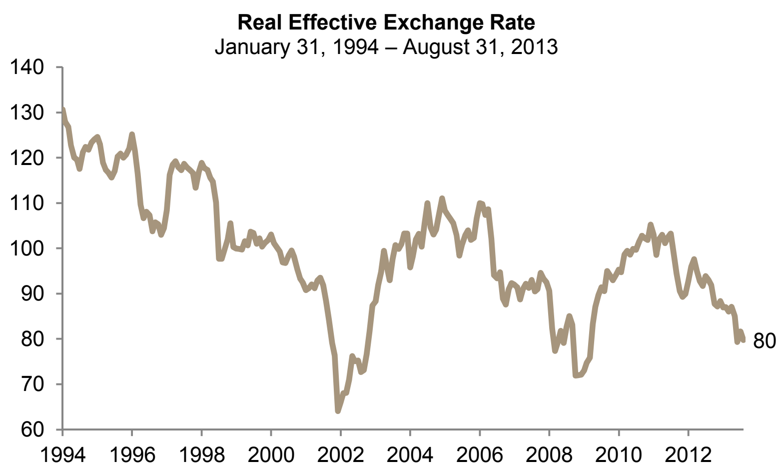
South Africa Currency Fundamentals

South Africa Macro Data



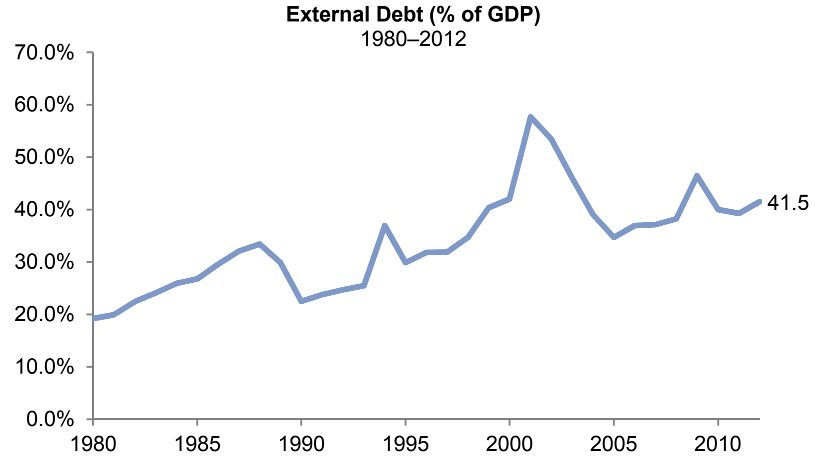


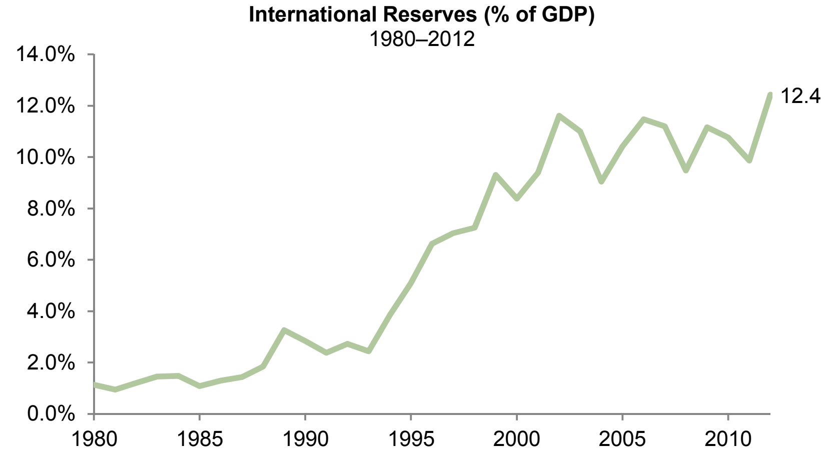


