UP AND DOWN WALL STREET--BARRON'S

Emerging Markets Lead the Plunge

Emerging markets are leading the plunge in global stocks. Why it will get worse.

By
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The world is too much with us," wrote William Wordsworth.

Not that we ever could get away from them, but the world's travails last week beset the financial markets seemingly as never before. And if there was any doubt, the U.S. stock market gave credence to the observation that what happens in emerging markets doesn't stay in emerging markets.

That isn't original, as it comes from David A. Levy, who heads the Jerome Levy Forecasting Center, and who collaborated with his father, Jay. The cogent, and definitely non consensus analyses of Levy, *père et fils*, have enlightened *Barron's* readers for decades. Once again, David, along with his associate, Srinivas Thiruvadanthai, has been ahead of the crowd in warning of the growing weakness in emerging markets and their impact on the rest of the world—well before the plunge in China's stock market and the effective devaluation of its currency, the yuan.
It has been their contention that EM, as emerging markets familiarly are called these days, are leading the global markets, given that they now account for approximately half of the world's economy, which may come as a shock to those in the so-called developed markets, or DM.

China's furious expansion, especially in the past decade prior to the 2008 financial crisis, resulted in huge growth based on capital investment to spur exports, which was based on the country's advantage in cheap labor, David explains. After the recession, however, China hasn't been able to regain those previous growth rates as its cost advantages were whittled down by technology.

China has been left with significant overcapacity in manufacturing, exemplified by news last week that one of its key purchasing managers' indexes fell to a 6½-year low in August, indicating the contraction was worse than estimated. That followed news of an 8% plunge in exports in July, which arguably was the factor that tipped Chinese officials to allow the yuan to float or, more accurately, fall the previous week.

Much of the emerging world has grown by supplying China with the raw goods it needed for its export machine. As it sputtered, those suppliers in Latin America, the rest of Asia, and Australia, felt the impact. Copper from Chile, iron ore from Australia, and oil from Russia all saw less demand.

And their currencies have slumped as a result, with the most dramatic example being last week's devaluation by Kazakhstan of its currency, the tenge, by 23%. (You'd be forgiven if you weren't able to identify the tenge, but few had heard of the Thai baht when it kicked off the Asian crisis of 1997-98.)

And those effects have reached U.S. shores with the plunge in energy prices, as U.S. benchmark crude hit $40.45 a barrel on Friday, battering leveraged energy producers. That's evident from the expected bankruptcy filing by Samson Resources, controlled by a KKR private-equity fund. Away from such high-profile credit crackups, prices of some triple-C-rated energy bonds -- really junky junk -- are off 50% or more this year.

Yet even with the steep declines last week -- culminating on Friday in the 500-point-plus plunge of the Dow Jones Industrial Average into so-called correction territory, some 10% below its recent peak -- the pain isn't over.

That's the conclusion of BCA Research in an extraordinary report last week that pulled no punches: "The Coming Bloodbath in Emerging Markets" (with "bloodbath" highlighted in red just in case the title was too subtle). In essence, BCA charges that emerging markets face structural problems of their own making, which will require structural solutions. Those changes won't be forthcoming until the crisis point is reached, however, in the financial and political bloodbath they foresee.

To summarize, BCA sees the coming crisis resulting from the "hubris" of EM leaders, who benefited from the payoff from the painful reforms that followed the 1997-98 EM crisis and the China-led, debt-funded expansion. But, from Argentina to Brazil to Turkey, less-reform-minded leaders have moved away from free-market policies and have reverted to more state intervention, they write.

In reaction to the mounting problems, BCA sees several possible outcomes. One is more stimulus from China, which "at best" would provide a temporary "reprieve for beaten-down Chinese capex plays such as Indonesian, South African, Brazilian, and, more broadly, South American risk assets."

Competitive devaluation also is likely as EM countries try to maintain export growth, which was evident in Vietnam's devaluation of the dong last week. But BCA sees little benefit, since most non-China EM countries' trade is with other non-China EM countries.

Devaluations of EM currencies will end up hurting countries with significant foreign borrowings, mainly in dollars. More than any prospective interest-rate hike by the Federal Reserve, the increase in foreign-currency liabilities is far more dangerous than a rise in U.S. interest rates, BCA concludes. (A 1% rise in the interest rate on a floating-rate loan would cost a tenth as much as a 10% drop in the borrower's currency versus the dollar.)

