APR
27
2020

# Emerging Markets - Hit Me One More Time

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**A black swan virus shock brought the world to its knees—dealing a particularly acute blow to emerging markets. It was only a year ago that emerging markets recovered from the previous Federal Reserve (Fed) tightening and trade war crises. Britney Spears's *...Baby One More Time* seems like an apt description for the series of shocks that emerging markets have gone through. However, this time around both developed and emerging markets have experienced large currency depreciations, yet this might morph into more of an emerging market stress than previously imagined. As we sift through the effects of COVID-19, we reflect on some of the stresses emerging markets may face and assess the road ahead.**

## Emerging Markets Under Stress

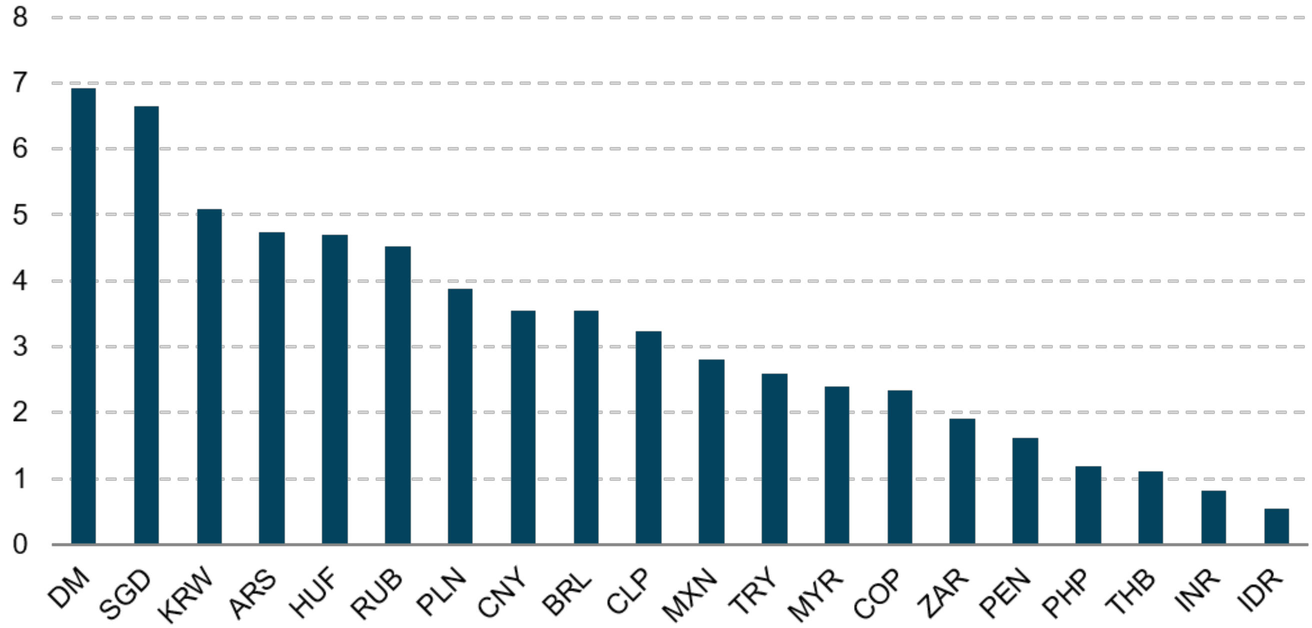
**Chart 1 shows a comparative ranking of emerging market health systems, relative to one another and developed markets. With weaker healthcare systems relative to developed markets, emerging economies may be less equipped to handle a pandemic like COVID-19. India, Philippines, Poland, Turkey, South Africa, Mexico, and Brazil have issued an economic-wide shut down once they realized how critical the health crisis would be, although some were very late or too slow.**

1

Healthcare Capacity

Score index out of 10, As of 4/16/2020

(Index consists of health expenditure per capita & Physicians per 1000 people)