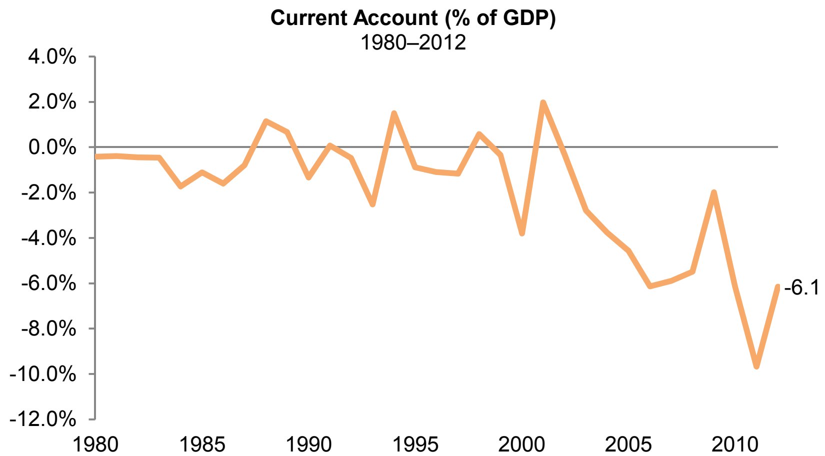


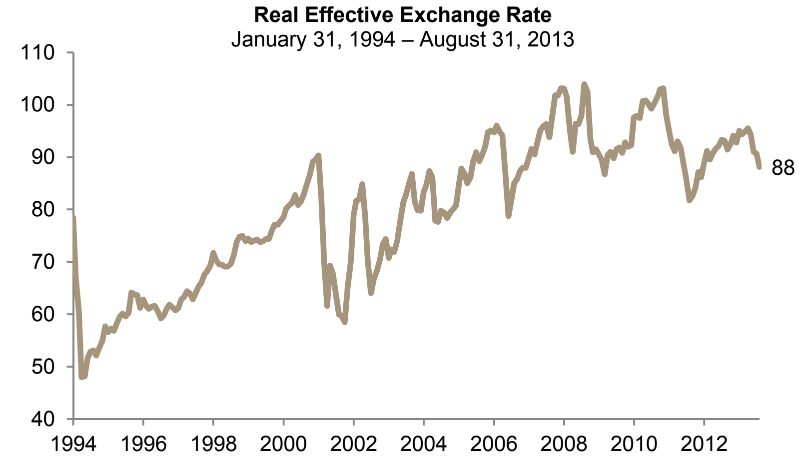
Sources: Bank for International Settlements, Oxford Economics, and Thomson Reuters Datastream.

