Ashmore

The myth of Emerging Markets' vulnerability to external shocks

By Jan Dehn

It is a time-honoured tradition to sell Emerging Markets (EM) when global conditions deteriorate. After all, EM countries are seen as particularly vulnerable to external shocks. The reality is somewhat different. EM countries are far more resilient to external shocks than they have ever been in the past, but markets have yet to catch up with this reality.

Two years after the EM bear market triggered by the Taper Tantrum – which has seen a 23% fall in EM currencies against the USD – we find that EM countries have displayed considerable resilience. Corporate balance sheets have not blown up due to FX mismatches, inflation is under control, portfolio outflows have not destabilised EM bond markets and, for 70% of EM countries, the fall in commodity prices has been beneficial rather than detrimental.

In fact, we find allocating money to EM to coincide with external shocks makes good sense. Rather than fearing external shocks investors should take a more nuanced approach and look upon shocks as opportunities. External shocks, it turns out, have little, if any, effect on EM fundamentals, but have large temporary effects on investor behaviour and therefore asset prices. The most important lesson is that today's EM economies are more diverse and self-reliant than in the past and that the most important driver of performance is not the shock, but rather the quality of the response to the shock.

A much changed fundamental reality in EM

EM today is far more resilient to external shocks than in the past. The period since the early 2000s has been particularly transformative. EM now comprise 56% of GDP and its financial markets are 10 times larger than a decade ago. Representative governments have replaced dictators in most countries and growth rates are at least twice as high as those in developed economies. EM economies have also become more diverse with new industries, manufacturing and services in addition to traditional commodity businesses. Many EM countries have now become very large holders of FX reserves indeed and they tend to be orders of magnitude less indebted than developed economies. Importantly, most EM countries now derive most of their financing from domestic sources rather than international capital markets. Inflation targeting, flexible exchange rates and prudent fiscal policies have become the norm. Sure, there are exceptions, including some very weak EM countries, but the majority are fundamentally stronger than developed economies.

EM countries have changed, but perceptions have not

Despite the profound changes in EM over the past decade and a half, markets are still trading EM assets from the perspective that they are as vulnerable to external shocks as ever. The last two years are a case in point: Over this period, global financial conditions have actually eased, but so profound has been the fear of an eventual normalisation of US monetary policy that EM has in effect been in a bear-market since Ben Bernanke's announcement of tapering in May 2013. Since then EM sovereign debt spreads have widened by 130bps, EM corporate high yield spreads are nearly 200bps wider, EM currencies are 23% lower and local bond yields have sold off from a low of 5.2% to spike to over 7%. The performance has been even worse when compared to developed markets bond and stock markets, many of which have set new all-time highs over the same period.

> EM countries have displayed considerable resilience to external shocks. Corporate balance sheets have avoided FX mismatches, markets have shrugged off portfolio outflows and the effect of commodity price falls has been more positive than negative

The overriding reason for the weak performance of EM assets has been the perceived deterioration in the global environment. Tapering and the prospect of US rate hikes as well as the stronger USD are the most frequently cited reasons for EM weakness, but falling commodity prices, declining risk appetite and the reversal of global QE flows are also frequently cited as negatives. These factors have one thing in common: They are exogenous to individual EM countries.

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A good time for a review

Almost two years have now passed since the Bernanke announcement, which puts us in a position to evaluate the plethora of external shocks that have impacted EM over this period. There are two good reasons for doing so. Firstly, if EM assets have been oversold relative to any actual fundamental deterioration in EM in response to the external shocks then there is value in EM right now. Secondly, it is likely that there will be more instability ahead. After all, developed economies have barely begun to normalise monetary policies and inflation has yet to resurface. The central question of how the heavily indebted developed countries will deal with the debt problem remains unresolved. The experience of the past two years can provide a very useful pointer for what may lie ahead.

