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Beyond Taper-phobia: Emerging Markets revisited

It's been a tough year for emerging markets (EM). Their long- term growth potential has been outweighed by a gradual re-setting of expectations, changing monetary policy and rising idiosyncratic risks. EM equities have continued their two-year under-performance against their developed counterparts, while emerging market debt has struggled over the summer.

However, supported by the Fed's decision not to taper, EM performance and the outlook have begun to turn.

Emerging Markets : Where Do We Stand

EM currencies have traded in several distinct phases this year. After a strong start to the year, the EM rally was derailed by Bernanke's tapering speech on May 22. EM currencies sold off for much of the summer, with most bottoming in late August or early September as weaker US data lowered the perceived risk of tapering in September. Then, EM was given a new lease on life when the Fed did not start tapering at the September 17/18 FOMC meeting, which led to further EM gains.

The delay in tapering also ushered in a new phase of differentiation. Many of the currencies saw their gains peter out quickly, with many peaking on September 19 and then drifting weaker since. Others built on those initial post-FOMC gains and rallied well into October, but even those are now suffering as the pendulum now seems to be swinging back towards a December taper.

For the most part, we believe that currencies will strong fundamentals should continue to outperform while those with weak fundamentals should continue to underperform. For instance, USD/BRL is now trading higher than it was on September 17, right before the tapering rug was pulled out from under the dollar. Looking at the rest of EM FX, we note that ZAR, CLP, IDR, MXN, TRY, BRL, RUB, PEN, and COP are all trading weaker now vs. USD than they were on September 17. On the plus side, INR, MYR, KRW, THB, SGD, and PHP are all trading firmer vs. USD since then.

Below, we look at EM FX price action in relation to the dollar's peak after the May 22 speech. Against most in EM, that dollar peak was reached in late August/early September. Many have retraced those moves already. Asia has held on to most of its gains, while Latam and EMEA have not held up as well.

Looking ahead, this current EM selloff may start to peter out as it becomes clear that a December start to Fed tapering is actually less likely than markets perceive. We do not think this Friday's jobs report can have much lasting impact on Fed policy and market perceptions of policy, since data will be distorted. So too will the November jobs data out in early December. So EM FX may be able to gain some temporary traction but we remain more concerned about further selling pressures when tapering is eventually warranted.

What has changed from the original May sell off is that the policy defenses in many EM countries are now firmly in place. There will be much less confusion about intervention mechanisms, key levels, and official conviction should we face another bout of prolonged EM selling. Hopefully, this will remove some of the impetus behind the panicky moves seen over the summer in EM. This has also helped reduce implied volatility in many EM countries. That said, the 3-month implied volatility for most major EM currencies have not returned to pre May-levels (with the exception of USD/KRW).

What's next for Emerging Markets Investors?

The vulnerabilities—or rather, perceived vulnerabilities—of emerging markets -have been the focus of heightened discussions over the past few months. Concerns about the health of emerging markets came on the heels of political upheavals in Egypt, economic deceleration in China and protest demonstrations in Brazil and Turkey this summer.

I think too many investors have failed to put those events and developments in the proper context. Rather, they have come to the conclusion that emerging markets are finished, particularly, they say, as the US Federal Reserve (Fed) is expected to turn off the money tap, depriving emerging markets of needed liquidity to protect their weakening currencies and pay their debts. For the time being, the Fed has decided to keep the tap flowing, removing one immediate investor fear. But I think there are also other reasons why investors who doubt the emerging markets' story need better context.

Inherent in this kind of doomsday thinking are a number of misconceptions. First of all, some emerging market currencies have been getting stronger, not weaker. Good examples of this are China and Thailand, where their currencies have become stronger against the US dollar over the past few years. The fact is that many emerging markets are not dependent on the support of the West and the developed world. Proponents of the idea that emerging markets are dependent on the developed market countries say that money from the US, Europe and Japan has allowed the emerging market countries to live beyond their means! Ironically, others say that a slowdown in the emerging world will have a negative impact on *developed* nations.