Turkey Macro Data





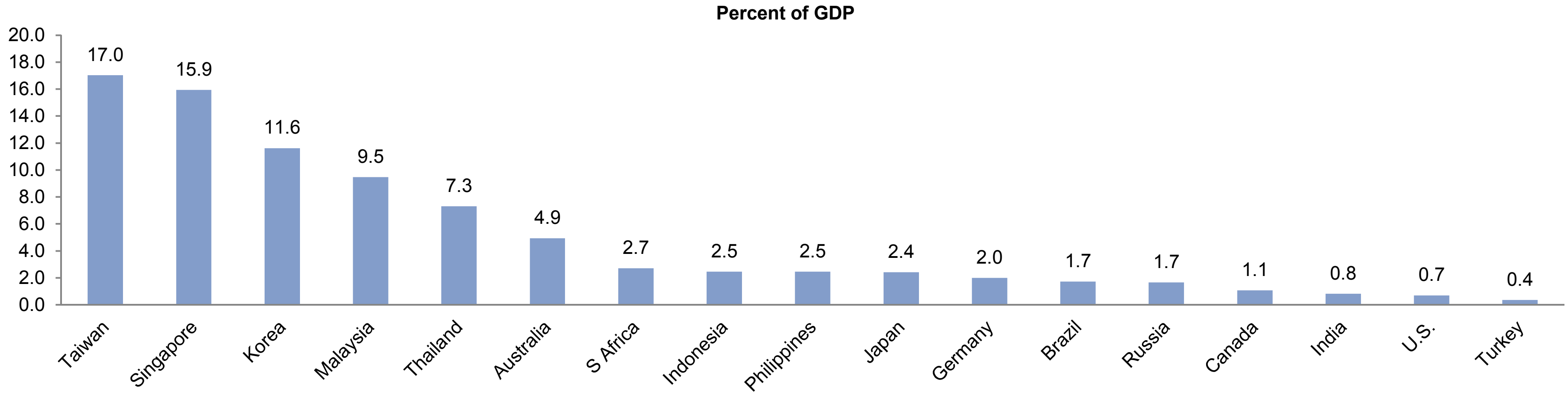


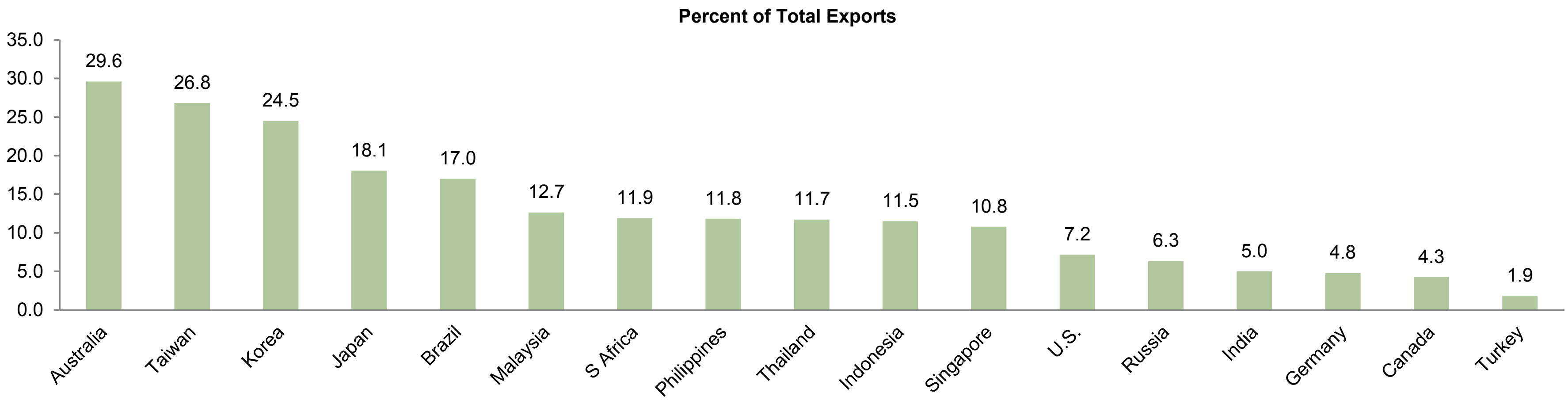


Sources: Bank for International Settlements, Oxford Economics, and Thomson Reuters Datastream.