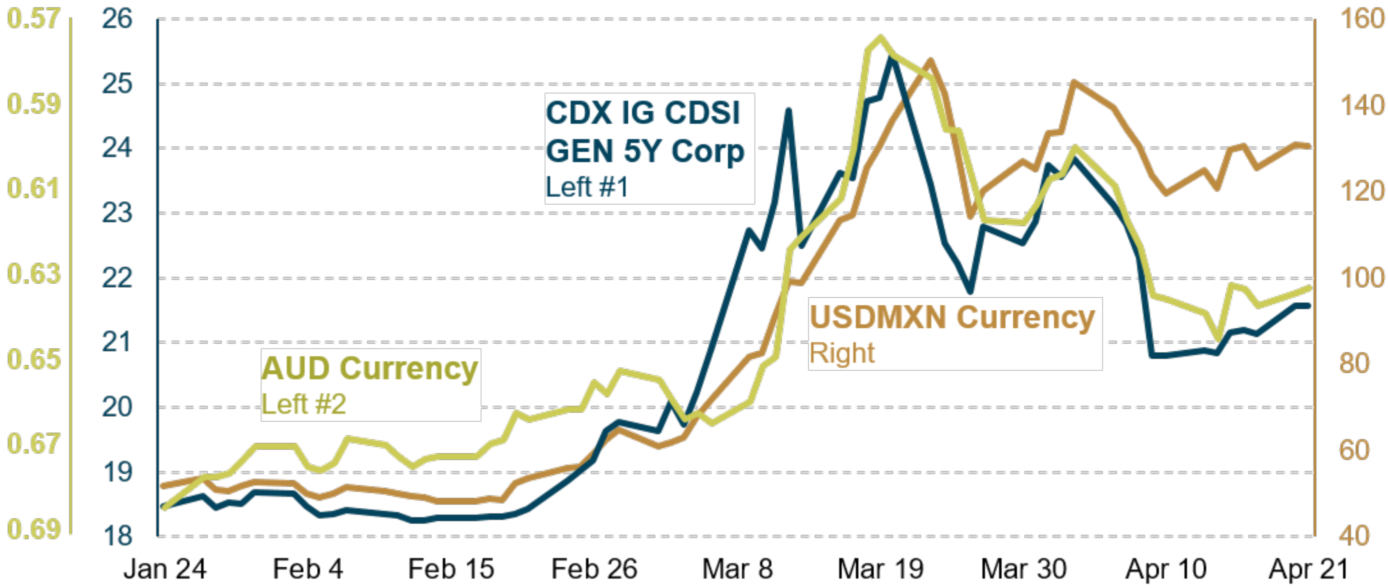



Source: Maplecroft

**Added to the health crisis was the liquidity squeeze caused by a global rush for U.S dollar cash. Even in this environment, the traditional relationship has held up, with currencies continuing to show a strong correlation to credit spreads in the U.S. (Chart 2). With the Fed and U.S government stepping in to do whatever it takes to ease both liquidity and credit market conditions, some stress across global currencies has eased on the currency basis. To this extent, the Fed has extended swap lines to major central banks in Europe, Japan, Switzerland, Australia, New Zealand, Norway, Mexico, Brazil, South Korea, and Singapore.**

**2** U.S Investment Grade CDX Correlation with AUDUSD, USDMXN

January 24, 2020 thru April 21, 2020



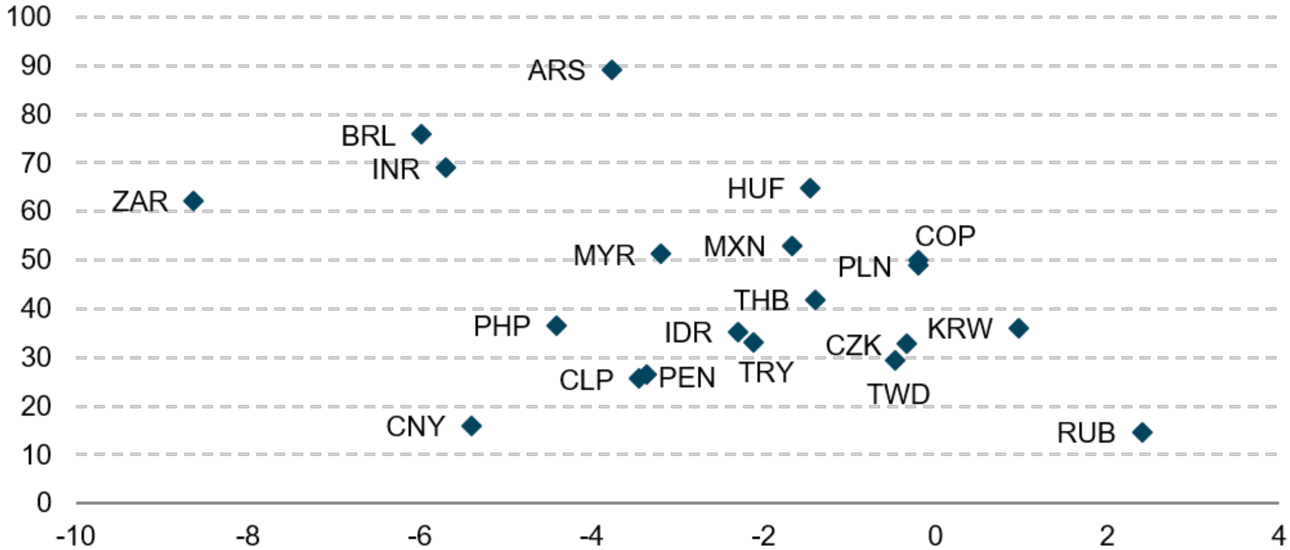

Source: Bloomberg (© 2020, Bloomberg Finance LP)

