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WEEKLY INVESTOR RESEARCH

Ashmore

Why other EMs do not share Argentina and Turkey's vulnerabilities

By Jan Dehn

Under which conditions are EM countries vulnerable to economic contagion via currency volatility? Two conditions have to be satisfied before currency volatility can morph into major economic malaise. First, the EM country in question must have serious macroeconomic imbalances to begin with, usually due to a long history of poor macroeconomic management. Second, the country must be unable to obtain its required funding domestically. Argentina and Turkey both fit the bill, but emphatically the other major EM countries do not. This is why the likelihood of transmission of the economic vulnerability from Argentina and Turkey to other countries via currency volatility is close to nil.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	10.7	–	0.60%
MSCI EM Small Cap	10.6	–	0.23%
MSCI Frontier	10.5	–	-0.88%
MSCI Asia	11.3	–	0.77%
Shanghai Composite	9.4	–	-0.71%
Hong Kong Hang Seng	7.0	–	0.23%
MSCI EMEA	9.0	–	1.78%
MSCI Latam	11.2	–	-0.74%
GBI-EM-GD	6.69%	–	1.07%
ELMI+	5.16%	–	0.75%
EM FX spot	–	–	0.74%
EMBI GD	6.55%	355 bps	0.63%
EMBI GD IG	4.83%	182 bps	0.28%
EMBI GD HY	8.57%	557 bps	1.00%
CEMBI BD	6.21%	324 bps	0.24%
CEMBI BD IG	4.93%	196 bps	-0.13%
CEMBI BD Non-IG	7.87%	490 bps	0.70%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	16.3	–	1.21%
1-3yr UST	2.78%	–	-0.08%
3-5yr UST	2.90%	–	-0.23%
7-10yr UST	2.99%	–	-0.36%
10yr+ UST	3.13%	–	-0.48%
10yr+ Germany	0.45%	–	-0.79%
10yr+ Japan	0.12%	–	0.01%
US HY	6.22%	319 bps	0.45%
European HY	3.51%	409 bps	0.29%
Barclays Ag	2.11%	-88 bps	0.02%
VIX Index*	12.07	–	-2.81%
DXY Index*	94.97	–	-0.18%
EURUSD	1.1629	–	0.30%
USDJPY	111.98	–	0.76%
CRY Index*	190.48	–	0.13%
Brent	78.2	–	1.10%
Gold spot	1196	–	-0.02%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

There are now clear signs that the storm of nervousness, which has blown through Emerging Markets (EM) this year, is moving into its final stage. US growth likely peaked in Q2 and the Treasury market is now heavily discounting Fed Chairman Jay Powell's bold rate hiking plans from earlier this year. This means that growth and rates are no longer going to drive the Dollar higher. EURUSD has also adjusted meaningfully lower and assumed what appears to be a more stable range. EM FX moved into buying territory as far back as June of this year, so now only President Donald Trump's recurring threats of tariffs against China and the uncertainty surrounding the upcoming election in Brazil, still weigh on EM sentiment. Markets are starting to distinguish between EM credits rather than trading EM as one amorphous entity and smart early movers are beginning to nibble at now very attractively priced assets. All this is very normal and very good. Even the two EM basket cases of 2018, Turkey and Argentina, have started to take important steps towards fixing their problems and value has emerged in some places, including segments of their Dollar-denominated debt markets.

Yet, many investors and especially members of the media continue to worry that the economic problems faced by Argentina and Turkey could somehow spread to other EM countries through some vaguely defined pathways of market-induced contagion, usually via currency volatility. These fears reflect an underlying assumption that foreign funding of EM countries is somehow critical to their economic survival. A recent Reuters headline illustrates this line of thinking perfectly: "Emerging Market currency crisis could lead to broader economic trouble".[1] In our view, such headlines are ill-informed. Firstly, there is no crisis. Secondly, such articles reflect a profound amount of ignorance about the true funding situation facing most EM countries. The purpose of this 'Weekly' is therefore to explain the specific conditions, which have to be satisfied for currency volatility and bouts of EM risk aversion in general to morph into serious economic problems. We believe that two basic conditions have to be satisfied, namely bad macroeconomic policies and inadequate

[1] Article by Karin Strohecker and Ritvik Cavalho. See https://uk.reuters.com/article/uk-emerging-markets-economy-analysis/emerging-market-currency-crisis-could-lead-to-broader-economic-trouble-idUKKCN1LU1VPb

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Emerging Markets

domestic funding. Both these conditions happen to be present in Argentina and Turkey, but they are emphatically not present in most other established EM countries. That is why, in our view, the likelihood of broader economic weakness arising from the recent currency volatility in EM is close to zero.