Exports to China

As of December 31, 2012



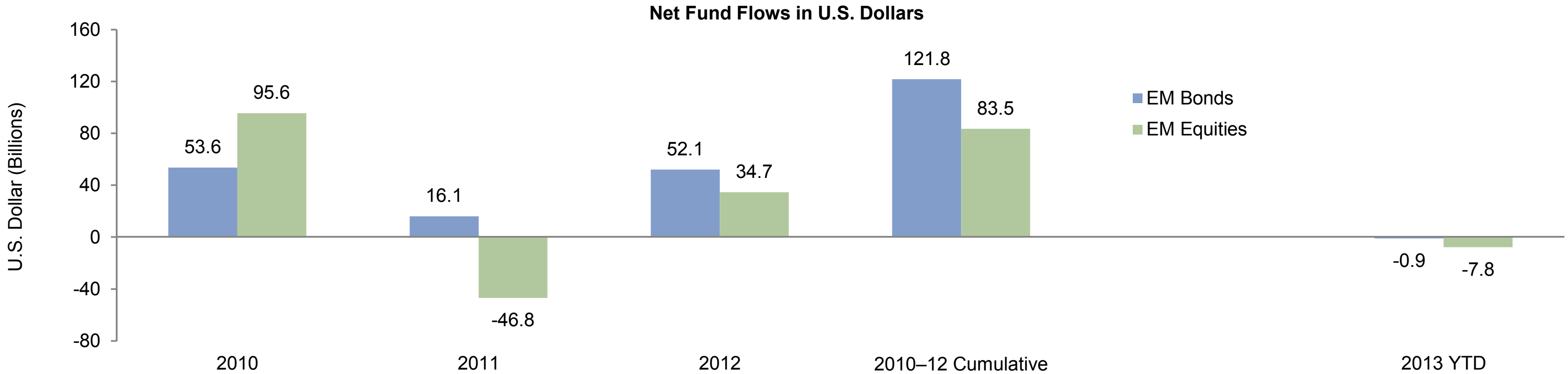


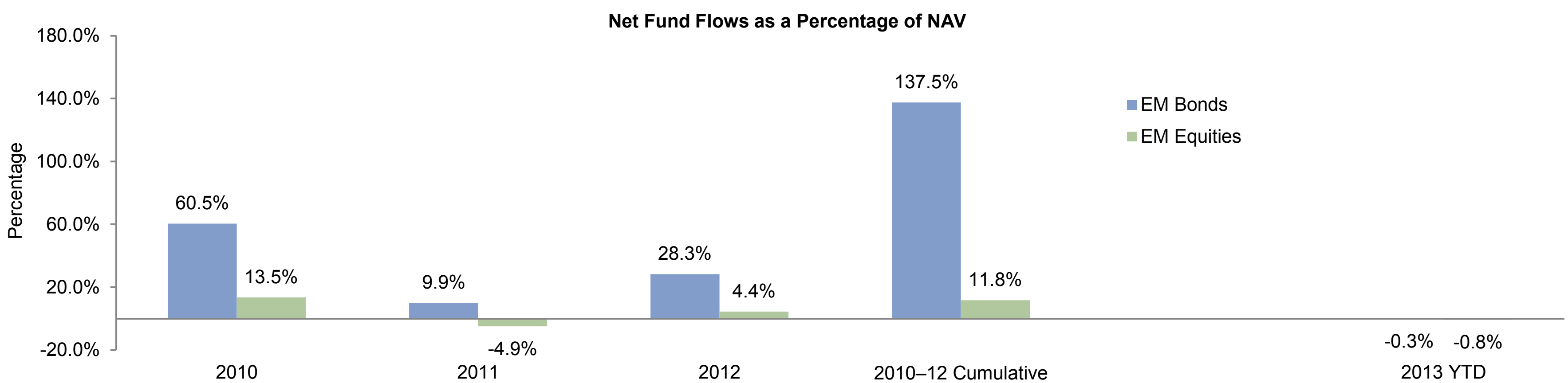
Sources: International Monetary Fund and Thomson Reuters Datastream.