But if you look at the global debt picture, many developed market countries have more debt in relation to their respective levels of GDP, have higher government deficits, and are more dependent on investors from all over the world buying their bonds. Additionally, the emerging market countries generally have far higher foreign reserves than the developed market countries.

There is a pattern of thinking among many economists and commentators that the emerging market countries are not capable of handling their economies and they need the guidance of the developed market countries. Many in the developed markets lectured Asian nations on fiscal discipline during the 1997 Asian crisis. Then, the emerging markets world watched as the disaster of the US and European financial systems unfolded in 2008–09 while many emerging countries themselves generally continued to not only survive, but prosper. The reality is that the emerging market countries have experienced, and we believe should continue to experience, the most dramatic increases in incomes at the national and individual levels. Their adoption of market economic models and acquisition of productivity-enhancing technology have engineered this positive result.

Asian Emerging Markets: Challenges and Opportunities

The largest of the emerging markets, China, always gets its fair share of attention. There's been much speculation about worrisome issues in China, including a potential housing bubble, debt problems, and so on. But growth in China has continued at a rapid pace. In September, my team and I visited a large housing development in Beijing, and this particular development was 70% sold out in a matter of weeks. I saw the same thing in other cities I visited, a clear demonstration to me that the demand for property in China remains strong.

Of course there will be some developments in China that will fail, and some problems with debtors. But generally speaking, we think that China has the potential to grow at a strong pace, particularly when compared with most developed markets. China's economy is now the second-largest single economy in the world, so growth is likely to naturally slow a bit from double-digits of the past. For an economy this size, growth in the range of 7% – 8%, which many forecasters are projecting, should hardly be disconcerting.

Elsewhere in Asia, of course Japan is pumping money out at a pretty rapid rate. We expect a lot of this money could find its way into Southeast Asia. Countries including Vietnam, the Philippines, Thailand, Cambodia, Malaysia, Singapore and Indonesia could potentially benefit.

There's been a fair share of negativity about India recently, but despite all the problems, the current growth trajectory this year still looks good to us. The International Monetary Fund projects growth of more than 5% in 2013[1], which is still above most developed countries. We believe India's elections in the spring of 2014 could bring solutions to some of the country's problems. From our perspective, challenges often present investment opportunities, and not always where you might expect. For example, you might think weakness in

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India's currency would be a very negative thing for the stock market, but there are companies that can potentially benefit. One example would be an outsourcing company that does most of its business outside of India and has costs in rupees, but income in US dollars. A weak rupee and stronger dollar could be very good for this company.

A Global Recovery Story

Even in the throes of a debt crisis a couple years ago, I felt Europe would eventually recover. I expected the process would likely be slow, with a lot of careful thought, but a recovery would come. We believe we are now seeing that in Europe. In the emerging markets in Eastern Europe, a growth slowdown tied to the crisis brought changes and reforms, in some cases quite dramatic. We think Eastern Europe could do well going forward, and if oil prices continue moving up, Russia, of course, could benefit as the largest emerging economy in the region.

It's not just large countries that are experiencing change. In September, I traveled to Georgia, a small country in Eastern Europe undergoing rapid change. Corruption had been a problem there, but it's been largely reduced. I saw construction all over the country, and people seemed to be very upbeat about the future there.

Looking at the global picture, we are quite optimistic. The recovery in Europe appears to be underway; in the US, the Fed's continuation of its QE program should drive growth in many other parts of the world; and Japan is determined to ramp up activity in its economy with its own ambitious monetary policy regime. We believe many emerging markets globally should likely benefit as liquidity currently remains plentiful. For example, in Latin America, countries such as Brazil, Chile and Colombia, which have widening current account deficits, may benefit from needed investment inflows. Mexico also appears well positioned to potentially benefit from greater trade and capital inflows due to its proximity to the US economy.

