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Underweight EMs: Heading Down a Rougher Road Than Widely Perceived

In the wake of the sharp declines in emerging market (EM*) currencies, equities, and bonds this past summer, there is a growing recognition that many EMs are vulnerable to a sudden reversal of international capital flows. Still, consensus expectations for EM economic performance remain too optimistic because of a failure to recognize that emerging markets as a group face a profound fundamental dilemma. In the present global environment, EM countries cannot simultaneously (1) sustain robust economic growth, (2) improve their current account balances, (3) stabilize their currencies, and (4) contain inflation and domestic financial problems. In the range of likely scenarios for EMs, the best possible outcome is disappointingly weak growth. Moreover, the potential for crises developing over the next two years is significant. (*Throughout this piece, "EMs" refers to the emerging market sector excluding China, the NICs, and oil-exporting countries.)

Underlying Problems Building over the Past Year

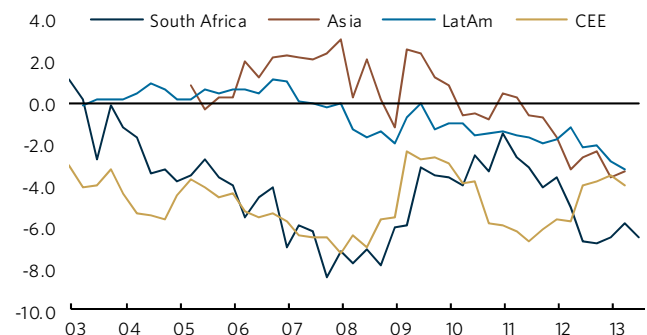
Over a year ago (see June 2012 *Levy Forecast*), we wrote that EM economies faced stiff headwinds and that investment returns on EM assets were likely to be disappointing and volatile over the next several years because (1) EM economies faced worsening current account balances due to the contained depression in the developed world, (2) the necessary shift toward domestic profit sources would prove challenging, and (3) financial conditions, domestic and international, would likely become more adverse. Since then:

- The current account balances of most emerging market regions have worsened (chart 1) as exports to the developed world have weakened even as EM imports have held up. (The chief exceptions are the central and eastern European economies; these countries have either been in recession or experiencing weak growth, so their imports have dropped more than their exports.)

- In many EMs, most notably India, growth in domestic profit sources has not only failed to make up for the loss of profits from the worsening current account balance but has also run into troubles of its own. Fixed investment, the most important profit source, remained flat in dollar terms in the major EMs taken together (chart 2).
- Over the past year, some EM central banks have been forced to tighten monetary policy to control inflation, and many others have been prevented from loosening policy aggressively in the face of slowing growth.
- Relatively rudimentary financial systems in many countries have been straining under the demands of rapid credit creation. The robust growth in domestic credit needed to finance domestic profit creation over the past few years has led to rising loan performance problems and, in turn, tightening credit conditions.

EM Current Account Balances CHART 1

Regional Current Account Balances (\$ terms) as % of GDP quarterly, last data point Q1 2013 except South Africa Q2 2013

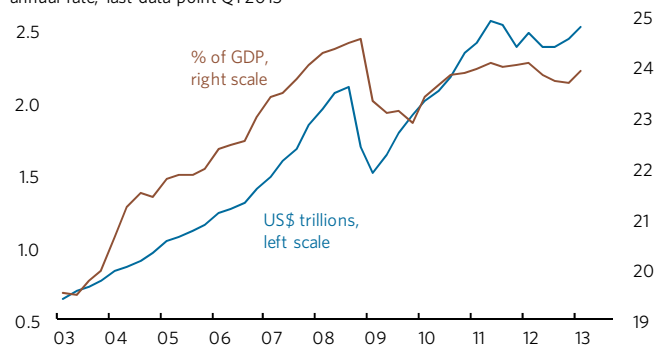


Countries and regions in charts 1 and 2 are as follows: South Africa; Asia is India, Indonesia, Malaysia, and Thailand; LatAm is Argentina, Brazil, Chile, Colombia, Mexico, and Peru; CEE is Czech Republic, Hungary, Poland, Romania, and Turkey.

Flat Fixed Investment in EMs

CHART 2

Gross Fixed Capital Formation, 16 EM Country Aggregate
annual rate, last data point Q1 2013



- International capital market conditions have become increasingly adverse for EMs. Spreads have been rising on EM bonds, and portfolio and direct investment flows have slowed markedly.

Conflicting Goals, No Easy Choices

EMs face a difficult path over the next few years as they attempt to balance the conflicting objectives of achieving robust growth, improving current account balances, stabilizing currencies, restoring confidence in international capital markets, curbing domestic inflation, and containing domestic loan performance problems. To be sure, a single country might be able to achieve the various objectives by greatly improving productivity and increasing its international competitiveness. It might be able to grab global market share, grow exports, and improve its current account balance enough to more than offset weaker domestic demand and thereby spur economic growth. However, EMs collectively cannot do so.

The dilemmas faced by the EMs have a number of dimensions.

1. Current Accounts Will Not Improve without Weaker Growth

Until recently, even the EMs with the worst current account deficits faced no great pressure from the capital markets to address these deficits. However, over the past few months, the currencies of many EMs have plummeted, spreads on EM bonds have widened, and ghosts of currency crisis past have arisen. Restoring international investor confidence has become an urgent issue and would likely require, among other things, improvements in the current account.