**But even as the liquidity squeeze eases, emerging market fiscal deficits and balance sheets remain in focus. Countries globally are spending more to fill the hole left by the economic shutdowns. Concurrently with the demand shock, oil prices have collapsed, resulting in a deep revenue squeeze for many commodity-based countries. It is therefore not inconceivable that fiscal deficits will be expanded by more than twice the amount seen during normal times. Some countries can afford to do so while others simply cannot (Chart 3).**

3

**Fiscal Balance vs Public Debt to GDP**

% GDP, As of 2/28/2020

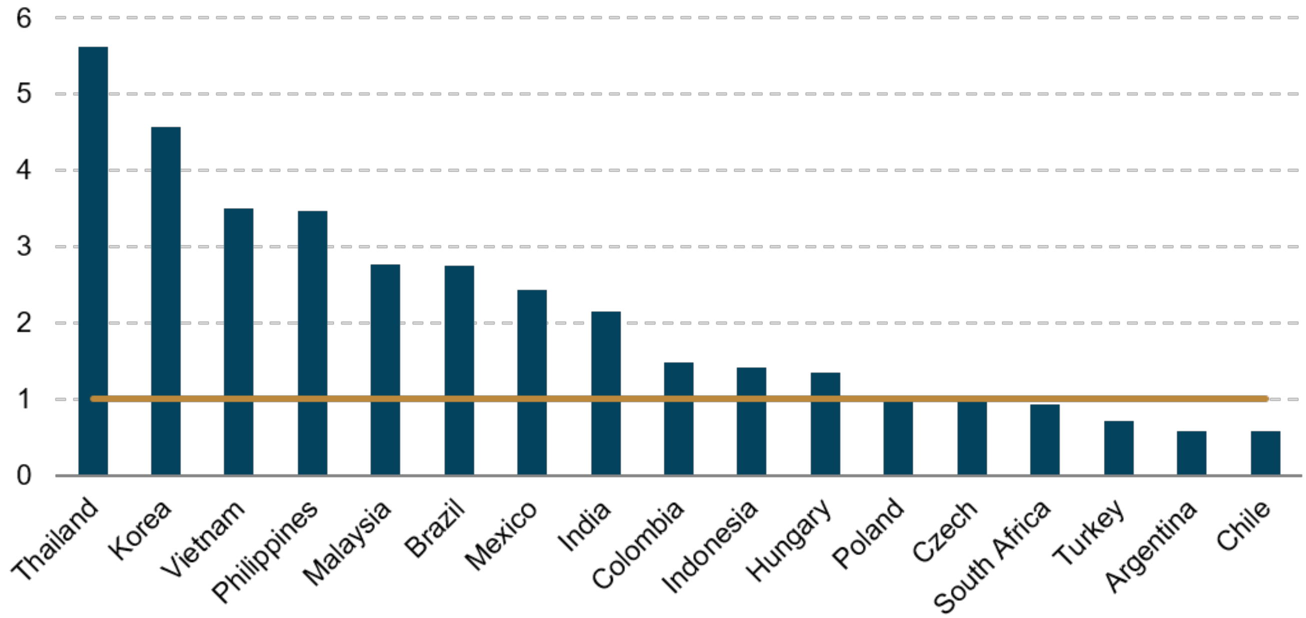



Source: Haver, Macrobond

**It is during such times that countries need financing. Yet private capital flows have almost all but dried up. The ratio of foreign exchange reserves to gross external financing is a chart to revisit every time financial market stress accelerates (Chart 4). Clearly some countries are more vulnerable to sudden stops in portfolio flows while others have sufficient foreign exchange reserves to see it through for a year—even if banks are unwilling to roll over all short-term external debts, or investors show a buyer strike at bond auctions. The vulnerable countries after accounting for extended swap lines are Argentina, Turkey, South Africa, and Chile.**

4 FX Reserves Including Swap Lines to Gross External Financing Needs Within a Year

FX Reserves / External financing needs, As of 2/28/2020




Source: Haver, IIF

**Note: When foreign exchange reserves fall below 1.00 to external financing needs, a country could face financing issues when capital flows stop.**

