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The Never Ending Story in Emerging Markets

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Since the last piece on the emerging markets, the asset class has continued to depreciate, with Turkey being the latest to fall into a depreciation trap, falling an estimated -24.5% since May 21. Investors by now are familiar with the narrative surrounding emerging markets this year: that emerging markets are hurt by the appreciating U.S. dollar and retreating capital flows driven by the drawdown of global liquidity.

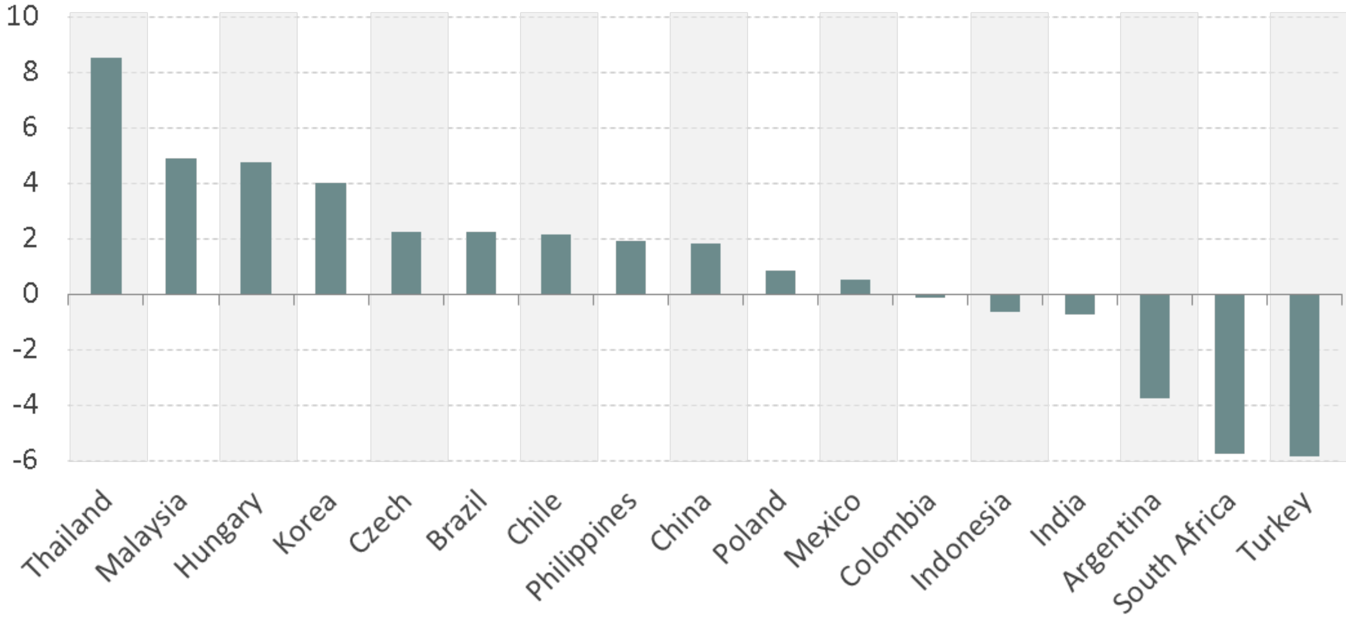
While emerging markets rely on dollar-based funding, Turkey is an outlier. Turkey fell due to a confluence of external and internal factors: withdrawal of global liquidity, the rising U.S. dollar, over-extended credit growth, high external debt, and wide current account deficits financed by capital flows. The deterioration in governance only compounded these issues, and the latest U.S. sanctions acted as a catalyst.

Sifting through a "Market for Lemons"

In a market where contagion fears can run wild, it is important to revisit the thesis that not all emerging markets are lemons. Nobel prize winner George Akerlof's theory "The Market for Lemons" points out a potential buyer has asymmetric information and the fear of getting stuck with a lemon results in the premium good not being able to be sold at a superior value. Indeed if emerging markets typically face a "sudden stop" in capital flows, the metric below (Chart 1) sifts out the countries that can survive in the event of a sudden stop in fickle portfolio capital flows. The latest round of emerging market depreciation caused by the short-term volatility from Turkey has made some of the countries on the left side of the x-axis in Chart 1 more undervalued. These include Brazil and Malaysia. Note that the concerns that Brazil is facing are not externally driven. Rather, the real is pricing in concerns over longer-term fiscal and debt sustainability caused by uncertainties in the upcoming presidential elections.