Condition 1: Sustained bad macroeconomic policies

The first condition, which must be satisfied for a country to get into serious economic trouble during bouts of FX volatility, is that the country in question has pursued misguided macroeconomic policies for a sustained length of time. This is the case in Argentina and Turkey, but not the case in most other established EM countries. For example, Argentina is the only country in the world, apart from the US, which pursued a combination of looser fiscal policy and tighter monetary policy in the hope of simultaneously bringing down inflation and avoiding recession. This policy mix is a classic recipe for hot money inflows and eventual currency instability. Similarly, Turkey is the only country in the world with a President, who firmly believes, indeed goes on TV to state, that raising interest rates results in higher inflation. Argentina and Turkey followed different but equally misguided macroeconomic policies for many years and the results included the widest current account deficits in EM and inflation rates in excess of two standard deviations above the EM average.

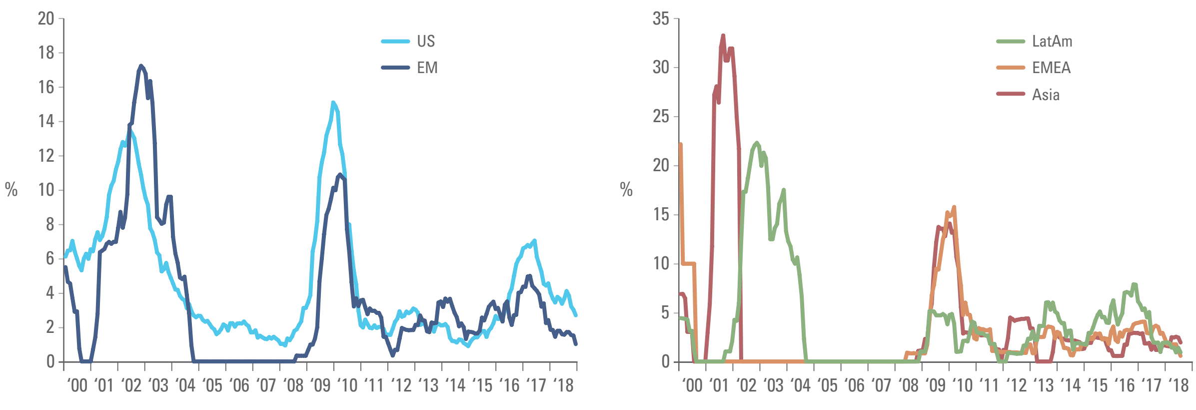
Condition 2: Inadequate domestic financing sources

The second and equally important condition, which must be satisfied before bouts of FX volatility can cause serious economic damage in EM countries, is that the country in question cannot meet its financing needs in domestic markets. Uniquely among the established EM economies, Argentina and Turkey do not have well-developed domestic pension systems. Argentina destroyed its own domestic pension system during the Kirchner era and the banker-led economic teams under current President Mauricio Macri have unsurprisingly prioritised myopic policies involving heavy overseas borrowing in preference to fixing the domestic pension industry. The fallacy of this choice is now obvious for all to see. In Turkey, there has been similar neglect of the domestic financing industry. Nearly every corporate and household in Turkey saves in foreign currency rather than in lira and the country finances its current account deficit using short-term external bank funding. The root of this dependence on flight-prone foreign capital is President Erdogan himself, who, despite being in power for many years with a large stock of political capital, never committed to the orthodox monetary policies required to make Turks feel comfortable about keeping their savings at home. He also did nothing whatsoever to encourage the development of the domestic savings industry.

The combination of bad macroeconomic policies and reliance on external funding is obviously toxic, particularly during bouts of currency volatility and risk aversion, when foreign investors are especially prone to pulling their funding. However, aside from Argentina and Turkey, practically no other major EM countries suffer from this combination of bad macroeconomic policies and inadequate domestic funding.[2] It may have escaped the attention of many journalists and even some investors, but the single most important structural development in EM over the last two decades has been the emergence of domestic savings institutions. Today, most EM countries obtain 90% or more of their financing from their domestic pension systems and only finance in overseas markets on an opportunistic basis. Even Nigeria now has a well-functioning domestic pension system, which supports a yield curve out to 20 years, where the sovereign obtains most of its funding. This means that they have access to funding even when external markets are cut off.

