

# Flash commentary

UBS Asset Management | **Emerging markets**

Erin Browne, Head of Asset Allocation, discusses the vulnerability of the broader emerging markets (EM) universe to rising US rates and US dollar strength, and the outlook for EM assets as Chinese growth slows.

In expressing a positive view of emerging market (EM) equities in early July we highlighted the attractive valuations and improved fundamentals since the last time fears about tightening US dollar liquidity conditions prompted a major sell-off across EM assets: 2013's Taper Tantrum. But despite these positives, we also highlighted that risks still remained to EM assets and currencies from rising US rates and a strengthening US dollar, heightened protectionism and a faster-than-expected China slowdown.

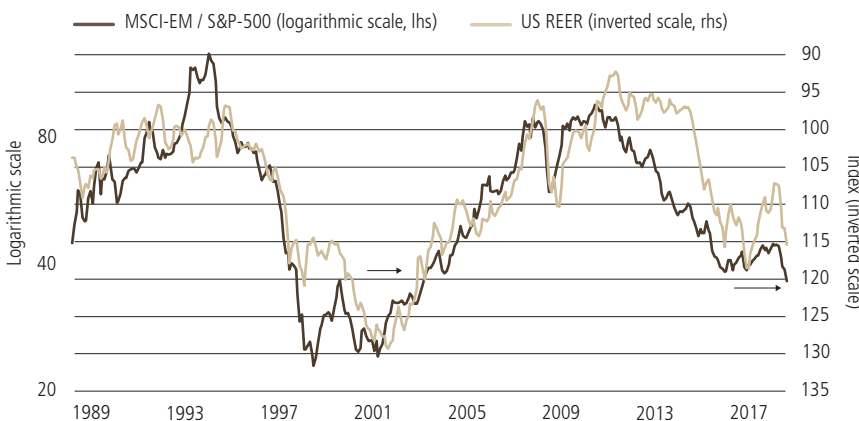
Since that update, all three of those risk factors have come more sharply into focus as the collapse in the Turkish lira amid heightened volatility across EM asset classes raise fears about a more sustained sell-off in EM assets.

Can the situation in Turkey really be categorized as idiosyncratic and Turkey-specific – or are Turkey's problems the 'canary in the coalmine' ahead of wider EM contagion? This Flash Update seeks to address this important question.

### Stronger USD, tighter financial conditions

The US dollar remains absolutely fundamental to EM prospects. Historically the relative performance of EM equities has demonstrated a strong statistical relationship with the US dollar on a trade weighted basis. The principal reason is that the overwhelming majority of EM corporate debt is denominated in US dollars. But there are other factors too, not least the negative impact of a stronger dollar on global trade – particularly commodities – to which EM demand growth is highly exposed.

**MSCI Emerging Markets v S&P 500 (Total Return, Log Scale, LH Scale)  
v US dollar Real Effective Exchange Rate (RHS)**



Source: ICE Bank of America Merrill Lynch Indices, as at 31 December 2017.

Since we last wrote about EM in early July the US dollar has continued to rise – up around 2% on a trade weighted basis since the end of June – and EM currencies, equities and debt have continued to fall. In our view recent US dollar strength primarily reflects that global growth has become increasingly desynchronized, with the sustained robustness of US demand standing in ever sharper contrast with the moderating growth profile of other major developed economies. The policy actions of major central banks are therefore likely to remain on similarly separate paths and we expect the US Federal Reserve to continue hiking rates, albeit gently, at a time when rate hikes and tighter conditions are still some time away for its major counterparts. Against this backdrop, it is not surprising that the trade-weighted dollar has continued to rise.

For EM countries with significant external funding requirements and large current account deficits this backdrop is clearly far from ideal. In addition to Turkey, we would highlight countries including Argentina, Colombia, South Africa and Malaysia.

But the critical point is that EM overall is in much better shape than during the 2013 Taper Tantrum when similar fears arose about the impact on EM assets of tightening US financial conditions. Clearly, EM central banks also have tools at their disposal in the form of higher rates to respond to currency weakness.

So what is the outlook for the US dollar given the somewhat self-sustaining vicious cycle of USD strength and EM stresses? In our view, the critical factor is ex-US growth. China's recent stimulus measures should cushion the economy, but will take time. Meanwhile, data in Europe and Japan have shown signs of stabilization after a weak second quarter – but are still notably weaker than the US. In the short-term, a strong US dollar is likely to ensure higher volatility in EM assets. Nonetheless, we believe fears about a step change in global financial conditions are overdone. Yes, the Fed is tightening. But it is doing so very slowly, with great transparency and with data dependence. Crucially in our view, real policy rates are zero. Meanwhile, the Fed has been unwinding its balance sheet precisely as it said it would a year ago, and may now end the process earlier than expected. What is very clear however is that the Fed will maintain a significantly larger residual balance sheet than it did prior to the onset of QE.