It is illuminating to review the effect on EM of the main shocks over the past couple of years. Many of these shocks have been propagated through a strong USD. Indeed, the rise of the USD is cited by many as a major negative for EM due to its alleged impact on EM via FX-mismatched corporate balance sheets, commodity prices, inflation in EM due to FX pass-through and portfolio flows. EM currencies have fallen by a whopping 23% versus the USD since May 2013 – now seems a particularly good time to evaluate the validity of these fears.

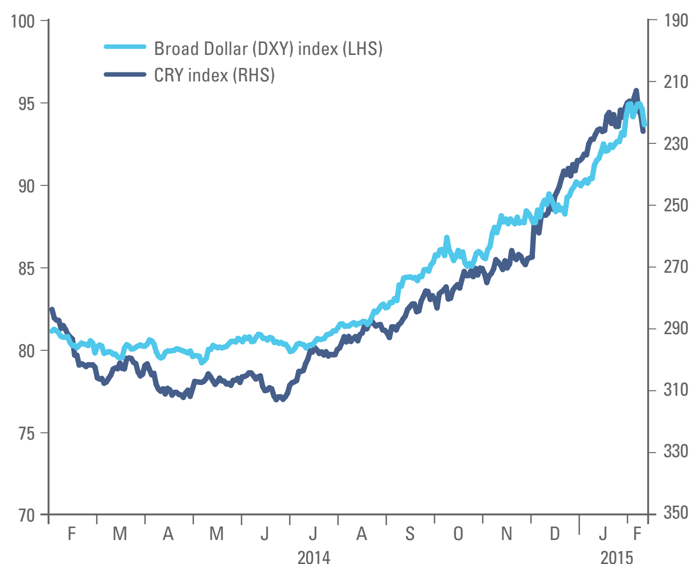
Corporate balance sheets

The commonly touted fears of widespread defaults due to FX mismatches on EM corporate balance sheets are unfounded. As we argued prior to the massive EM FX sell-off in the past year, the volume of external borrowing by EM corporates does not equate to their FX risk. Most EM corporates that borrow in USD do so because they also have USD revenues, and where they do not, they hedge their FX risk. Besides, most EM companies are serious businesses that will not risk their futures on the roulette table of global currency markets.[1] Not only has the corporate default rate in EM halved to 1.7% in 2014, it is also below the long-term average of 1.95%. None of the few defaults in 2014 were directly attributable to FX mismatches.

Commodity prices

Global commodity prices have fallen by 25% since June 2014. The move has been extremely closely correlated with the rally in the USD, a correlation that is unlikely to be spurious, in our view. Over this period, some EM countries have experienced a sharp worsening of their terms of trade, notably oil producers. But what is remarkable is that 70% of EM countries have experienced a *positive* terms of trade 'shock' averaging 7%[2] as a result of the fall in broad global commodity price indices.[3] This shows that the assumption that falling commodity prices are bad for EM is quite simply wrong, in our view. Additionally, EM countries have become far more diversified in recent decades, so the impact of a given commodity shock is now far smaller than just a few years ago. As an aside, an identical analysis of developed economies showed that only 60% of developed economies experienced positive terms of trade shocks since June 2014. It is time to put to bed the simplistic prejudice that EM countries are wholly commodity dependent.

Fig 1: **Commodity prices and the USD: Correlation and causation**

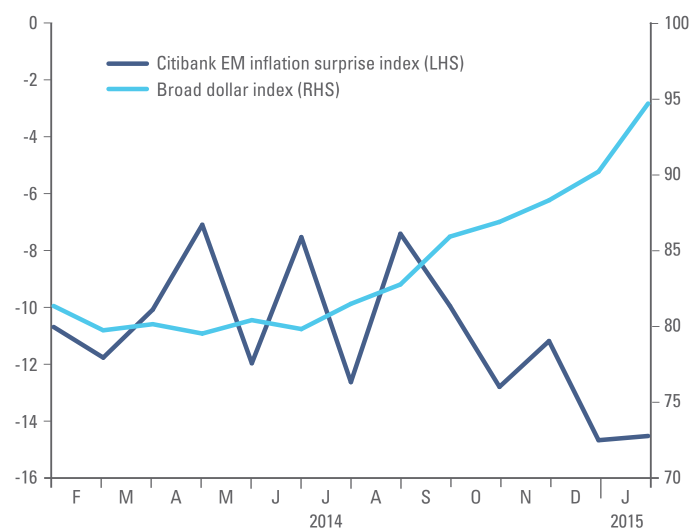


Source: Ashmore, Bloomberg.