Given Recent Flows, End of QE Could See Further Pressure on EM Debt

Emerging Markets Mutual Fund Flows

As of August 31, 2013





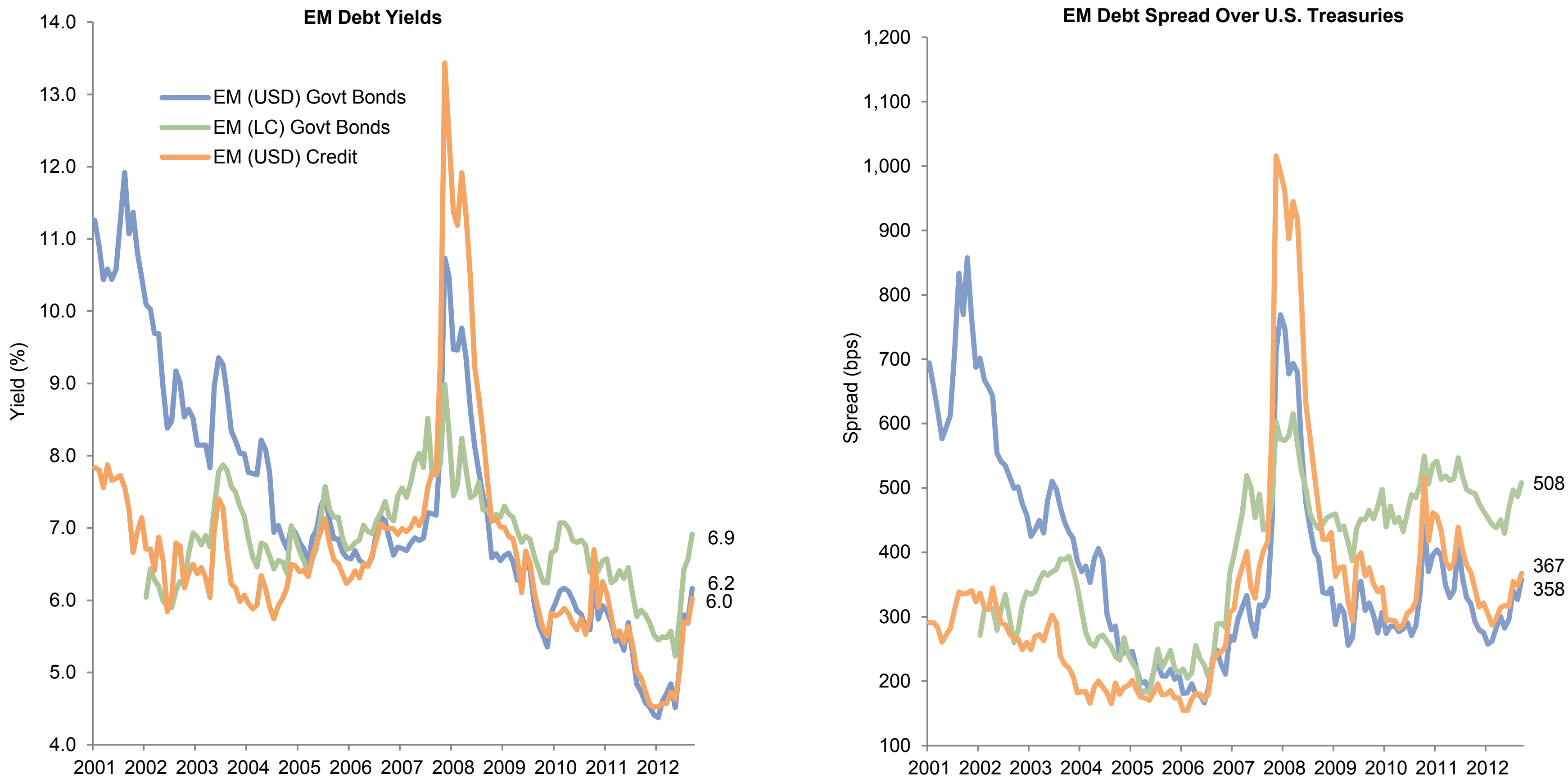
Sources: BofA Merrill Lynch, EPFR Global, and International Monetary Fund.

Note: The bottom chart is calculated by taking the net flows from each year and dividing the figure by the previous year's net asset value.