#### Outlook for trade as protectionism escalates

On the trade front, President Trump's initiation of a process to implement tariffs from 10%–25% on USD 200bn worth of Chinese goods is a credible threat. With 'America First' playing well to the US electorate, it seems unlikely that the US-China trade tensions at the center of investors' concerns will dissipate before the US midterm elections in November. Nonetheless, we are also keenly aware how quickly investor sentiment can shift in either direction. At the time of writing,

Indicators of external and fiscal balances and their evolution since pre-“Taper Tantrum”

	CA % of GDP			Ext Debt % of GDP			FX Reserves % of ST Ext. Debt			Primary Balance % of GDP		
	Q1 2013	Q1 2018	Diff	Q1 2013	Q1 2018	Diff	Q1 2013	Q1 2018	Diff	Q1 2013	Q1 2018	Diff
Argentina	-0.7	-4.8	-4.1	26.3	36.6	10.3	107.2	101.7	-5.6	–	-3.7	–
Brazil	-3.3	-0.4	2.9	19.0	26.7	7.7	736.2	728.7	-7.5	-1.5	-7.0	-5.5
Chile	-4.3	-1.0	3.3	46.1	65.5	19.3	215.6	221.3	5.7	0.3	-2.6	-2.9
China	2.6	0.9	-1.7	–	14.0	–	–	285.7	–	6.8	6.6	-0.2
Colombia	-3.5	-3.1	0.4	21.8	39.6	17.7	334.3	373.3	39.0	-1.1	-2.6	-1.5
Czech Republic	-1.9	0.4	2.3	59.8	94.3	34.6	165.6	152.4	-13.2	-1.5	-0.1	1.4
Hungary	2.6	2.9	0.3	95.1	63.7	-31.5	189.8	200.0	10.2	-2.4	-4.9	-2.5
India	-4.8	-1.9	2.9	22.4	20.5	-1.9	302.0	419.1	117.1	-5.1	-4.1	1.0
Indonesia	-3.0	-2.0	0.9	27.6	34.7	7.1	230.3	265.8	35.5	-1.8	-2.4	-0.6
Israel	1.9	2.6	0.7	37.2	25.4	-11.8	203.7	341.1	137.4	-4.2	-1.9	2.3
Korea	5.1	4.5	-0.6	32.9	27.3	-5.6	265.0	335.8	70.8	1.1	1.3	0.2
Malaysia	4.8	3.7	-1.2	62.6	69.0	6.4	138.5	98.4	-40.2	-5.2	-3.0	2.1
Mexico	-1.8	-1.3	0.5	30.0	37.9	8.0	205.7	333.3	127.5	-2.0	-1.0	1.0
Peru	-3.8	-1.3	2.5	29.5	31.4	1.8	664.7	733.0	68.3	1.4	-3.1	-4.5
Philippines	4.2	-0.6	-4.8	22.8	23.3	0.6	857.9	571.4	-286.4	-2.5	-2.6	-0.2
Poland	-2.8	0.1	2.9	71.8	72.0	0.2	252.3	224.3	-28.1	-2.0	-1.1	0.9
Russia	2.5	2.2	-0.3	31.2	32.6	1.4	621.5	840.2	218.7	0.0	-1.4	-1.4
South Africa	-5.6	-2.5	3.1	36.0	49.6	13.6	204.2	154.2	-50.0	-3.8	-3.4	0.3
Taiwan	8.9	14.4	5.5	28.1	33.0	4.9	321.5	254.7	-66.8	2.7	2.1	-0.5
Thailand	-1.4	10.6	12.0	34.0	32.7	-1.3	346.7	364.9	18.2	-1.8	-3.4	-1.6
Turkey	-5.3	-6.3	-1.0	39.2	53.4	14.2	109.0	91.5	-17.5	-1.4	-1.6	-0.2
EM Average	-0.5	0.8	1.3	38.7	42.1	4.8	323.6	337.6	16.7	-1.2	-1.9	-0.6

Sources: UBS Asset Management, Goldman Sachs. Data as of June 27, 2018.

investor concerns about the impact of a protracted trade war between the US and China on Chinese growth and corporate profitability are high. Low level talks between the two sides are, in our view, a positive sign albeit a small one.

Away from US/China trade relations, we believe it is unlikely that the US will seek to repeal its trade agreement with Mexico and Canada, or that the US will impose additional tariffs on the European Union. On the negative side, EM export volume growth had already begun to slow down prior to the increase in trade tensions. In our view, the most likely source of this trend is China's deleveraging and rebalancing process.