FX pass-through

Weaker EM currencies push import prices higher in EM and cause inflation, right? Wrong. Not only is EM experiencing disinflation, the pace of disinflation has in fact accelerated since the surge in the USD last year. The chart below shows the EM inflation surprise index from Citibank[4] plotted alongside DXY, the broad US dollar index. Why is EM FX depreciation not showing up in price indices in EM? Clearly, there is an important offset from commodity prices (many EM countries import commodities and export manufactures and services). More importantly, EM economies now have larger domestic economies that can supply a growing proportion of consumed goods. EM countries also increasingly trade with other EM countries. Finally, the inflation targeting regimes of most EM central banks have become very credible over the years – this ensures that temporary inflationary shocks do not affect expectations.

Fig 2: **EM inflation and the USD**



Source: Ashmore, Citibank, Bloomberg.

[1] *"Worry about end-clients, not the asset manager"*, Letter to the Editor, Financial Times.
[2] Source Ashmore, Citibank, Bloomberg: Produced by analysing trade data from sample of 23 EM countries to calculate each countries' Terms of Trade index since June 2014 and take simple average of those with positive readings.
[3] For example, the Thompson-Reuters Core Commodity CRB Index (Bloomberg ticker 'CRY Index').
[4] The inflation surprise index measures the inflation levels relative to market expectations. A negative reading, as illustrated in figure 2, means inflation readings are lower than market expectations.

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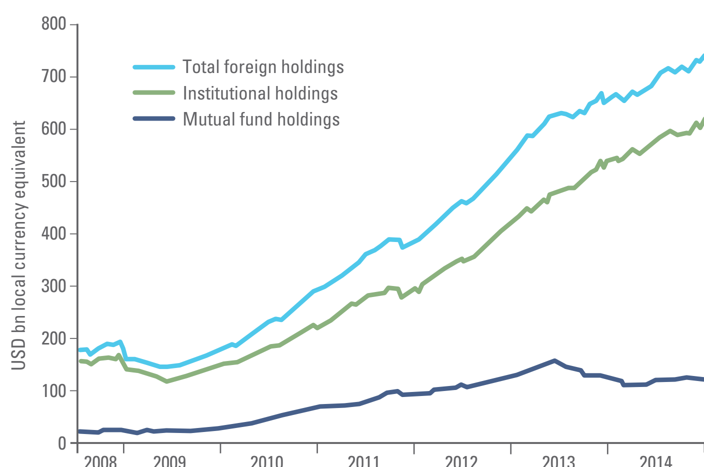
Flow risk

One of the most deep-seated prejudices in EM is that portfolio investors control the fate of whole EM economies. Thus, in this view a USD rally could prompt foreign portfolio investors to flee, wreaking havoc on EM local bond markets and destabilising whole EM economies in the process. This view ignores the single most important structural change in EM in the past quarter of a century, namely the emergence of a domestic savings industry. Thus, when in 2013 US and European mutual fund investors pulled half of their investments in EM local bond markets – a bigger outflow even than in 2008/2009 – local bond markets certainly reacted, but neither they nor EM economies blew up. Local bond yields in EM re-priced by 200bps (from 5.25% to 7.25%) in tight liquidity conditions over a nine month period following the Taper Tantrum in May 2013. This was sufficient to wipe 0.5% off the average growth rate in EM in 2014. This is actually a surprisingly modest impact – imagine what effect an equivalent 200bps re-pricing of developed market bond curves would have had. As an aside, EM central banks are still sitting on nearly 80% of the world's FX reserves.

Fig 3: **EM fund flows – local bond markets**



Source: Standard Chartered Bank Data to 16 December 2014.