Chart 1: Current Account – Net Foreign Direct Investment

% of GDP, As of 3/31/2018



Source: Haver Analytics

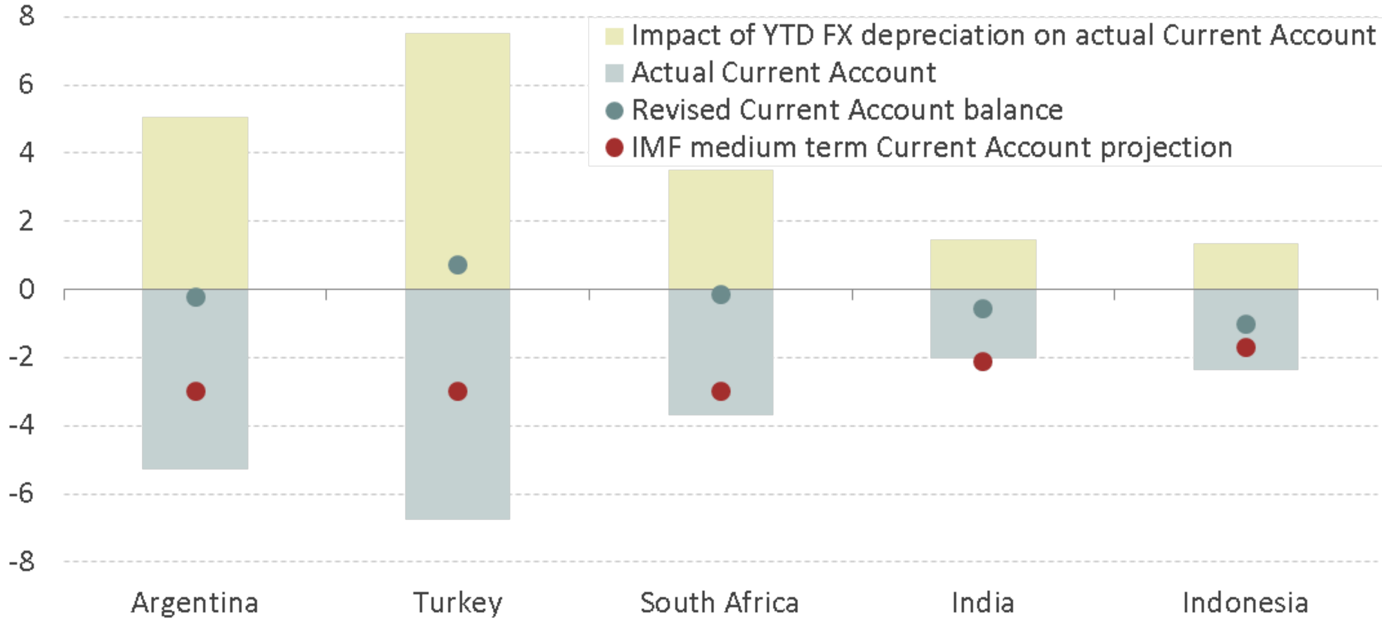
What about the lemons in this market?

Our investment process requires us to think about whether there are any feedback effects from the current price profile that could be changing the macro story. To this end, it is important to assess how the current account in Argentina, Turkey, South Africa, India, and Indonesia will evolve in the next few years from the 2018 exchange-rate depreciation.

Simulations using standard trade elasticities (Chart 2) show that the wide current account deficits that these countries face will be re-balanced in coming years due to the exchange rate depreciation so far. We think that is good news for investors.