Emerging Markets Debt Yields Have Risen Sharply and Back to Fairly Valued

Emerging Markets Debt Yields and Spreads

December 31, 2001 – August 31, 2013

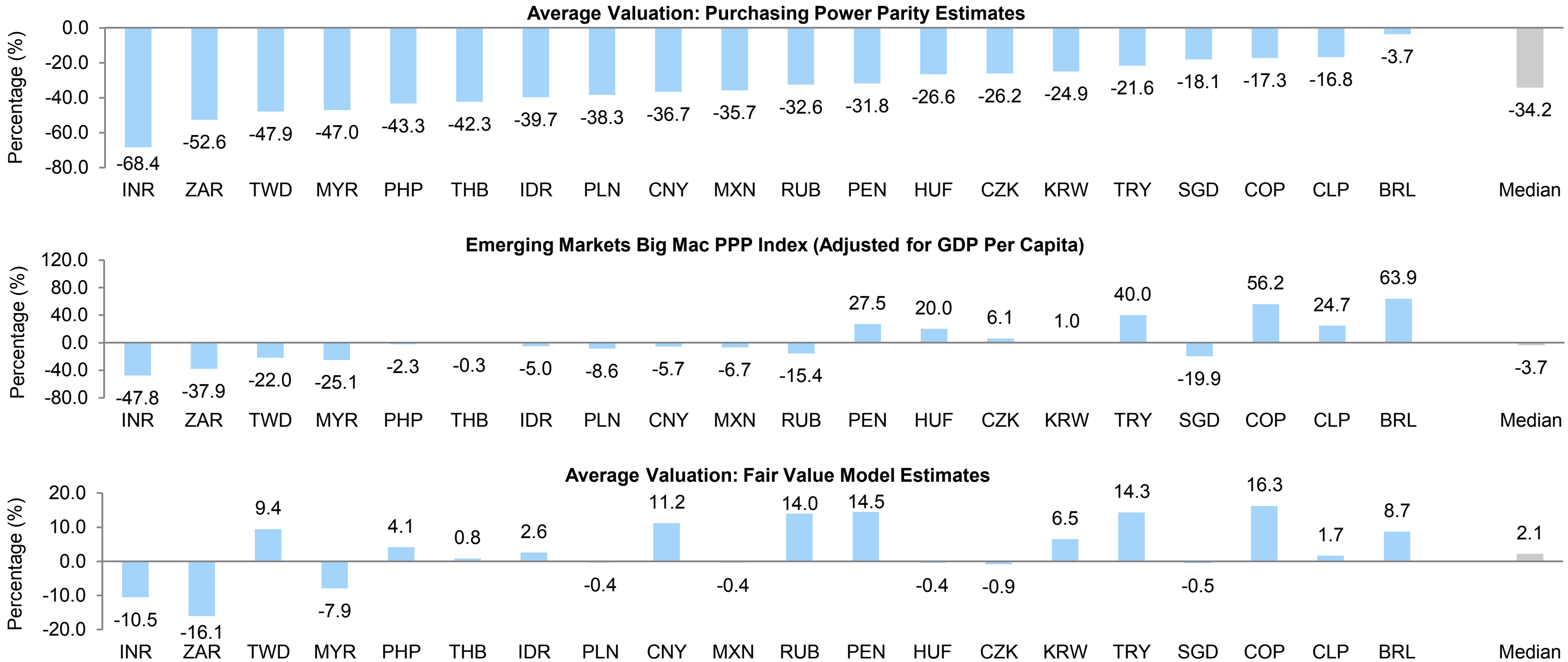


Sources: Barclays and J.P. Morgan Securities, Inc.

Notes: Spreads are yields over the U.S. Treasury curve. Yields are represented by: J.P. Morgan EMBI Global Diversified Index ("EM (USD) Govt Bonds"), J.P. Morgan GBI-EM Global Diversified Index ("EM (LC) Govt Bonds"), and J.P. Morgan CEMBI Diversified Index ("EM (USD) Credit").

Most Emerging Markets Currencies Are Fairly Valued

Valuation Versus the U.S. Dollar: Emerging Markets Currencies
As of August 31, 2013