The vast majority of EM countries also pursue credible macroeconomic policies and have strong fundamentals. We draw attention to the fact that Dollar-denominated corporate junk bonds, which are easily the most vulnerable part of the EM credit universe, have extremely low default rates. As Figure 1 shows, EM high yield default rates are currently three times lower than default rates for equivalently rated US high yield bonds, based on data from Bank of America Merrill Lynch up to and including 31 July 2018, that is seven months into the currency pullback in EM. In short, there is no evidence whatsoever of broad-based credit stress in EM today.

Figure 1: **Default rates for EM and US high yield corporate bonds (aggregate and by EM region)**



Source: Ashmore, BAML.

[2] We do not include frontier markets here. Frontier markets are defined in part by their lack of domestic institutions, so they too have greater vulnerability during bouts of global risk aversion, though many make up for this vulnerability by having very close links to multilaterals, such as the World Bank, IMF, bilateral aid agencies and China.

Emerging Markets

That is not to say that there are no problems in EM countries. All seasoned EM investors know well that every year a small handful of EM countries have elections and a couple of EM countries screw up their economies. Moreover, even EM countries with strong records of sound macroeconomic policies and strong fundamentals still experience conventional business cycle dynamics. Thus, today the Philippines is clearly in the late stage of its long business cycle expansion, while South Africa finds itself in a standard recession. These are normal events for all countries, not just the EM variety. What sets these situations apart from the situations facing Argentina and Turkey are that the Philippines and South Africa both have strong fiscal and monetary policy credentials as well as plentiful financing options. It is quite simply misguided to conflate their problems with the serious challenges faced by Argentina and Turkey. Again, we re-emphasise that it is the combination of bad macro and inadequate domestic financing, which forms the basis for serious economic vulnerability during bouts of EM pessimism. On these metrics, Argentina and Turkey stand out like sore thumbs in an otherwise healthy EM landscape.

What, then, can investors expect to happen in crisis-afflicted countries like Argentina and Turkey? These countries have brought problems upon themselves and must now walk down one of three well-worn paths. Argentina has chosen the IMF route, which involves upfront conventional macroeconomic adjustment – devaluation, fiscal adjustment and monetary policy tightening plus perhaps some structural reforms – in exchange for fresh funding. The IMF route usually leads to recession, but at least the country can start with a fresh slate after the recession, which bodes well for long-term investment. Turkey appears to have chosen a combination of austerity and the 'Hungary route'. During the Greek debt crisis in 2011, Hungary famously opted to convert the Swiss Franc-denominated flexible rate mortgage contracts held by Hungarian households into fixed rate Forint-denominated contracts. This effectively transferred all the interest and FX risks in the mortgages from Hungarian households to mainly Austrian banks. While the 'Hungary route' helps to balance the books by passing costs onto selected scapegoats, often by breaking contracts, which has obvious political advantages, it is often difficult for countries going down this path to attract capital in the future due to the legacy of contract infringement. Finally, a very small number of countries choose to apply ever-tighter control regimes in a bid to suppress the symptoms of overheating without actually addressing the underlying causes at all. Thankfully, neither Turkey nor Argentina has opted for this suicidal option (Venezuela is an example of country, which has gone down this route).

To sum up, the likelihood that the economic problems of Argentina and Turkey spread to the other established EM countries via currency volatility is close to zero. This is because most EM countries have both sound macro and adequate domestic funding options. Nervousness among investors, such as we have seen this year, can certainly impart significant volatility across the entire EM universe, but such bouts of volatility are both commonplace and generally harmless (recall that even the collapse of the entire Western banking system in 2008/2009 failed to trigger serious and sustained economic malaise in EM). This means that contagion fears are generally massively over-stated. As such, the correct response to contagion fears is to look to enter the market, since the vast majority of EM assets move into buy territory. Even at such times, however, investors should never forget that there are differences between EM credits. Some countries will be in the midst of elections or conventional business cycle dynamics, which means that opportunities differ in size as well as type. Finally, investors should not forget that the deepest value opportunities often arise in the most vilified countries, because markets have proven repeatedly that they are particularly bad at pricing risks in precisely such circumstances. The smart money is therefore buying selectively in both Argentina and Turkey.

