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Investment Publications Highlights

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"What Happens in EM (Mostly) Stays in EM"

Goldman Sachs, January 29, 2014

Problems common to multiple emerging markets have attracted increasing attention from investors, helping cause a global sell-off in January. While the domestic challenges for EM countries are likely to persist, argues Goldman Sachs' economics research team, the risk that they will impact DM growth is limited.

Difficulties in several emerging economies have dominated headlines at the start of 2014. Turkey made a sharp shift to tighter monetary policy after its current account imbalances came under renewed investor focus. India and South Africa also hiked interest rates. The Argentine peso and Ukrainian hryvnia have depreciated dramatically. Concerns about bad loans in China have again resurfaced. Although investors are right to wonder whether the problems affecting these countries pose risks to growth in DM economies, Goldman Sachs believes that any spillovers are likely to be short-lived due to relatively limited DM reliance on EM trade and financial linkages. In other words, the growth outlook for developed markets will depend far more on domestic conditions than on conditions in emerging markets.

The drama that unfolded in January is the reversal of a decade-long supportive environment for EM growth. Previous "macro tailwinds" such as low inflation, sovereign deleveraging, rising commodity prices, and falling real interest rates have changed course. The upward pressure on EM currencies from extraordinary DM central bank easing has begun to dissipate with Federal Reserve tapering. The rapid increase in credit in China has forced policymakers there to move toward lower, "better" growth in the future. Weaker currencies, higher interest rates, and restrained domestic demand and credit will be necessary adjustments for many emerging economies.

Adjustment in emerging markets may affect developed markets through two channels. The first is trade. If growth in EM demand slows, the exports and earnings of DM companies that sell to those countries will suffer. A sharp slowdown in China's domestic demand, for example, would have a large negative impact on commodity-producing developed markets. That said, the largest DM economies are relatively closed. Gross exports to emerging markets compose less than 5% of GDP for the United States and 8% for developed markets as a whole. Similarly, sales exposure of S&P 500 companies to emerging markets is also only 5%. Moreover, reductions in exports to emerging markets would likely be partially offset by lower commodity prices, lower bond yields, and capital flowing back from troubled emerging economies to developed ones. The magnitude of a shock to emerging markets would have to be large for a material slowdown to be transmitted to developed markets through the trade channel.

The second channel through which EM troubles might hurt DM growth is through banking and financial linkages. If DM banks have significant exposure to EM borrowers, and concerns about those borrowers' financial health grow, interbank lending markets could be disrupted. The Bank for International Settlements estimates that overall DM bank exposure to emerging economies stands at about $5 trillion (20% of all external positions), and that exposure to those economies in recent focus (the "fragile five") is only about $1.14 trillion. DM institutions do not appear to have overly concentrated exposure to any one of these markets. Many observers are also concerned about the recent rapid expansion of credit in China, the largest emerging economy. China's banking system, however, is relatively insulated and is not especially integrated with the DM financial system. The main risk of a credit crisis in China is not a direct financial impact on developed markets, but a sharp slowdown in growth in commodity-producing countries.

"The US Current Account and Vanishing Global Liquidity"

Charles Gave, GK Research, February 7, 2014.

The improvement in the US current account deficit has led to less dollar liquidity outside the United States, notes Charles Gave. This is creating challenges for weak EM countries, which have been forced to raise interest rates, devalue their currencies, and suppress domestic demand. Investors should favor US$-denominated assets over their global counterparts.

As the world's de facto reserve currency, the US dollar is used by many countries to settle transactions. Put differently, the United States has the unique privilege of settling foreign obligations with its own currency. When the US current account position improves—in other words, when the sum of its trade balance, net investment income, and cash transfers moves toward surplus rather than deficit—fewer dollars "show up" outside the United States. In contrast, a worsening US current account position increases the size of the pool of dollars available outside of the United States.

Today's environment is one of US current account improvement. The US current account position has improved by about 4% of US GDP since 2006. Much of the improvement has come on the back of the dollar's trade-weighted depreciation of nearly 30% since 2002. If the current account is segmented into three thematic blocks—the US energy balance with the rest of the world, the US trade balance with China, and the US deficit or surplus with the rest of the world—the latter category has driven all of the improvement. The net effect of energy and China combined has been zero.

The losers in this environment are weak emerging economies that run significant current account deficits. The improvement in the US current account deficit has occurred at the same time emerging markets such as Brazil, India, Indonesia, and Turkey have seen their current account balances deteriorate. Not only has the US adjustment reduced the output from the rest of the world, but these weak economies must fund their current account deficits with US dollars to buy energy, settle trade, and service US$-denominated debts, despite no longer earning these dollars. Most exported US dollars have been going to China. To fill the gap, these weaker markets face a stark choice: either sell assets or raise interest rates to choke demand (and thus imports). With many markets opting for the latter strategy, their financial markets and currencies have come under pressure. Lower domestic demand in these emerging economies may also reduce international trade, hurting the US economy and creating a negative feedback loop of contraction.

Major improvements in the US current account deficit have often preceded financial crises. Historically, in periods when the US current account is improving, investors have been well served by overweighting US assets. Specifically, within equities investors should favor the S&P 500 over the MSCI EAFE. In bond allocations, investors should be overweight US Treasuries versus comparable safe-haven German bunds. Investors holding cash should prefer US$ assets. While falling oil prices or a shrinking Chinese trade surplus may cause shifts in the US current account balance, to date weak emerging markets have taken the brunt of the adjustment, suggesting an increased risk of financial accidents in peripheral, US$-dependent regions. ■