Sources: BofA Merrill Lynch, *The Economist*, Goldman, Sachs & Co., and the International Monetary Fund (IMF).
Notes: Purchasing power parity (PPP)–implied exchange rates are based on relative price levels between countries, with the assumption that a basket of identical goods should cost the same across countries. Average PPP estimates for each currency reflect a simple average using International Monetary Fund and *The Economist* data, which are based on consumer prices. Fair value model estimates are derived from econometric models that take into account several variables such as PPP, interest rate differentials, fund flows, etc., to produce an equilibrium exchange rate. These fair value estimates differ from currency forecasts, as it is not always assumed that currencies revert to fair value over the forecast horizon. Average fair value model estimates for each currency reflect a simple average using Goldman Sachs and Bank of America Merrill Lynch data.
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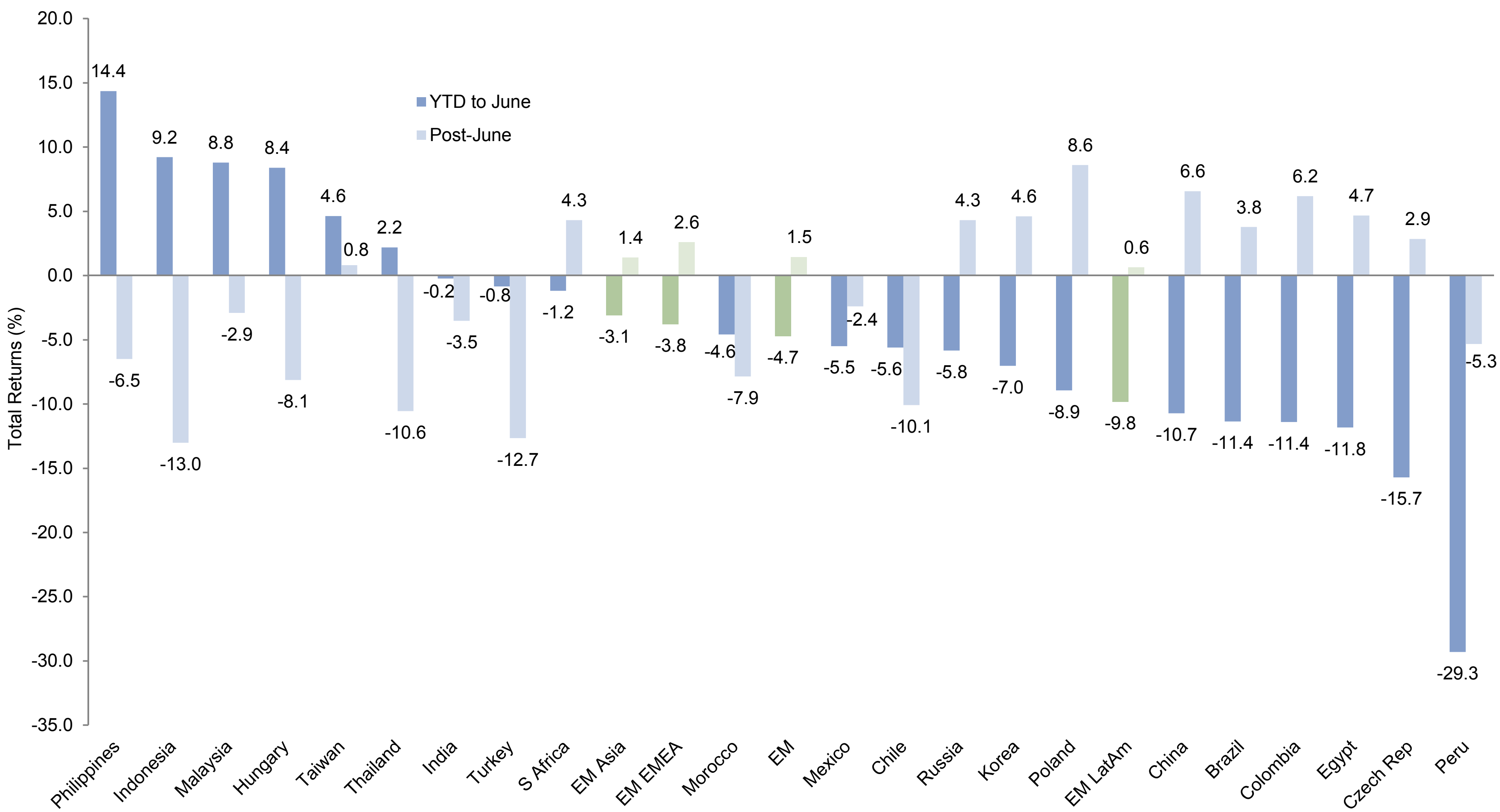
Recent Emerging Markets Equity Dispersion