However, in the present global environment, EMs cannot improve their current account balances unless domestic demand and economic growth weaken substantially. Growth has slowed recently in many EM countries, but EM growth has

still been faster than that of developed markets. Thus, import growth has been faster than export growth. Even with the stabilization in Europe and improvements in Japan, developed market growth will remain anemic and EM export growth will remain tepid at best. EM domestic demand has to slow further to prevent continuing widening of the trade deficit, let alone reverse the trend.

If growth weakens and current account balances improve enough to allay investor fears of a balance of payments crisis, deteriorating domestic profits and economic growth will hurt—among other things—investor optimism, not least because robust growth has been the biggest allure of EMs.

2. Letting Currencies Weaken Is Problematic

Many EM currencies have depreciated sharply in recent months, fueling the hope that this will lead to improving current account balances. However, currency depreciation is no panacea for EMs. Indeed, several EM central banks have recently taken steps to arrest the slide in their currencies.

A weaker currency increases import prices in domestic currency terms. Thus it tends to stoke domestic inflation, pressuring central banks to tighten monetary policy, which in turn aggravates domestic loan performance problems. A weaker currency will also hurt loan performance problems by increasing the debt-service burden of domestic borrowers with foreign-currency-denominated debt.

Furthermore, currency weakness will erode international investor confidence. As investors pull back, the resulting pressure on the currency can cause further depreciation, fueling a vicious cycle.

Finally, a weaker currency will not necessarily spur rapid export growth, especially when global growth remains anemic. As an example, in the aftermath of the 1997 Asian Crisis, Thailand and Malaysia—two countries that had experienced especially severe currency declines—did not show any noticeable gain in market share from 1998 to 2000. Rather, their exports grew in line with those of other EMs over this period (chart 3). Their acceleration primarily reflected robust growth in the United States and an upturn in the global inventory cycle.

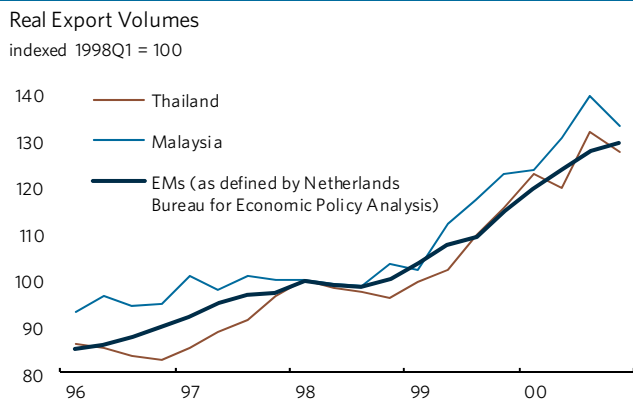
3. Weaker Growth Will Stoke Domestic Financial Problems

In analyzing China, we have emphasized that slowing an economy from a high growth trajectory is more complicated than widely assumed (see June 2013 *Levy Forecast*). Much of this applies to other EMs as well because they have experienced rapid growth over the past decade. EM firms have been

building capacity and taking on financial commitments based on high growth trajectories. Capital spending has plateaued, but it has to fall much further to bring capacity back in line with present and expected capacity needs. Meanwhile, debt taken on to finance the creation of new assets expected to earn robustly growing revenues becomes more likely to go bad when revenues grow much more slowly than the borrowers and their creditors had counted on. Thus, because of balance sheet effects, a rapid economic slowdown will have nonlinear consequences and damaging feedback effects.

In fact, EMs are already experiencing declining corporate cash flows, rising nonperforming loans, and tightening domestic financial conditions. A further slowdown in growth will aggravate loan performance problems and stoke financial instability. Domestic financial problems will further deter international investors.

Exports Failed to Outperform after Devaluation CHART 3



Conclusion

Barring the unlikely event of a major acceleration in growth in the developed markets, the outlook for EMs is at best disappointingly weak growth and at worst recession. To be sure, there is no imminent risk of a balance of payments crisis—foreign currency reserves, even in the most beleaguered EMs, are high relative to levels that have contributed to currency crises in the past (table 1). However, continued running of large current account deficits and increasing reliance on short-term international borrowing will erode the margin of safety within the next two years, making a crisis increasingly likely. Thus, EM growth has to weaken more to repair current account balances and forestall a crisis—catch 22.

EM assets rallied sharply in the wake of the Fed's September decision not to taper. Rising bond yields were clearly aggravating the EM problem and the drop in yields provided some temporary relief. However, the impact of QE on the financial markets is temporary and on the economy is insignificant. Thus, the Fed's decision did not alter the fundamental outlook for EMs over the next two years. Indeed, for our own portfolio, it provided an attractive point for re-entering our EM short. Any EM rally from here would provide another opportunity for shorting EMs or for lightening or exiting EM positions.

Current Accounts Worse, Reserves Higher, Debt Lower TABLE 1

Financial Indicators for Selected Emerging Market Countries, all expressed as % of GDP

	Year of Last Crisis (India 1991, Turkey 2001, Brazil 2002, Thailand & Indonesia 1997)			2012		
	Current Account	Reserve Assets	External Debt	Current Account	Reserve Assets	External Debt
India	-0.4	2.3	28.8	-4.7	15.8	20.8
Turkey	1.9	15.1	56.6	-6.1	17.5	42.8
Brazil	-1.5	7.3	40.7	-2.4	16.5	13.9
Thailand	-0.9	17.7	71.7	0.1	49.6	36.5
Indonesia	-2.1	7.3	57.1	-2.8	12.8	28.7



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