- Russia: The world's most formidable central bank governor struck again; Central Bank Governor Elvira Nabiullina hiked the policy rate by 25bps in the face of widespread expectations on no change in rates. The policy rate in Russia now stands at 7.5%. The central bank expects inflation to end the year around 4%. The US State Department is threatening further sanctions on Russia by November. Each round of sanctions undermines foreign investors' ability to trade Russian bonds, but does little to hurt Russian fundamentals.

- Turkey: The central bank undertook a very important volte-face, when it jacked up the policy rate by 625bps, which was far more than expected. The policy rate now stands at 24%, which implies +6% real policy rate. However, at the same time President Erdogan ordered Turkish entities to settle contracts in lira instead of foreign currencies. The Turks are clearly aiming to complement a temporary return to more orthodox monetary policies with a strategy of targeting adjustment on specific groups ('Hungary route' – see main section above).

- Argentina: Monthly inflation accelerated to 3.9% in August from 3.1% in July. Pass-through from a weaker currency is the likely culprit, because the central bank in Argentina has not managed to establish inflation fighting credibility. The central bank, which is now trying to make amends, left the policy rate unchanged at 60%.

- Brazil: The latest polls ahead of October's election suggest that Fernando Haddad of the left-wing PT party and Jair Bolsonaro, a hospitalised far-right populist, will go through to the second round after the first round election scheduled for 6 October. Greater TV time has so far made little impression on the poll ratings for Geraldo Ackmin of PSDC, who remains far behind Haddad and Bolsonaro. Leftist Ciro Gomes, tied with Haddad, could do well in a second round due to his lower rejection rate, but he is no market favourite, so nervousness continues to surround Brazil. Retail sales softened in July.

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Emerging Markets

- **China:** House prices increased 1.3% in the month of August. This is the biggest monthly increase since September 2016. Consumption growth also picked up from 8.8% in July to 9.0% in August on a yoy basis. Consumption should pick up further in the next few months following a recent cut in income taxes. Infrastructure investment slowed, however. Total social financing increased to RMB 1.52trn in August from RMB 1.04trn in July.
- **India:** The government has taken steps to encourage more capital inflows, including easing limits on foreign borrowing. However, as long as India continues to cling to quotas, which make the local bond market ineligible for index inclusion, flows in and out of India will continue to be more erratic than in other EM countries. Industrial production expanded at a yoy rate of 6.6% in July versus 6.5% yoy expected, while the yoy rate of inflation declined to 3.7% in August from 4.2% in July.

Snippets:

- **Colombia:** Retail sales expanded at a yoy pace of 3.2% in July, below the market expectation of 5.5% yoy.
- **Czech Republic:** The yoy rate of inflation increased to 2.5% yoy in August from 2.3% yoy in July.
- **Egypt:** The monthly rate of CPI inflation declined to 1.8% yoy in August from 2.4% mom in July and 3.5% mom in June.
- **Hungary:** EU has voted to begin Article 7 proceedings against Hungary. The EU is concerned about the deterioration in Hungary's commitment to Democracy. Inflation was unchanged at 3.4% yoy in August.
- **Indonesia:** The trade deficit narrowed to USD 1.0bn in August from USD 2.0bn in July.
- **Mexico:** Industrial production increased 0.2% in the month of July versus -0.2% mom expected.
- **Peru:** The central bank left the policy rate unchanged at 2.75%.
- **Philippines:** The trade deficit increased to USD 3.6bn in July from USD 3.2bn in June as the central bank edges closer to further hikes in the policy rate.
- **Romania:** The rate of inflation was 5.1% yoy in August compared to 4.6% yoy in July.
- **Singapore:** The rate of unemployment for Q2 was revised down to 2.9% from a preliminary reading of 3.0%, but retail sales declined at a yoy rate of 2.6% in July versus +2.2% in June. August's trade numbers were stronger than expected as non-oil domestic exports increased at a rate of 5.0% yoy versus 3.9% yoy expected.
- **South Korea:** The government issued measures to tighten the housing market, including heavier property taxes and measures against mortgages for those buying multiple homes. Employment edged up 3K in August compared to last August compared to 5K in July.
- **Venezuela:** Yet another attempt by the government to liberalise the FX regime was met with the usual well-founded scepticism. This is because the government continues to pursue overall macroeconomic policies, which are inconsistent with economic stability.