The irrationality of markets

Of course EM countries are impacted by external shocks – all countries are. But in EM the market reaction to external shocks is disproportionate and does not reflect the structural improvements that have taken place.

The ultimate 'proof' that markets overreact when EM countries experience external shocks is that EM markets bounce back strongly from such episodes. Quantifying this bounce-back, we found that EM investors can 'lock in' between 110bps and 410bps of excess return by timing their purchases of EM fixed income specifically to coincide with global risk-off episodes (as measured by 10+ point moves in VIX).

Why can investors increase their returns by buying during sell-offs? Precisely because the sell-offs are irrational. Markets bounce back because these episodes do not cause genuine damage to EM fundamentals. All they do is damage investor sentiment and create value.

Fig 4: **Normal and excess return (bps) to buying EM fixed income during 10+ VIX spikes (2003-2014)**

	External debt (IG)	External debt (non-IG)	Corporate debt (IG)	Corporate debt (HY)	Local government bonds	EM FX forwards
Excess return to buying on VIX spikes	410	190	240	190	330	110
Normal returns	710	1120	680	1060	940	590

Source: JP Morgan, Ashmore. IG = Investment grade HY = High yield

Using industry-standard EM fixed income benchmark indices, we calculated annualised returns for each EM fixed income asset class over the whole history of the series and returns when investing following 10+ points spikes in VIX. EM external debt and FX forward indices (EMBI GD and ELMI+, respectively) start on 31 December 1993. Corporate bond indices (family of CEMBI indices) begin on 31 December 2001. The local currency bond index (GBI EM GD) begins in January 2003.

We identified VIX shocks using the methodology of Bock and Filho[1], who define global risk-off episodes as spikes of 10 points or more in the VIX index (CBOE's index of implied volatility of the index options of the S&P 500 stock market index).[1] The VIX index annualises the expected movement in the S&P 500 index over the next 30 days. As such, it is a forward-looking indicator of risk appetite, which is largely exogenous to the vast majority of individual EM countries. For further detail on this analysis, see *'Beware Rules of Thumb'*, Market Commentary November 2014.

[1] Reinout De Bock and Irineu de Carvalho Filho (2013) *'The Behaviour of Currencies during Risk-off Episodes'*, IMF Working Paper, No. 8 (January 2013).

Look at what I do, not what they say

By far the most important impact of external shocks in EM is actually not the shocks themselves, but how countries respond.

The overwhelming conclusion from observing EM countries that have experienced shocks of the type discussed above over the past decade has been that they tend to respond with decisive measures that ultimately adjust to the shock. For example, since May 2013 a number of important EM countries have been put through the financial market wringer. The original trigger is usually some external shock – such as tapering. Then markets focus in on some perceived vulnerability, say a current account deficit. Investors then lose confidence and markets begin to experience stress. At this point, governments in the affected country usually take decisive action, whether it be fiscal, monetary or on the reform front. Countries that have been through this experience in the past few years include Chile, Brazil, Indonesia, South Africa, China, India, Egypt, Turkey, Malaysia, Argentina, Venezuela, Thailand, Poland, Russia, Hungary and Ukraine. So far, only Argentina has defaulted, but this was not because of an external shock (and besides Argentina's spreads narrowed 400bps after it defaulted to make it one of the strongest performing sovereign bond markets in the world in 2014).

The majority of EM countries respond to stress with sensible and decisive policy adjustments, sometimes with a lag. India and Indonesia were both labelled 'fragile five' countries by Morgan Stanley in 2013, but have turned out to be excellent performers in a very short time due to conventional cyclical adjustments. In other words, their alleged structural problems turned out not to be structural at all. Brazil and Russia are currently being targeted as vulnerable EM countries, but in our view both countries will get through their current difficulties successfully. Why? because they are taking steps to remedy their problems.

And herein lies one of the important differences between EM countries and developed economies; the latter tend to ignore structural problems in favour of additional monetary stimulus, while EM countries can simply never count on such luxuries. Ironically, it is the irrationality of investors which ensures that they remain such good investments.

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