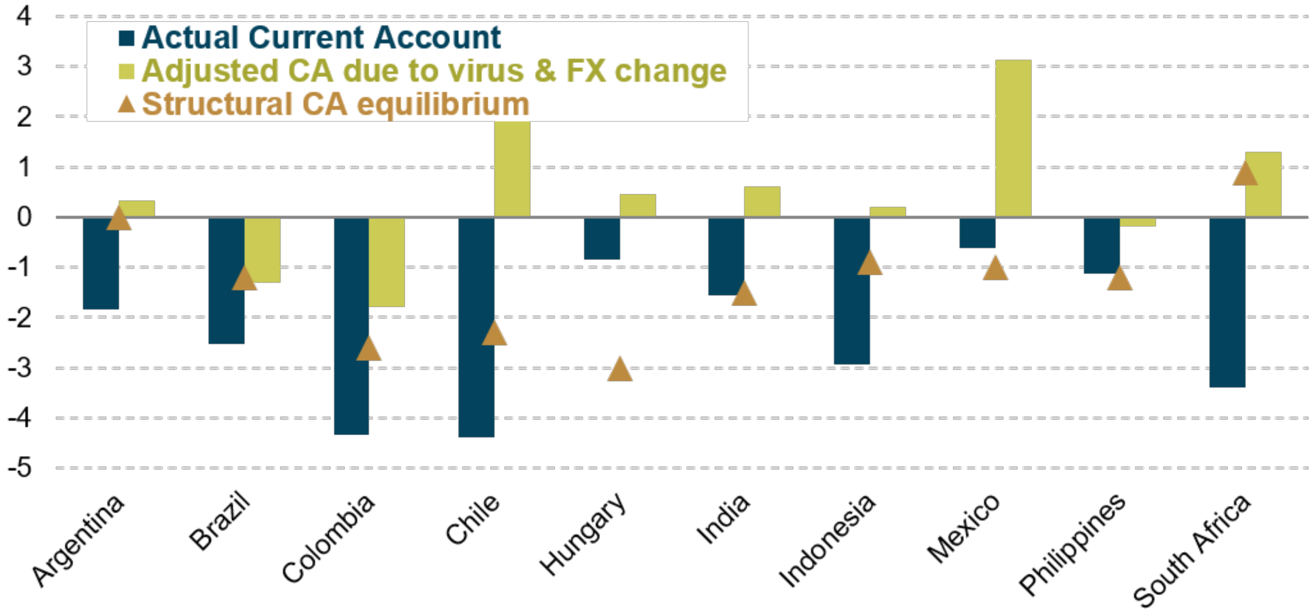
**The International Monetary Fund has responded by pledging a $1T line to vulnerable countries to tide over this crisis, which has helped smaller emerging markets. The larger ones have reacted by allowing their currencies to depreciate to some extent while engaging in intervention and/or modest quantitative easing to keep their bond markets functioning with lower rates. Altogether, emerging markets have also lowered rates by some 50 to 100 basis points.**

## Have Currencies Depreciated Sufficiently? Who Likely Recovers First?

**With currencies having depreciated by some 6% to 25% across different emerging markets, the question is whether currencies have depreciated enough such that there would be an economic feedback via the current account.**

**5** Current Account Changes Due to Cyclical Virus Shock & FX REER Change

Chart Units/Description, As of 3/31/2020




Source: Bloomberg (© 2020, Bloomberg Finance LP), Haver

Looking at Chart 5 suggests that some currencies have depreciated sufficiently to counter the virus shock. One could make a judgment that the virus shock will change the economic landscape structurally, and therefore, currencies may need to depreciate further to the new norm. In light of the currency depreciations, it pays to be careful in sifting through the quality versus weak emerging markets. If a large emerging market were to default, it may cause a U.S. dollar squeeze once again across the spectrum.

Despite how gloomy the world may be now, we cannot and will likely not remain in this dismal state forever. Medicine and science are advanced and the likes of China and Korea have shown that we can overcome the virus. In envisioning a recovery, emerging markets that have a larger reliance on manufacturing exports—South Korea and Taiwan in Asia, and the Czech Republic and Poland in Europe—are likely to recover first as the China experience suggests. Many of these manufacturing economies have sufficient U.S. dollar liquidity with swap lines and no external financing issues. In the next tier of higher-yielding countries—ones with some fiscal discipline but flexibility, fewer issues with external financing needs, and credible central banks—like Indonesia, Russia, and Mexico, are perhaps likely to be able to tide over this stressful period more quickly than others.

# The Long Road Ahead

The structural landscape is changing rapidly for emerging markets. As mentioned by my colleague Tracy in her previous blog on [The Unintended Consequences of COVID-19](), there would be a reshuffle of global supply chains after the dust settles from the virus outbreak. China's growth may slow more drastically as the major G3 economies realize the perils of supply chain concentration. However, ultimately emerging markets depend on China's growth. Nevertheless, China's economy will recover as the credit impulses imply, though its efforts will be focused more on investing in new technology and infrastructure, rather than piling into old-school infrastructure stimulus. Due to the virus, emerging markets will yet again engage in more borrowing leading to an even larger debt pile. Overall, the global economy will reopen slowly and in stages due to extreme caution around the virus and the potential for second-wave outbreaks. Against a backdrop of slowing growth, de-globalization, and higher savings rates globally, this may warrant exercising more caution and selectivity with respect to emerging markets over the next decade.

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