Focus: Emerging Markets

20 August 2013

Emerging Markets: Brace for More Turbulence

SUMMARY

Emerging Markets (EM) have entered a period of turbulence, with worse expected over coming weeks and maybe months. There are different country-specific dynamics underlying the equities and FX sell-offs of recent days in Indonesia, India, Brazil, and some other emerging markets. But there is also a common theme -- receding fund flows are exposing structural vulnerabilities in emerging market economies.

An important driver of the fund outflows from EM is imminent tapering of quantitative easing in the United States, rising US Treasury yields, and a generally strengthening US dollar. But there is, in the background, economic resilience in the US; a nascent recovery in the Euro Area; and greater confidence in Japan.

Meanwhile, economic growth has slowed in many key emerging markets, while inflation remains a concern. And vulnerability to the drying up of foreign direct investments and portfolio inflows is a function of EM economies' domestic savings shortfalls, manifested in current account deficits, particularly in India, Indonesia, Turkey and Brazil. The underperformances of Emerging Markets and Asia ex-Japan equities relative to the US and global benchmarks are at an advanced stage. And valuations are already cheap. But we have not seen enough bearishness to signal a climactic sell-off and a troughing of relative underperformance.

Until now that is. We may be about to see that now. Indeed, beyond underperformance -- which is relative -- we are likely to see significant absolute losses. But for those with the stomach for volatility and a 12-month time frame, we could see terrific value opportunities in the next few months.

TACTICAL ASSET ALLOCATION

	3 Months	12 Months
EQUITIES	**OVERWEIGHT**	**OVERWEIGHT**
United States	Overweight	Overweight
Europe	Overweight	Neutral
Japan	Overweight	Overweight
China	Neutral	Overweight
Asia ex-Japan	Underweight	Overweight
Emerging Market	Underweight	Overweight
BONDS	**UNDERWEIGHT**	**UNDERWEIGHT**
Global ex-Asia	Underweight	Underweight
Asia ex-Japan	Underweight	Neutral
ALTERNATIVES	**NEUTRAL**	**OVERWEIGHT**
Property	Neutral	Neutral
Commodities	Neutral	Overweight
Gold	Neutral	Underweight
Hedge Funds	Neutral	Neutral
CASH	**UNDERWEIGHT**	**UNDERWEIGHT**

Notes: Down from start of 3Q13; Up from start of 3Q13.
Source: DBS CIO Office, as of 20 August 2013

What is happening in EM is cyclical and not secular. That is, this is not a long-term decline. Remember that long after the US Federal Reserve exits quantitative easing (QE), there will still be structural problems in the Developed Market (DM) economies. And the one enduring theme will be government debt and deficit -- something common to the US, the Euro Area and Japan.

Market sentiment is now glossing over those DM structural deficiencies and focusing on EM vulnerabilities. Sentiment is fickle. And these things go round again. Sentiment will soon become overwhelmingly bearish on EM. Already attractive valuations could soon reach extremes. And when that occurs, the structural EM story -- growth through their competitive advantages in the global supply chain, young demographics, and urbanisation -- will re-assert itself. That is probably when value investors should start buying.

We had recognised the problems that EM and Asia ex-Japan economies faced from the tapering and eventual exit from QE -- hence our 3-month neutral weightings on these markets vis-a-vis our overweight ratings on developed markets US and Japan. But these problems appear to be coming to a head with significant absolute losses likely. We are cutting our 3-month weightings for emerging markets and Asia ex-Japan (excluding China) to underweight. The beneficiaries of these weighting cuts will be developed markets US and Europe, where a cyclical recovery is gathering pace. We are retaining our 3-month neutral weighting for Chinese equities as China is arguably the strongest of the emerging market economies. It runs a current account surplus, has a strengthening rather than weakening currency, and its growth rate exceeds its inflation rate. We are putting gold back to neutral from underweight. We are not convinced that gold is over its worst. But over coming months, EM turbulence could drive emerging market demand for gold as an alternative to the Dollar.

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Technical outlook for EM equities and currencies is bearish. Whatever happens these next few days -- even if there is some respite from recent bearish price action -- things will likely get worse before they get better. The aggressiveness of the recent sell-off suggests accelerating fear in some emerging markets. The technical outlook -- what the charts are signalling to us about the downside pressures on EM currencies and stock prices -- is bearish.