Chart 2: Current Account Rebalancing Over Next Few Years from FX Depreciation

% of GDP, As of 3/31/2018



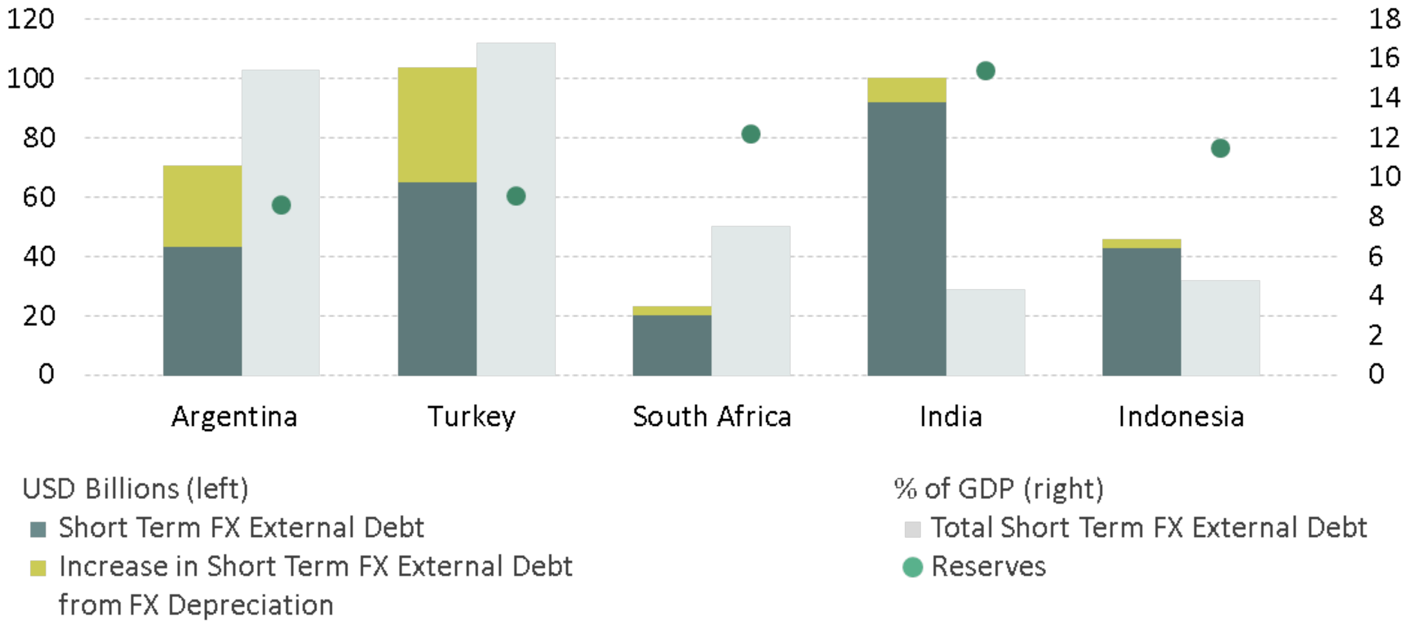
Source: Haver Analytics, IMF

Despite the corrections in the current account, one needs to consider that the exchange-rate depreciation results in increased short-term foreign currency debt financing. Based on March 2018 external debt statistics, the 37% year-to-date depreciation in the Turkish lira has increased short-term foreign exchange debt financing by an estimated $38billion (bn). So far, Turkey has managed to secure $15bn from Qatar and $3bn from China. While Turkish banks have hedged out their foreign-exchange liabilities, corporates have not and continue to face foreign-exchange asset liability mismatches. Unless the U.S. dollar depreciates meaningfully from here, Turkey continues to face an external debt financing problem which may manifest into greater lira depreciation. The risk of continued complacency from the central bank could also affect lira valuations.

In contrast, the Indonesian rupiah has depreciated by 7.4% year to date, resulting in an estimated increase in short-term foreign exchange debt financing of $3.4bn. To finance this, the Indonesian government has secured $2.5bn in additional loan commitments, while raising rates by some 150 basis points (bps) since April to attract capital flows. The Indonesian government has started to reduce the current account deficit via prioritizing infrastructure projects and is looking to attract more export earnings. The Indonesian government's actions signal it is preparing for a longer, drawn out withdrawal of capital flows. With foreign exchange reserves as a percent of GDP able to cover the total short-term foreign exchange external debt, Indonesia will likely be able to survive better from the fallout emanating from Turkey or a further increase in the U.S dollar.

Chart 3: Increase in Short-Term Foreign Currency External Debt Due to FX Depreciation

As of 3/31/2018



Source: Haver Analytics, World Bank, Central Banks

Conclusion

No one can definitively predict that a greater emerging market fallout will or will not happen. But until Turkey capitulates and resolves its external financing issues, its central bank actually continues down the path of tighter monetary policy, and/or G3 central banks reduce their pace of normalization, further drawdowns in emerging markets may continue. However from the glass half full perspective, the U.S. dollar may start to stabilize. As my colleague Jack McIntyre wrote in his recent blog, we hold the view that a strong dollar is counterproductive to the U.S economy. Meanwhile the exchange rate depreciations we have seen so far in emerging markets have a positive feedback loop into eliminating current account deficits; China has put in place some stimulative policies to support its targeted growth going forward. While the negativity toward emerging markets may seem never ending, we think there is a more realistic story at play, supported by the data.

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