

Srinivas Thiruvadhanthai
Director of Research

China's Troubles: Further Reason to Underweight or Short Emerging Markets

*Based on an article in the July 2013 *Levy Forecast*.

The profound transformations in the profit sources of emerging market (EM) economies (considered broadly as a group) has been a theme in our writings for a few years now. They were the key reason for our forecast for surprisingly weak EM performance in 2013 and, in our own portfolios, for our having been short the MSCI Emerging Market Index against long positions in the United States and Japan for most of the year. Given how much EM equities and currencies have already underperformed, should one still be underweight or short EM equities and currencies?

Our answer is yes, and adverse developments in China have reinforced our conviction. In the event of a hard landing in China (a recession with broad-based financial consequences), clearly the global economy, and notably the EMs other than China, will be in trouble, and EM stock markets and currencies would be something to avoid or short. On the other hand, if the Chinese government succeeds in warding off a recession, it will likely do so in part by using beggar-thy-neighbor policies that in effect take profits from other countries, especially other EMs.

EMs Weakened Over Past Year

Over a year ago (see June 2012 *Levy Forecast*), we wrote, "consensus expectations for EM economies remain too optimistic and investment returns for EM assets are likely to be

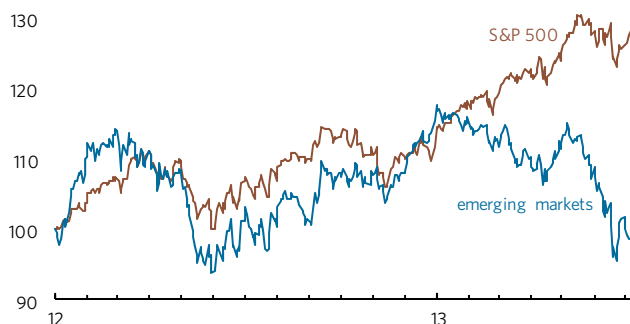
disappointing and volatile over the next several years." Since then, economic growth in the emerging economies has decelerated and now the IMF (along with most other analysts) has lowered its forecast for emerging market GDP growth for 2013 and 2014. EM equities have lagged badly behind developed market equities (chart 1), and EM currencies have depreciated sharply in recent months (charts 2-5).

Last June we identified three major secular challenges for emerging markets: (1) worsening trade balances with the developed world and the need to slash investment in the export

(continued on the next page...)

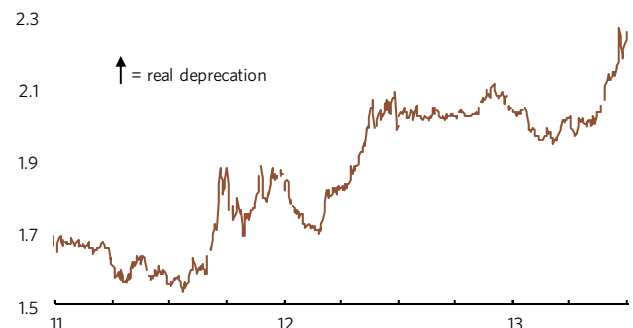
S&P Outperforms Emerging Markets CHART 1

S&P 500 Index, MSCI Emerging Market Index
January 3, 2012 = 100, daily through July 9, 2013



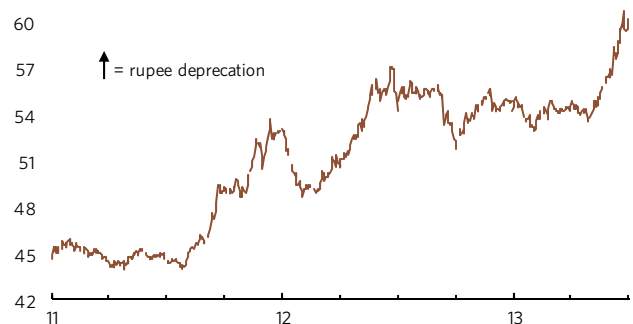
Brazil CHART 2

Brazilian Reals per U.S. Dollar
daily through July 5, 2013



India CHART 3

Indian Rupee per U.S. Dollar
daily through July 5, 2013



sector, (2) declining international capital inflows, and (3) difficulties in pursuing a growth strategy based on domestic profit sources—difficulties including rising credit problems, greater cyclicality, and finding the balance between controlling inflation and maintaining growth. And, indeed, over the past year, most emerging markets have experienced worsening current account balances (chart 6) and declining capital inflows (chart 7), and some are facing rising credit problems. Inflation appears to be fading in most countries but only because growth has weakened noticeably. The challenges facing the EMs continue to loom large, and now China poses a major threat to emerging market stability.