What QE gave in spillovers into EM economies, tapering will take back. There are different country-specific dynamics underlying the sell-offs of recent days in Indonesia (USD/IDR, JCI), India (USD/INR, Sensex), Brazil (USD/BRL), and some other emerging markets. But there is also a common theme -- receding fund flows are exposing structural vulnerabilities in emerging market economies. Investors would be familiar with that old Warren Buffett line: "You only find out who is swimming naked when the tide goes out." Well, the tide is going out from emerging markets. And this is, at the most immediate level, being driven by imminent tapering of quantitative easing in the United States, rising US Treasury yields, and a generally strengthening US dollar. But there is, in the background, economic resilience in the US; a nascent recovery in the Euro Area; and greater confidence in Japan. Meanwhile, economic growth has slowed in many key emerging markets, while inflation remains a concern. Indeed, inflation is running ahead of GDP growth in India, Brazil, Russia, and Turkey. And vulnerability to the receding "tide" is related to EM economies' domestic savings shortfalls, manifested in current account deficits in India, Indonesia, Brazil, and Turkey.

What started with current account deficit economies is spreading to others through global financial market linkages. Things are likely to get worse for emerging markets before they get better. Indeed, as I write this, the bearishness that shook markets in Indonesia, India and Brazil in recent days is spreading to Thailand, Malaysia and even Singapore. Even where the economic structures are robust -- as in Singapore -- there are economic linkages and globalised fund flows. The FSSTI is breaking below a technical support and could very quickly descend towards the June low of 3000-3100. USD/SGD is accelerating upwards. And this is an Asia ex-Japan-wide phenomenon. USD/MYR is also accelerating up. The Asia ex-Japan currencies index, ADXY, is breaking through a key 200-week moving average support. A sustained break of this support level is something not seen since the global financial crisis of 2008 (Figure1). And the recent rebound in AUD/USD is most likely over. Indeed, AUD/USD may have double to pay as over recent days it had been diverging upwards from a downward pointing ADXY index. So last week's divergence between stronger Asia ex-Japan equities and a weaker ADXY is now looking, as I suspected, "unsustainable". It was a suspicious divergence whose sustainability I questioned in our weekly publication, given the long-standing positive correlation between Asia ex-Japan equities outperformance and stronger currencies (Figure 2). So the divergence will close, with Asia ex-Japan stocks moving lower together with weaker currencies over coming weeks.

EM stock valuations already cheap but could get even cheaper. The underperformances of Emerging Markets and Asia ex-Japan equities relative to the US and global benchmarks are at an advanced stage. And valuations are already cheap. But we have not seen enough bearishness to signal a climactic sell-off and a troughing of relative underperformance. Until now that is. We may be about to see that. Indeed, beyond underperformance -- which is relative -- we are likely to see significant absolute losses. But for those with the stomach for volatility and a 12-month time frame, we could see terrific value opportunities in the next few months. Asia ex-Japan price to book valuation is currently at around 1.5x-1.6x. It is now 1-standard deviation below the mean from 1995. And it compares with peaks of around 2.2x just before the Asian Financial Crisis and almost 3x just before the Global Financial Crisis (Figure 3). But with the risk of a worsening of fund outflows, it might be prudent to wait a little longer before accumulating aggressively. During the lows of both financial crises, the price to book valuation fell to around 1x. But if this falls short of a financial crisis -- and it might just avoid it with a bit of luck -- it might trade a little lower towards 1.3x-1.4x book. Picking the bottom is always difficult, if not downright impossible, so investors may have to cost average through a valuation range.

