Emerging Markets

A "Back to Markets" Update

Back to school and back to the markets. We drill down on the key drivers behind recent volatility in emerging market (EM) currencies and outline what we are monitoring for the seasons ahead.

"We view recent volatility as a reflection of country-specific sell-offs rather than a full-blown EM crisis." – *Sam Finkelstein, CIO of Emerging Market Debt*

What has weighed on emerging market (EM) currency performance this year?

A moderation in global growth. Ongoing strength in US economic data versus a moderation in other developed and emerging market countries has tempered investor sentiment toward non-US risk assets, including EM currencies. This growth moderation was in line with our expectations and as discussed in our Mid-Year Outlook, we remain strategically pro-risk but continue to emphasize a dynamic investment approach as volatility re-emerges.

Withdrawal of global liquidity and tighter financial conditions. The US Federal Reserve has raised rates twice this year and is on track to hike twice more before year-end, the European Central Bank is set to draw its quantitative easing program to a close in December, and the Bank of Japan has modulated its policy framework to allow for reduced asset purchases. Withdrawal of global liquidity alongside higher US rates and a stronger US dollar has led some investors to expect EM capital outflows, although they have so far been relatively contained. US financial conditions remain easier than when the Fed began raising rates in 2015 but are trending higher given moves in US rates and the dollar.

Political uncertainties. Bouts of market volatility this year have been motivated by electoral events across both developed (Italy and Spain) and emerging markets (Russia, Turkey, Indonesia, Mexico, and upcoming in Brazil). Uncertainty around outcomes and resultant policy agendas has dented market sentiment and weighed on risk asset performance, particularly in EM.

Higher oil prices. WTI crude oil prices have climbed from a low of $42.5 per/barrel in June 2016 to over $70 today. This can be helpful for oil-exporting EMs, but negative for oil-importing economies.

What drove pronounced weakness over the summer?

Country-specific fragilities. US sanctions on Russia, concerns around external funding needs in Turkey and Argentina, and doubts around policymaker commitment to necessary economic reform in South Africa have weighed on each country's respective currency. More recently, several other EM currencies have come under pressure amid broader EM contagion risks.

Intensification of US-China trade tensions. Concerns around the macro implications of further US tariffs on Chinese exports weighed on the Chinese yuan. Currencies from countries geared toward Chinese growth also weakened, including several Asian currencies. In our view, the direct growth effects of trade measures announced will be manageable; not least given policymakers have intervened to stimulate domestic demand, though we are alert to the second-order impacts through reduced business confidence and investment.

EXHIBIT 1: OUTSIZED WEAKNESS IN SELECT EM CURRENCIES THIS SUMMER

Source: Macrobond, J.P. Morgan. As of September 4, 2018.

Why have Turkish assets experienced outsized weakness?

Macro imbalances given unorthodox policies. Expansionary policies following an attempted coup in 2016 saw Turkish GDP growth rebound sharply in 2017, rising from -0.8% year-over-year in the third quarter of 2016 to over 11% a year later. Growth has since moderated to ~7% but remains above-trend. Meanwhile, inflation has overshot the central bank's target for over 80 consecutive months. Prices are currently rising close to 18% year-over-year, well in excess of the central bank's 5% target. This inflation over-shoot is a function of overly accommodative policy, which partly reflects a lack of central bank independence. Furthermore, the current account deficit widened materially last year due to loose fiscal policies such as a credit scheme underwritten by the Credit Guarantee Fund.

Geopolitical tensions leading to concerns around funding needs. In August, a diplomatic dispute saw the US levy tariffs on Turkish goods and sanction two Turkish ministers. Potential for further US trade actions and sanctions led investors to question Turkey's ability to finance its wide current account deficit and doubt the capacity of its financial and corporate sector to obtain external funding.

What are you watching to gauge the outlook for Turkey?