The most likely outcome for emerging markets, according to BCA, is what it calls the "Argentina option" of increased populism, which it says "is far more likely than investors think."

In the meantime, Levy sees problems of overcapacity and falling commodity prices hitting countries such as Brazil and Russia, which he notes also have other problems. India, an importer of energy and other commodities, should be less affected, however.

At the same time, emerging-market countries have less scope to stimulate their way out of a slump. They would be averse to cutting interest rates while they try to slow their currencies' decline. They also are less apt to take fiscal actions such as cutting taxes or boosting spending, which could undermine markets' confidence.

Europe, meanwhile, has begun to show some positive growth, but he notes that's mainly been the result of the salutary effect lower oil costs have on their trade balances. But European stocks were hit hard last week, including the German market, on diminished export prospects to Asia and other emerging economies.

As for the U.S., Levy notes exports account for a relatively small 14% of U.S. gross domestic product. Big U.S. multinationals rely on foreign profits to a much greater extent, as shown by the recent battering of stocks of auto makers like General Motors (ticker: GM) and Ford Motor (F). The U.S. was at the epicenter of the last financial crisis, in 2008. This time, it's the rest of the world and the emerging markets in particular, Levy concludes.

THE EFFECTS OF THE GLOBAL ECONOMIC SLOWDOWN, initially felt in commodities and then the credit markets, hit U.S. stocks, with the Dow shedding over 1,000 points on the week, or 5.8%, and falling into so-called correction territory of a 10% drop from the recent high, with the Standard & Poor's 500 suffering about equally. The Nasdaq Composite fared even worse, with a 6.8% shellacking.

More to the point, the U.S. stock market lost some $1.4 trillion in value last week, according to Wilshire Associates' reckoning, with more than half of it coming in Friday's rout. Since its recent high back on June 23, the Wilshire 5000 is down a cool $2 trillion in value. Much of that was concentrated among this year's four faves, aka FANG, for Facebook (FB), Amazon.com (AMZN), Netflix (NFLX), and Google(GOOGL), which alone shrank by about $100 billion, to $949 billion. And the world's biggest stock, Apple (AAPL), is down $172 billion, or 22%, to a market cap of a mere $603 billion.

The options market finally took note of the increasing risk by pushing up the VIX, or fear gauge for the S&P 500, to a worrisome reading of nearly 29 in Friday's selloff. But until early last week, the

VIX slumbered in the mid-teens, while the credit markets have been alert to increasing risk, not just in junk bonds, where energy credits have been hit, but also among investment-grade bonds.

The credit markets' backdrop looks "eerily similar" to the 1998 emerging-market crisis, observes Michael Darda, chief economist for MKM Partners. Spreads of Baa-rated (lower-investment-grade) corporates over Treasuries actually are wider now than their peak then. Different then was the economy: Nominal gross-domestic-product growth was cooking at over 6%, while the U6 "underemployment rate" (taking in part-timers who want full-time work and those not actively looking for a job but who want one) was 8%, compared with current nominal growth of just over 3% and a U6 jobless rate of 10.4%.

Of course, back then, the Fed wasn't pegging short-term rates near zero. But, Darda points out, the Fed cut the rates three times between September and November of 1998 despite robust growth. Now, with low core inflation, falling inflation expectations, rising credit-risk spreads, and a historically low employment-to-population ratio, he says the Fed is considering tightening policy -- for which Darda says there is no justification "this year whatsoever."

Most Fed watchers are sticking with their forecast of a September liftoff, although Friday's market rout may have them revising their calls over the weekend. The Treasury market, meanwhile, has brought yields lower, with the 10-year benchmark down to 2.05%. Bond yields have been edging down rather than plummeting, which may be an indication of institutions reallocating assets during the slide. The chief investment officer for fixed income at one of the largest public pension plans confided that he was bracing for orders to sell bonds to put into equities to maintain the fund's asset allocation as stocks sold off.

In addition, watch for more possible policy moves out of Beijing over the weekend, according to Evercore ISI. After last week's 11.4% plunge in the Shanghai Composite, the average sits just above the 3500 line, which many market participants think the authorities will defend. It's likely to be anything but a quiet summer holiday for investors.

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