MSCI Emerging Markets: Performance

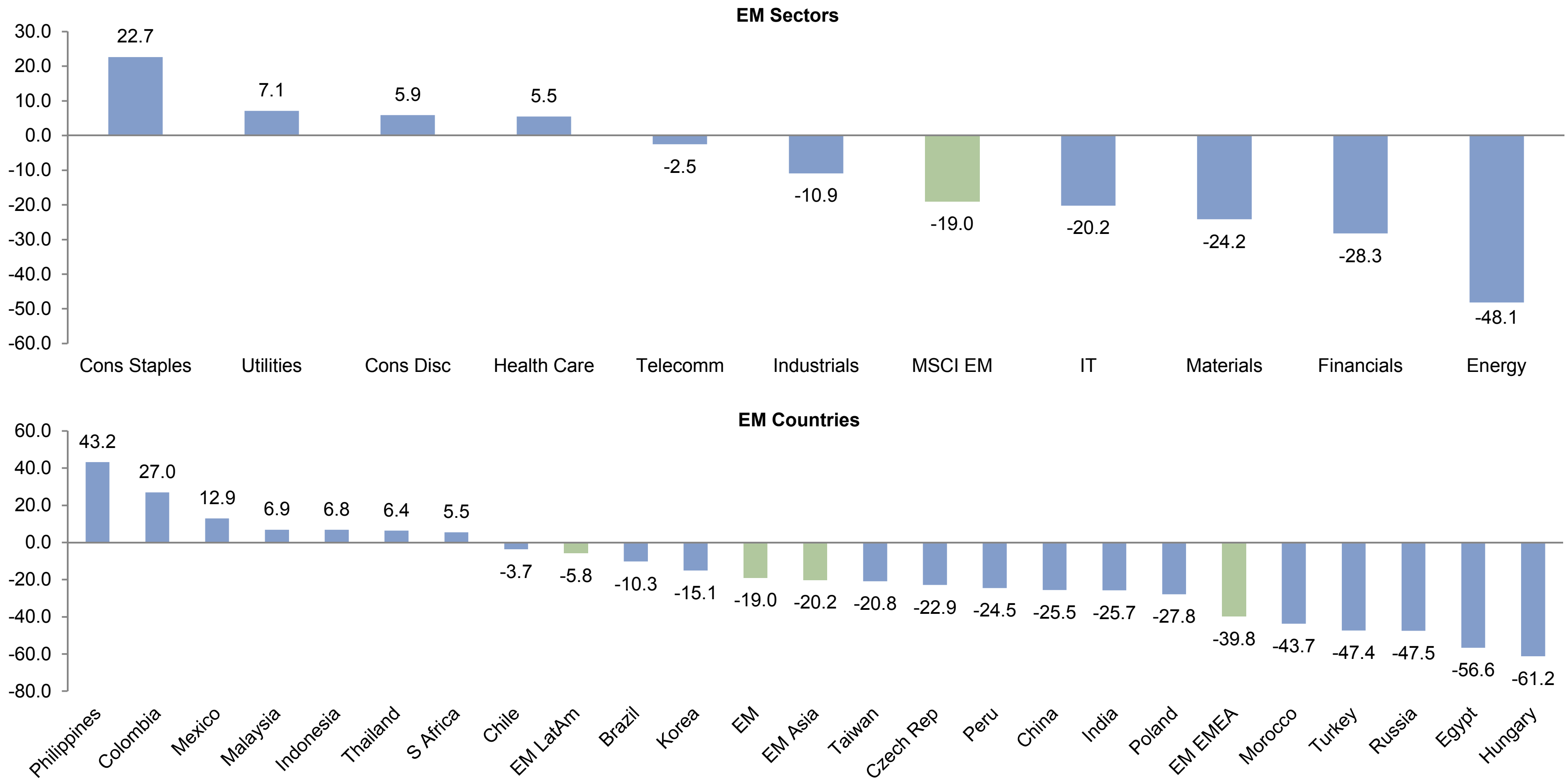
December 31, 2012 – August 31, 2013



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Emerging Markets Sector and Country Valuations

MSCI Emerging Markets: Price-to-Book % Deviation from Historical Average
January 31, 1996 – August 31, 2013



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: For IT valuation, the bubble period (1998–2000) has been removed from the average and standard deviation calculations.