Fig 1: Asian Currency Index Breaking Through Key Support

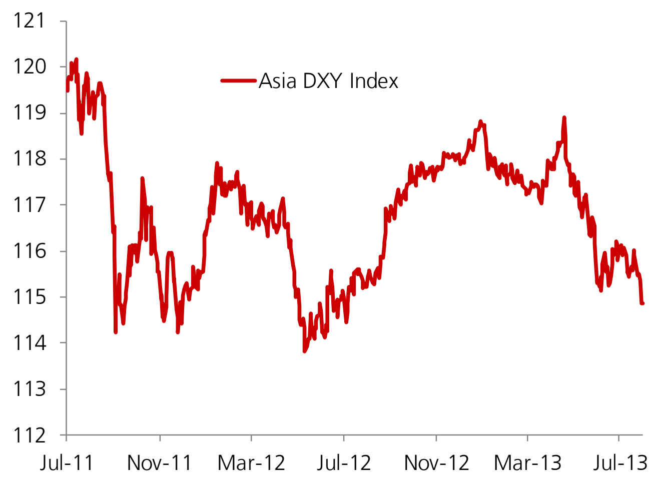


Fig 2: Gap Between APxJ Equities and Currencies to Close

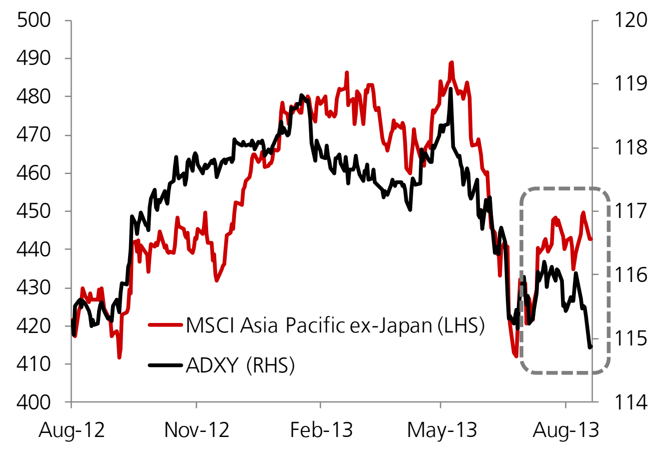
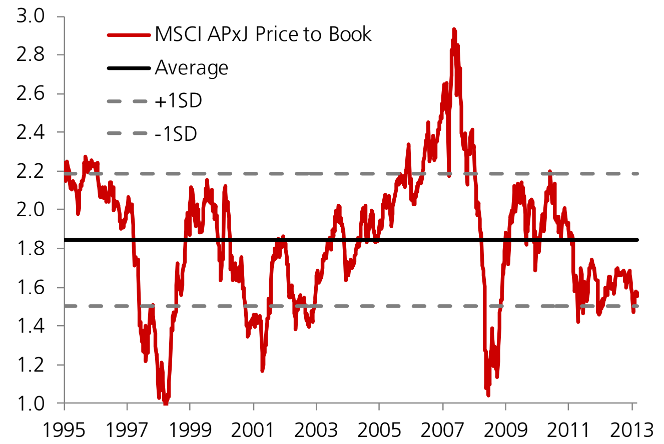


Fig 3: Asia Pacific ex-Japan Equities PB Valuation Range



Source: Bloomberg, as of 20 August 2013

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EM economies will probably undertake painful economic adjustments. The global economy will continue to strengthen. The developed market economies will probably surprise with their resilience. And this will help EM economies' exports. Meanwhile, EM economies will address their vulnerabilities -- they will narrow fiscal and current account deficits; they may try to raise funds to shore up their FX reserves; they will likely absorb some social and political pain to control inflation; and they will undertake structural reforms. EM-wide generalisations are difficult because of the different circumstances confronting each of these economies. So the above is not generic to all but specific to individual economies.

***Sentiment du jour* -- glossing over DM structural defects and focusing on EM structural flaws.** Remember that long after the Fed exits quantitative easing, there will still be structural problems in the Developed Market (DM) economies. And the one enduring theme will be government debt and deficit -- something common to the US, the Euro Area and Japan. Market sentiment is now glossing over those DM structural deficiencies and focusing on EM vulnerabilities. Sentiment is fickle. And these things go round. Sentiment will soon become overwhelmingly bearish on EM. Already, some analysts/strategists and media commentators are talking about a "secular" decline in EM. What we are seeing is cyclical not secular/long-term.

We will probably avoid another emerging market-wide financial crisis but it will likely be a scary ride. The risk is policy mis-steps in EM economies. Governments might be tempted to defend their currencies, rightfully concerned as they will likely be about currency weakness driving imported inflation and fund outflows. All legitimate concerns. But it is a gamble. If they fail in their defense of their currencies, they might end up even more vulnerable for having spent limited FX reserves.