1. **Policymaker actions:**

- **Tighter monetary policy.** We think a sizeable rate hike is required to restore central bank credibility and investor sentiment toward Turkish assets. Recent central bank actions include a US$6bn liquidity injection through a reserve requirement adjustment, raising the cost of currency hedging, regulatory forbearance for the banking sector with respect to losses related to currency depreciation and increasing the upper bound of the interest rate corridor. These reactive measures may help to contain near-term financial volatility but insufficient for addressing underlying macro imbalances.
- **Commitment to fiscal discipline**. We think the government needs to target a fiscal deficit-to-GDP ratio of below 2% in 2018 and also outline plans to improve the ratio to around 1.5% over the medium-term. We will be looking for indications of this in the Government's Medium Term Program which will be unveiled by September-end.
- **Acceptance of economic rebalancing**. The finance minister has assured investors that lowering inflation to single digit territory is a high priority. Policymaker acceptance of a more moderate growth profile is also required to temper domestic price pressures and lower elevated inflation expectations.

- **Government capacity to recapitalize the corporate and banking sector**. We think the ability of the government to intervene and recapitalize the corporate and banking sectors (should they face funding pressures) is important. In a stress scenario, we estimate the cost of recapitalization to amount to ~11% of GDP. We think Turkey can afford this; its sovereign debt-to-GDP ratio is around 28%. This is low relative to other EM economies and pales in comparison to Italy's 130% ratio. We think this strong fiscal position should serve as an anchor for external sovereign debt, though recent weakness in its currency has challenged performance in all Turkish assets.
- **Obtainment of multi-lateral funding support**. The Finance Minister has confirmed that capital controls will not be imposed. We think requesting an International Monetary Fund (IMF) stand-by agreement could help restore policymaker credibility.

2. **The banking sector:**

- **Non-performing loans (NPLs).** Recent volatility in Turkish assets has potential to weigh on Turkish banks' balance sheets and earnings via four key angles[1]: (1) lower net interest income due a mismatch between loans and deposits in a rising rate environment; (2) mark-to-market losses on securities portfolios due to a rise in sovereign bond yields; (3) a pick-up in NPLs due to currency weakness and a slowing economy; and (4) currency depreciation pressuring capital adequacy ratios as regulatory capital is largely denominated in local currency. Although we expect to see an uptick in NPLs, we think Turkish banks are better positioned to withstand near-term stress than in the past due to an improvement in capital ratios.
- **Rollover risk.** The ability of Turkish banks to rollover external debt in the coming months will be a key signpost for credit sector stress. Turkey's banking sector has been through several stress tests since 2001, including the Global Financial Crisis (GFC) in 2008, the 2013 'Taper Tantrum' and the failed military coup in 2016. With respect to rolling over external debt, we think Turkish banks will fare better today than during the GFC, though we will be closely monitoring upcoming events.

3. **Current account adjustment**. The recent adjustment in the currency and resultant slowdown in growth may cause this deficit to shrink as a weaker currency compresses imports but boosts export competitiveness.

Why have Argentine assets come under pressure in recent weeks?

Macro imbalances despite orthodox policies. The Macri Administration inherited an economy in 2015 that was experiencing annual inflation in excess of 25% and running both a current account and government budget deficit (or "twin deficits"). Argentina had also defaulted in 2014 for the second time in thirteen years[2]. The new reform-minded government appeared committed to fiscal discipline, orthodox monetary policy and market-friendly regulations. Nonetheless, inflation has risen to above 30% and the twin deficit remains in-tact. Extreme drought conditions earlier this year crippled production of agricultural products – Argentina's largest source of export revenue. This has prevented the current account from improving, despite policy tightening.

Concerns around funding needs. Similar to Turkey, given its wide current account deficit and high external financing needs, Argentina is sensitive to a potential decline in foreign investment, global liquidity conditions and investor perceptions of policymaker credibility. Against a backdrop of less synchronized global growth and developed market monetary tightening, Argentina's ability to access capital from foreign sources to meet its funding needs has fallen. This prompted President Mauricio Macri to request the International Monetary Fund (IMF) to accelerate disbursement of a loan worth up to $50 billion in order to meet its debt obligations.