Why China May Turn on Other EMs

We argued in last month's forecast that "it is far from certain that China will be able to make the adjustment to slower growth without crashing." Among the challenges is the potential for financial instability. Explosive credit growth over the past several years has failed to keep economic growth from slowing but has stoked asset speculation, exacerbated overcapacity,

and led to nonperforming loans. The recent spike in Chinese overnight lending rates has highlighted the fundamental dilemma facing Chinese officials: they must curb credit growth in the interest of long-term stability, yet they need rapid credit growth for short-term stability. Rapid credit expansion is needed to prevent bad debt problems from mushrooming. Chinese private (and local government) debt is already at dangerous levels relative to GDP, and averting a financial implosion requires the debt ratio to rise even further. Chinese financial conditions are likely to become increasingly volatile as policymakers see-saw between providing liquidity when events threaten to go over the brink and attempting to rein in credit when the situation appears calmer. The risk of a hard landing cannot be ruled out.

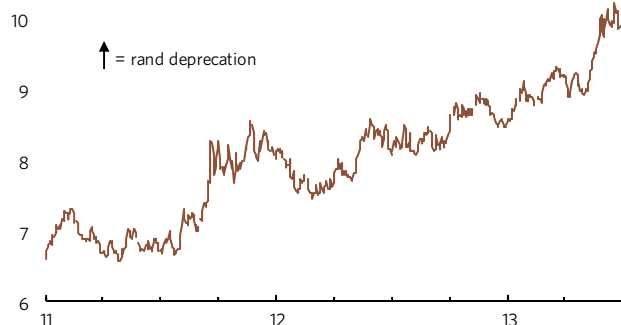
On the other hand, with major difficulties in increasing domestic profit sources, if China does avert a hard landing, it is likely to do so in part by increasing its share of global exports, which will have adverse consequences for other EM economies. Having

(continued on the next page...)

South Africa

CHART 4

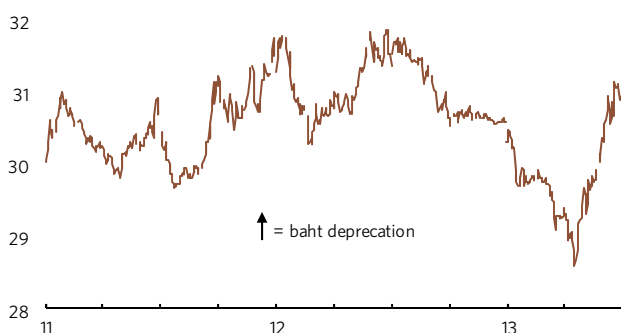
South African Rand per U.S. Dollar
daily through July 5, 2013



Thailand

CHART 5

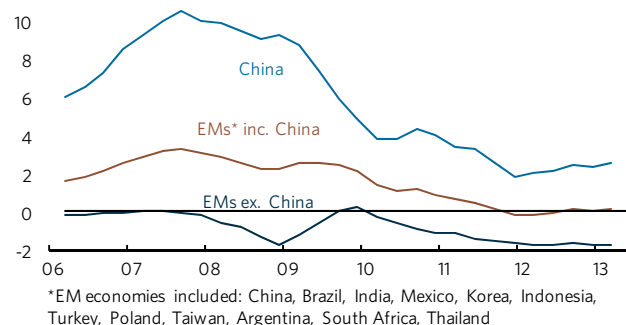
Thailand Baht per U.S. Dollar
daily through July 5, 2013