Global backdrop

In the US, retail sales in August softened and core CPI inflation in August was just 0.08% mom versus 0.2% mom expected. On a yoy basis, core inflation is now 2.2%, which is nevertheless still higher than the Fed fund rate of 1.75%-2.00%. In other words, monetary policies in the US remain stimulatory. US industrial production was stronger, inventories were higher and long-term inflation expectations declined. President Donald Trump instructed his advisors to proceed with long-threatened tariffs on another USD 200bn of US imports from China. Many of these goods will be intermediate goods, i.e. inputs for American companies. US businesses will therefore face higher tax-induced costs at a time when the Dollar is also overvalued. China will likely respond to Trump's trade taxes with tariffs of their own, while at the same time stimulating domestic demand. China has enormous room to support domestic demand given high savings rates. In Europe, the European Central Bank press conference offered few surprises, but the Governing Council continues to emphasise rising inflationary pressures over the next two years, which suggests that European policy rates will soon start to rise just as the market has started to discount planned hikes from the Fed.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.48%	-9.30%	-3.99%	11.37%	3.62%
MSCI EM Small Cap	-2.63%	-11.54%	-5.31%	7.78%	3.43%
MSCI Frontier	-1.38%	-13.81%	-8.44%	3.81%	3.02%
MSCI Asia	-2.51%	-7.20%	-0.76%	12.52%	6.75%
Shanghai Composite	-1.52%	-17.01%	-18.52%	-2.77%	6.06%
Hong Kong Hang Seng	-2.40%	-6.02%	-0.85%	7.06%	4.00%
MSCI EMEA	-2.62%	-15.90%	-8.48%	4.51%	-2.50%
MSCI Latam	-1.13%	-11.88%	-15.03%	10.14%	-3.02%
GBI EM GD	0.02%	-10.45%	-10.85%	3.97%	-1.87%
ELMI+	0.19%	-5.33%	-4.44%	2.88%	-1.13%
EM FX Spot	0.08%	-9.76%	-10.96%	-2.27%	-7.44%
EMBI GD	0.30%	-4.21%	-3.51%	5.13%	5.53%
EMBI GD IG	-0.28%	-2.30%	-1.83%	4.37%	4.95%
EMBI GD HY	0.90%	-6.22%	-5.33%	5.95%	6.08%
CEMBI BD	0.10%	-2.42%	-1.73%	4.74%	4.87%
CEMBI BD IG	-0.34%	-1.23%	-1.01%	3.53%	4.44%
CEMBI BD Non-IG	0.67%	-3.85%	-2.51%	6.75%	5.42%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	0.22%	10.17%	18.67%	16.51%	13.77%
1-3yr UST	-0.18%	0.18%	-0.22%	0.42%	0.61%
3-5yr UST	-0.51%	-0.88%	-1.84%	0.33%	1.20%
7-10yr UST	-0.95%	-2.39%	-3.51%	0.25%	2.30%
10yr+ UST	-2.01%	-4.87%	-3.88%	1.55%	5.10%
10yr+ Germany	-1.67%	2.60%	2.82%	2.95%	6.84%
10yr+ Japan	0.10%	-0.03%	0.43%	3.74%	4.43%
US HY	0.32%	2.32%	3.33%	6.90%	5.60%
European HY	0.02%	0.20%	1.17%	4.85%	5.76%
Barclays Ag	-0.41%	-1.92%	-1.59%	2.08%	1.27%
VIX Index*	-6.14%	9.33%	18.68%	-42.90%	-16.93%
DXY Index*	-0.18%	3.09%	3.37%	0.45%	17.04%
CRY Index*	-1.28%	-1.74%	3.49%	-3.90%	-33.56%
EURUSD	0.22%	-3.13%	-2.71%	1.66%	-12.95%
USDJPY	0.86%	-0.63%	0.37%	-6.70%	12.97%
Brent	1.03%	16.97%	40.63%	59.37%	-27.70%
Gold spot	-0.48%	-8.24%	-8.56%	5.66%	-8.78%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.

Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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