[1] Source: Eurasia Group.
[2] This this de facto default was a function of a U.S court ruling in favor of investors who were unwilling to accept debt-restructuring terms. As a result of this, no repayments were made, given the so-called RUFO clause would have allowed other investors to demand the same treatment.

What are you watching to gauge the outlook for Argentina?

1. **Policy actions:**

- **Tighter monetary and fiscal policy.** The central bank has raised policy rates by over 31.25% this year – more than thirteen times the combined rate hikes of G10 economies since 2009. This includes a notable 15% rate hike to 60% in August amid renewed downward pressure on its currency. While we think these actions are appropriate, we also appreciate that the effectiveness of policy tools can be blunted by market sentiment. To restore investor confidence we think fiscal and further monetary tightening is required.
- **Policymaker implementation**. Given elections will be held in October 2019, we are cognizant of risks around implementation of politically unpalatable policies such as fiscal tightening. We will be closely monitoring political polling and signs of social unrest which may see policymakers reverse course. Furthermore, we think it is important for the incumbent Administration to receive support for appropriate policies from opposition parties. This will help to alleviate market concerns around policy continuity beyond next year's election.

2. **Current account adjustment.** Preliminary data suggests the current account deficit is already narrowing. Activity data, such as industrial production in July, has also decelerated sharply. The silver lining of a rapid decline in real activity momentum is swifter trade and current account balance adjustment.

3. **Domestic stability.** Argentina has been in a technical recession on four occasions since 2008 and the economic turmoil that followed a sovereign default in 2001 still resonates with many consumers, businesses, investors and savers. Political instability and economic volatility has eroded domestic confidence in institutions, including the banking sector. In short, Argentina is faced with a loss of both domestic and foreign confidence, and so restoring both will be important for the economic outlook and asset performance.

4. **IMF support.** Discussions between Argentina and the IMF regarding changes to its $50 billion aid package, namely bringing forward its disbursement, are ongoing. We think Argentine assets will be susceptible to volatility until we receive clarity on the status of Argentina's stand-by-agreement, local sentiment improves and the political outlook is more certain.

What is your outlook for EM more broadly?

Economic fundamentals for majority of EMs are healthy. In its 2018 External Sector Report, the IMF highlighted that since the Taper Tantrum in 2013, current account imbalances had improved in several EM economies such as Brazil, South Africa and Mexico (among others). These findings align with our analysis. In our July note, Emerging Markets: Blow-Up? Or Blow Over?, we highlighted the improved ability of EM economies to withstand a sudden stop in foreign capital inflows compared to prior episodes of market stress due to a buildup in foreign exchange reserves (which can be used to offset capital outflows) and a reduction in current account deficits. Macro fundamentals, such as growth and inflation dynamics, are also healthier.

Structural tailwinds remain in place. In the near term, patience may be required when assessing value and the potential for rebound in EM assets. However, we believe the medium- to long-term case for holding EM assets – strong growth potential, favorable demographics, low debt, better balance sheet resilience and corporate earnings growth potential – remains intact.

EM is a diverse asset class. Last year we noted that EM corporates are as varied as the language, climate and cuisines of their home countries. The same applies for EM sovereigns. In August, the total return on external EM debt and local-currency denominated sovereign debt was -1.7% and -6%, respectively. That said, these relatively modest aggregate index moves conceal disorderly price action in select markets such as Argentina and Turkey, where external debt spreads widened 216bps and 166bps, respectively. These moves highlight that risks and opportunities can vary considerably by EM economy. Importantly, we do not think recent country-specific events should serve as a bellwether for the broader EM complex and we continue to see investment potential across EM markets.

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