EM Current Account Balance Deterioration

CHART 6

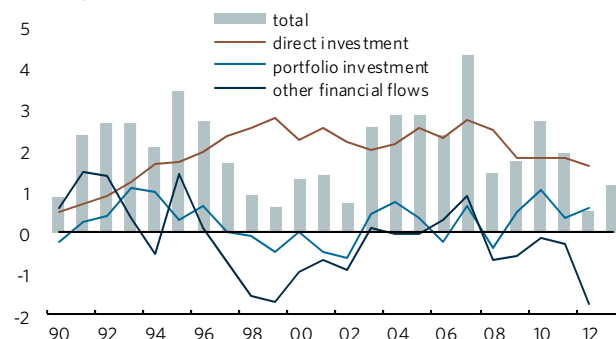
Emerging Market Current Account Balances as % of Nominal GDP
not seasonally adjusted, 4-quarter moving averages



Financial Flows into EMs Weakened in 2012

CHART 7

IMF: Net Private Financial Flows into Emerging Markets as % of GDP
annual data, 2013=IMF estimate for total



experienced problems with monetary and fiscal efforts to stimulate the economy, China's leaders appear to be wary of aggressively using these tools. Moreover, setting the Chinese financial system on a sustainable long-term path would require policymakers to force banks to write-off bad loans, to recapitalize banks, and to restrain credit growth, which in turn would result in weak private domestic profit sources. Thus, the leaders may well feel compelled to shift toward policies that directly harm their EM brethren: currency devaluation, enhanced support and subsidies for exports, and dumping. Indeed, previously when China faced serious waves of bad debt and undertook massive bank restructuring—in the early 1990s and early 2000s—it relied on surging exports and a bulging trade surplus to overcome domestic profit source weakness (chart 8). At the end of 1993, China devalued its currency by a whopping 50% in order to spur exports, jolting its Asian competitors. In 2001, China's inclusion in the WTO vastly increased its market access, resulting in soaring exports.

In a global economy with stagnant trade and shrinking imports by developed countries, rapid growth in Chinese exports will come at the expense of other EM economies. China's efforts to boost exports would only exacerbate the deterioration of other EM trade balances and intensify the financial and economic pressures at a time when emerging economies are struggling.

A hard landing in China would unquestionably be damaging for other emerging markets. China has become the major export destination for many developing countries, especially commodi-

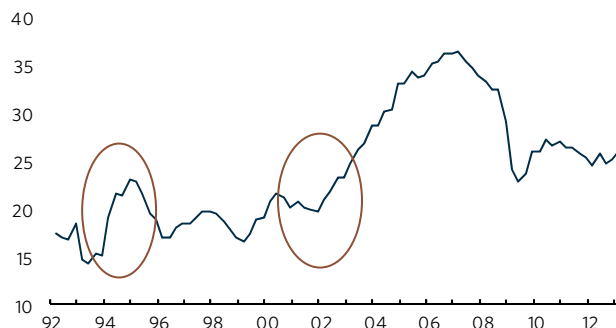
ty exporters. Moreover, troubles in China can trigger capital flight from emerging markets broadly. China is a major part of EM investment buckets, and if international investors pull money out of these buckets, funds will flow out of other EMs. In addition, investors suffering losses in China will likely reduce their exposure to other emerging markets—the contagion effect.

China's troubles are an important reason why emerging market equities and currencies will continue to underperform. Investors would do well to lighten their exposure to emerging markets, and businesses would do well to reevaluate their emerging market expansion plans and to consider defensive strategies for the next few years.

Past Financial Crises Brought Export Push CHART 8

China: Goods Exports as % of GDP

quarterly data, seasonally adjusted by Haver Analytics



**The Jerome Levy
Forecasting Center**

macroeconomic insights for business and investment strategy

Improving risk management and providing a fuller understanding of economic trends with unique framework "The Profits Perspective"

Visit www.levyforecast.com

Contact Douglas Williams: DWilliams@levyforecast.com (914) 666-0641

© 2015 by The Jerome Levy Forecasting Center LLC. Based on an article in the July 2013 Levy Forecast. Redistribution of this publication in its existing form is permitted; reformatting or redistributing without attribution is prohibited.