RBC Global Asset Management

Emerging Market Distress

January 28, 2014

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Political and economic uncertainty in emerging markets (EM) has become a significant risk for today's investors. World equity markets have waned over the past few days, 10-year Treasury yields are down approximately 13 basis points, and the S&P 500 Index is down 3% since January 20. EM equities are also down roughly 5% as investors worry about the longer-term outlook for the asset class. Although the EM trade has come under selling pressure in the last couple of days, it's important to note that the issues facing EM are not new, and represent a continuation of last year's weakness. EM equities are 16% lower than they were at the start of 2013 and EM credit spreads have stretched roughly 100 basis points since the start of last year. However, this month we have witnessed several key catalysts that have exacerbated the trend.

Key Regional Catalysts

- **China:** Weak PMI data out of China coupled with concerns about the nation's shadow finance sector has put China's stability and growth prospects in doubt.
- **Turkey:** Protests are once more rippling through Turkey, raising fears of prolonged unrest before the country's elections at a time when the economy is also coming under pressure. The country's central bank is carrying a large current account deficit and is rapidly running through its foreign reserves.
- **Argentina:** Argentina's structural deterioration continues and the peso has made a rapid descent against the U.S. dollar as the Argentinean central bank runs out of reserves with which to prop up its currency.
- **Ukraine and Thailand:** Political crises in Ukraine and Thailand are intensifying.

Underlying Global Risks

- **Fed Tapering:** The U.S. Federal Reserve's initiation of tapering has led to some trepidation given the assumption that there will be less automatic support from the world's most important central bank, should conditions deteriorate. In addition, higher rates attract money to the U.S. and tend to increase global borrowing costs.
- **Credit Excesses:** Concerns about credit excesses reared their head last summer and several EM countries, including "The Fragile 5" (India, Indonesia, Brazil, South Africa, Turkey) faced weaker currencies and higher yields. We are witnessing similar concerns now, albeit intensified, and South Africa and Turkey, in particular, are problematic. China is currently at the forefront of credit-related concerns, though it is less exposed to the market's punishment and thus not included among the five due to its strong capital controls and interest rate repression.

Potential Consequences

While it is difficult to predict the effect of the current state of affairs in EM, there are a few possible scenarios that could unravel:

- A worst case scenario could superficially resemble the Asian financial crisis of 1997. We believe this is a less likely scenario as most EM countries:
  - are well insulated from credit problems
  - have substantial FX reserves and smaller public debt burdens than 15 years ago
  - are less reliant on foreign borrowing, particularly their banking sectors
  - are savvier about how to manage capital controls
  - are ready to benefit from improving global growth, thanks to stronger developed economies
- Recent events are more likely to result in a handful of EM countries underperforming significantly, and, more generally, EM growth failing to live up to investor expectations, but avoiding a broader, more intense regional crisis:
  - Dysfunctional economies with structural deficiencies, such as Venezuela, Ukraine, Thailand and Argentina, are at high risk of underperforming the broader EM space.
  - The Fragile 5 are at risk given their large current account deficits and upcoming elections, which reduce the probability of meaningful reform in the near term. South Africa and Turkey are the two most problematic countries. The silver lining is that once the elections have passed, these countries

may start to become attractive once again. Generally, these countries have long-term opportunities to reform their economies to access faster growth over time.

- China also remains on the radar given concerns about the magnitude of credit growth and possible credit defaults. Fortunately, there is a long history of the Chinese government bailing out banks (and ultimately, investors) as needed. It appears that the high-profile investment trust that was on the cusp of default will likely be resolved as the facilitating bank compensates investors for most losses. Thus, any crisis should be contained. The issues in China are still a very real growth threat to the world's second-largest economy.
- Most other emerging market countries should be less affected, with weaker exchange rates potentially stabilizing, or even helping, their growth.
- Finally, global trade should improve over the next six months, which should limit the downside for many EM countries.

Emerging Market Equities

When we look at EM equities as an asset class, it appears as though many of the risks are already priced in – keeping in mind that catching the low is always difficult. EM equities are trading at trough valuations, with a price-to-book ratio around 1.4 times, and at a 30% discount to developed market equities. Currencies have been depreciating in the last 12 months and are now much more competitive, while funding costs have risen considerably given the rise in both bond yields and spreads. From a consensus standpoint, EM has gone from being overweight to an underweight, and the shift in sentiment may herald that the bottom is near. Ultimately, the long-term superior growth story for EM is very much intact, driven by lower debt, better demographics, urbanization, rising productivity and a growing middle class.

Emerging Market Bonds

Given recent market volatility related to China, we have skewed our EM bond holdings to more defensive positions. Notwithstanding concerns about the magnitude of credit growth in China and pending credit defaults, markets are still more sanguine than those seen during the more aggressive People's Bank of China tightening of last June. While 7-day Shibor (short-term bank financing rates) have recently nudged up, they are still well down from peaks of last June and even the spike witnessed at the end of the year (which was prompted by regulatory requirements to meet bank loan-to-deposit ratios). While credit spreads for Chinese banks have recently nudged up, markets are still not showing levels of alarm consistent with past crises (e.g. those associated with the Eurozone). With sub-50 flash PMI readings announced out of China this week, we remain watchful and believe we could see some volatility over the coming few weeks.

- The theme of differentiation across EM economies continues. We have seen strong month-to-date performance from long maturities in Morocco and Hungary in our portfolio, for example, even as the long end of Indonesia has come under pressure.
- We remain underweight Ukraine, Argentina and Venezuela based on the structural deterioration we see in all of them. We are more constructive in our views of Indonesia where the current account deficit is falling, foreign exchange reserves are rising (bolstered by $4 billion in new sovereign issuance this month) and growth is still expected to be a decent 5% (or more), even in the face of political uncertainty around upcoming elections.

Outlook

To conclude, the risks associated with emerging markets are real, and we maintain below-consensus growth forecasts for most EM nations over the near term. Notwithstanding these short-term issues, the key long-term arguments in favour of EM outperformance remain evident. We continue to recommend that investors should retain exposure to this asset class.

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