### **China outlook**

How do we expect Chinese economic growth to evolve from here? Another important comparison of the backdrop for EM now versus in the first half of the decade is the state of China's growth. After injecting significant stimulus into the economy after the Global Financial Crisis, China reined back fiscal and credit support for the economy. In 2015, China's nominal GDP growth fell as low as it did in the 2008 crisis and 2000 recession before the country eased policy late that year and in early 2016. Of course, China is the world's second largest economy, contributing somewhere between 25% to 30% of global GDP growth in recent years (World Bank). It is integral to global supply chains and commodity prices, and the collapse in China's nominal GDP growth amplified pressures across EM over this period. Now, China's growth

momentum is again cooling as authorities de-risk the financial sector and address pollution. This managed slowdown has been well communicated and is set to be gradual, having learned the lessons from the sharp downturn several years ago. Moreover, China's recent cuts to its reserve requirements signal a bias towards liquidity provision and careful focus on the downside risks to growth. China's leaders currently face a very delicate balancing act in improving the long-term quality of Chinese growth without precipitating a sharper-than-expected short-term slowdown in demand in the process. But having experienced something of a 'nominal hard landing' in 2015, China's more balanced approach to deleveraging should ease concerns that history is repeating itself.

The most recent hard data shows the effects of deleveraging and the clampdown on local government spending as China rebalances its economy. The unemployment rate has edged higher from 4.8% to 5.1% while fixed asset investment in China's non-rural areas rose 5.5% in the January-July period from a year ago, the slowest rate since end-1999. This is not necessarily something to be overly concerned about given that it is uneconomic capital investment that China is seeking to avoid going forward. Retail sales have slowed marginally from 9% y/y to 8.8%, but the underlying rate remains robust. Data showing that the contribution of emerging and high value-added industries rebounded strongly in July also strikes a more positive note about the success of China's rebalancing.

**Conclusions**

In our view, it is an entirely logical response by investors to events in Turkey to look around at other EM countries with similar twin deficits and wonder who is next. However, while the Turkey situation has thrust the vulnerabilities of specific EM economies under the spotlight, most EM countries have significantly better fundamentals than they had in spring 2013, prior to the Taper Tantrum. While EM currency sell-offs can lead to vicious circles even without an obvious fundamental catalyst, we do not see this happening this time.

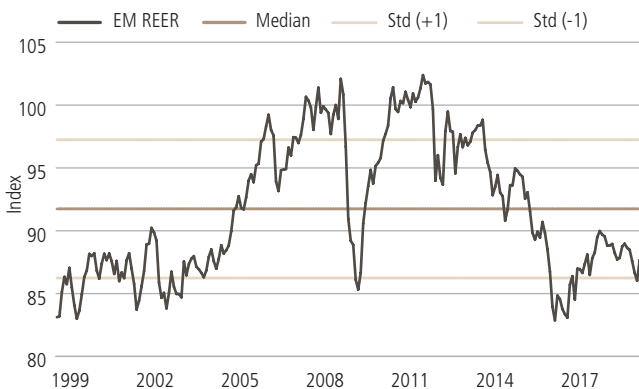
Moreover it is worth remembering that the situation in Turkey has escalated because of the lack of an orthodox or independent policy framework with which to address the current crisis and the imbalances in the Turkish economy. While there are political obstacles to overcome in a number of countries with similar profiles to Turkey, we do not see the rejection of economic orthodoxy as something likely to take hold across EM. In time, we believe investors will view events in Turkey as idiosyncratic.

EM assets are likely to remain volatile in the short-term but given valuation support and overall investor positioning, there is the scope for a sharp rebound should the dollar stabilize, China growth rebound or the combative trade rhetoric between the US and China evolve into something more conciliatory.

We would also point out that one of EM’s enduring attractions is the economic diversity within its broad universe. While we are not stock pickers, we believe this heterogeneity offers the opportunity to add value across EM asset classes through skilled active management.

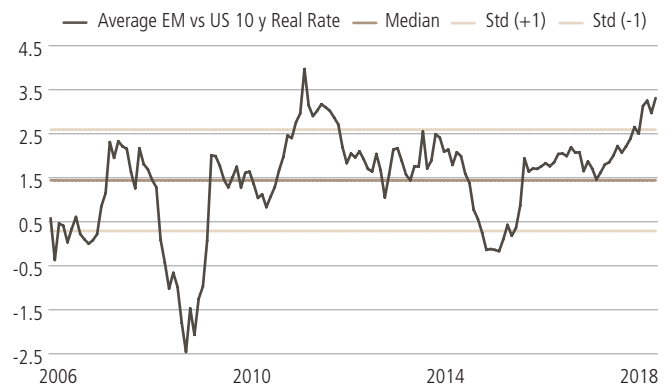
And while there are clearly reasons to approach EM asset classes with some caution over tactical investment horizons, we do not see sufficiently strong arguments for long-term investors to abandon EM exposure given secular support from factors including attractive valuations, diversification benefits and structural demographic trends.

**EM real effective exchange rate**



Source: Bloomberg, UBS Asset Management as at August 2018

**Average EM vs. US 10y real rate**



Source: Bloomberg, UBS Asset Management as at August 2018

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