Economic, social and political pain may be necessary. The markets, if left to their own devices, will find their own levels. But in the process, there could be quite a bit of economic, social and even political pain. Already attractive valuations could soon reach extremes. And when that occurs, the structural EM story -- growth through their competitive advantages in the global supply chain, young demographics, urbanisation -- will re-assert itself.

Fig 4: India's Weakening Current Account Deficit

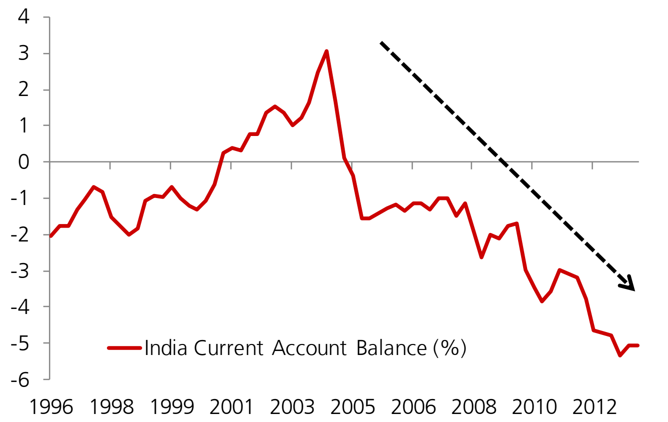

Fig 5: Indonesia's Current Account Also Worsens

Source: Bloomberg, as of 20 August 2013

Downgrading EM and Asia ex-Japan equities to underweight but staying neutral on China. We had recognised the problems that EM and Asia ex-Japan economies faced from the tapering and eventual exit from QE -- hence our 3-month neutral weightings on these markets vis-a-vis our overweight ratings on developed markets US and Japan. But these problems appear to be coming to a head with significant absolute losses likely. We are cutting our 3-month weightings for emerging markets and Asia ex-Japan (excluding China) to underweight. The beneficiaries of these weighting cuts will be developed markets US and Europe, where a cyclical recovery is gathering pace. We are retaining our 3-month neutral weighting for Chinese equities as China is arguably the strongest of the emerging market economies. It runs a current account surplus, has a strengthening rather than weakening currency, and its growth rate exceeds its inflation rate. We are putting gold back to neutral from underweight. We are not convinced that gold is over its worst. But over coming months, EM turbulence could drive emerging market demand for gold as an alternative to the Dollar.

India -- structural problems exposed by fund outflows. Structurally, India is one of the more vulnerable of the EM economies. Its current account deficit is one of the largest amongst EM economies at over 5% as at end-March (Figure 4). And its FX reserves is relatively low at around 25% of GDP, with an import cover of around only 7 months -- hence its sensitivity to a drying up of fund inflows. The government faces a policy dilemma. If it sits back and allows the currency to weaken sharply, it risks imported inflation, exacerbating fund outflows, and Dollar shortages. But its FX reserves are slim. And if fails in its defense of the Rupee, it could find itself in an even worse position, having used up scarce FX reserves. And even with the economy weakening, there is no room for interest rate cuts, as that could further weaken the Rupee.

Indonesia -- a similar story of a domestic savings shortage funded by external savings. The latest current account deficit figure of 4.4% of GDP has busted the deficit just before the Asian Financial Crisis -- which was a deficit of 3.64% of GDP (Figure 5). And there appears little prospect of reducing that near-term given weak commodity prices; politically sensitive fuel subsidies; and the inelasticity of import demand in some sectors. Then there is the presidential election coming up next year, which makes dampening demand a difficult exercise. Meanwhile FX reserves are also slim relative to imports -- at around 7 months, a figure comparable with India.

China -- the strongest EM economy. Policy uncertainty is holding back Chinese equities. Yes, China suffers from structural economic faults. The government's controls over interest rates, the CNY and the capital account have caused economic distortions. These distortions manifest themselves in a large shadow banking sector; a tendency towards overheating in the property sector; over-investment in low ROE projects; non-performing loans in local government investment vehicles; and high credit intensivity of growth -- just to name a few. But China has a savings surplus -- it runs a current account deficit. And whatever the structural distortions that a closed capital account might cause, it makes the economy less vulnerable to the "fireball" inflows and outflows that cause financial crises. And China's FX reserves at over USD3 trillion is ample for foreseeable contingencies. We would remain neutral weight on China over 3-months and overweight over 12-months.

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