We recognize that it hasn't been smooth sailing for emerging markets investors this year. Late in the second quarter and into the third, there was a move away from both emerging markets equity and debt markets. However, we believe the recent outflows are likely to prove temporary. Not only is there still plenty of liquidity in the system, but, given the outflows that occurred, we believe many investors have reduced their weightings to emerging markets. I'm not saying everyone will or should increase their allocations to emerging markets, but I think that many could very well rebalance their portfolios as market sentiment should improve.

The macro backdrop

EM equities have under-performed developed markets (DM) for more than two years as long-term growth expectations have been rebased. The negative sentiment has been further exacerbated by uncertainty around US monetary policy and its impact on economies with higher vulnerability to capital outflows such as Turkey, India and Indonesia.

However, September has seen the beginnings of a turnaround driven by an uptick in economic data, relative to reduced expectations. On one hand, a cyclical recovery in DM has driven some of the recent EM improvement, especially on the sentiment front. On the other hand, better data has emerged from parts of EM, especially China.

September's equity performance is being echoed in ETP flows,both at the broad level as well as single countries where fundamentals look more constructive. However, recent positioning data shows global funds remain underweight EM equities. With the EM turnaround potentially gaining pace as the overhang of immediate tapering uncertainty subsides,many investors could find themselves under-positioned for a further leg up in EM equities. Yet, looking forward, the ultimate waning of US quantitative easing and/or stronger US dollar – which have weighed on performance in the past – remains a key risk in EM investing. ..

Differentiation is key

Emerging markets may have struggled this year but some economies have been more vulnerable than others. One example of such a country is Indonesia. A combination of an unexpected inflation spike, substantial exposure to foreign investment (>30% of government bonds are foreign-owned), and a rapid run down in foreign exchange reserves forced Indonesia's central bank to hike rates by 1.5% within a period of 2

months. While this temporarily protects the Indonesian Rupiah from depreciating further, it inevitably strains the fragile economic growth already in decline.

Differentiation is increasingly prominent in EM investing, and this is reflected in the divergence of emerging market performance and single country flows. South Korea, for example, benefited from an increasing current account surplus and strong trade ties with the US as well as other emerging economies, and attracted the most single country EM inflows YTD.

Korea and Taiwan have also been bright spots this year both in equity market and currency performance. YTD, Korean and Taiwanese equities have outperformed broad Emerging Markets by 5% and 12% respectively. In the case of Korea Q2 GDP continued an upside growth surprise that indicates the sharpest recovery in two years. Simultaneously, its current account surplus (at 5.64% of GDP, Bloomberg as at June, 2013) is amongst the highest in emerging economies, and globally, driven by a strong uptick in exports. As for Taiwan where the current account surplus stands at 10.96% of GDP (Bloomberg, as at June 2013), its strong trade linkages with the US tech sector position it favourably.

Tactical opportunities: China and Brazil

China has been leading the recent data uptick in emerging markets with increasing investment spending and credit growth likely to put the country on track to achieve the growth target of 7.5% for this year – a gesture welcomed by the market. In the long term however, this signals a potentially slower pace of reform from an increasingly debt-laden investment-led growth model to a more balanced and sustainable economy. Going into the year end, we expect more clarity around the balance between reform and growth at the annual party plenum in Beijing – the first full year wrap for the new government, and investors are likely to position favourably beforehand given recent data improvement. The implication is a tactical opportunity in Chinese equities, despite long-term reservations about the difficult growth model transition.

Alongside China, Brazil is staging a stealth summer rally. China is Brazil's biggest trade partner and major importer of soft commodities and iron ore - as demand from China picked up amidst better economic data, Brazil followed. At the same time, domestic Q2 growth surprised on the upside as inflation stabilised, giving the central bank breathing room in policy setting, a potential turning point for subdued investor sentiment. From a valuation standpoint, Brazilian equities trade at 1.5x price to book, the lowest in Latin America, and significantly lower than the second largest Latam economy, Mexico, that trades at 2.9x.