Ashmore

Déjà vu 2002

By Jan Dehn

The 2018 sell-off in EM local markets is more than a mere conventional 'buy the dip' opportunity.

In addition to being overdone and far too indiscriminate, the sell-off also coincides with a likely return to a multi-year decline in the Dollar over the coming months.

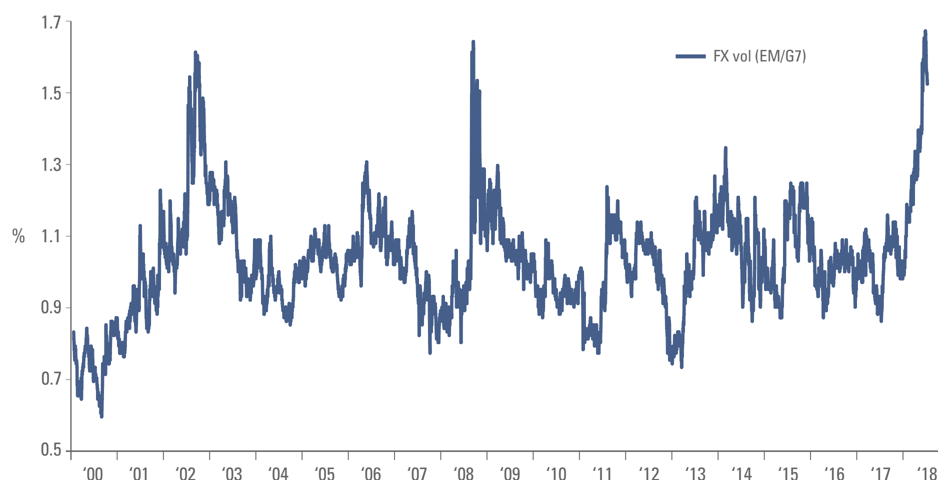
Investors entering EM local markets can therefore now expect exceptionally strong returns over the next several years. In fact, the closest resemblance to the 2018 sell-off is the sell-off in 2002, which was the best ever entry point for EM local debt.

There are strong parallels between the sell-off in 2002 and this year's sell-off. The parallels are interesting, because 2002 was the best ever entry point to EM local markets

Parallels between 2002 and today

There are only two equals to this year's spike in Emerging Markets (EM) currency volatility. The first was in the run-up to Lula Ignacio da Silva ascent to the presidency of Brazil in 2002. The second time it happened was when the Western banking system collapsed in 2008/2009 (Figure 1).

Fig 1: **Spike in EM FX vol vs G7 FX vol**



Source: Ashmore, Bloomberg, JP Morgan. Data as at 21 September 2018.

There are three strong parallels between the sell-off in 2002 and this year's sell-off. First, in 2002, markets feared Lula, while today they fear the Argentina and Turkey, although Brazil also weighs on sentiment now ahead of an uncertain election outcome next month. Second, just like in 2002 these fears surrounding a small number of EM countries have morphed into concerns about wider EM contagion, which pushed down valuations across the board. Thirdly, investors feared that the strong rally in the Dollar, which has taken place between 1994 and 2002 would continue forever and the same is true today, when the Dollar rally is also into its eighth year (Figure 2).

2002 was such a great entry point because all these fears, which spooked investors in 2002 turned out to be misplaced. Lula's first term as president was characterised by market friendly policies rather than disaster. The rest of EM did not succumb to fundamental contagion and within months of the Brazilian election, the Dollar embarked on a sustained 30% decline against EM currencies.

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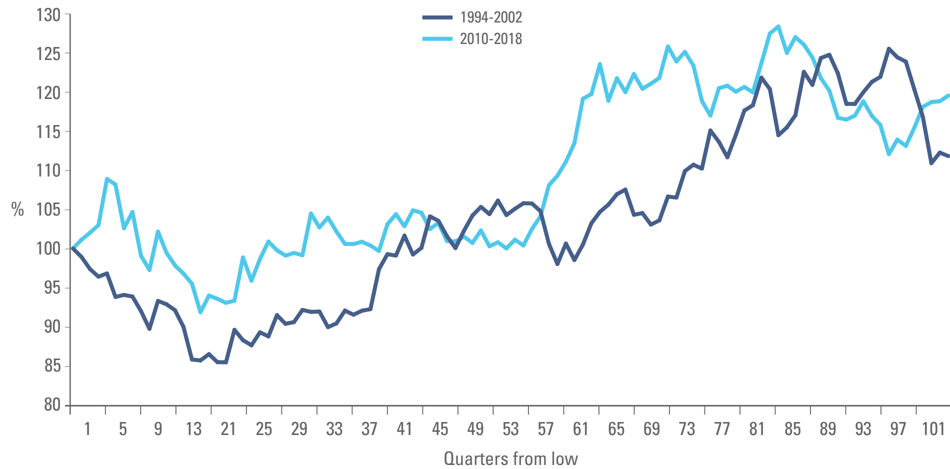
Fig 2: **Broad Dollar rally 1994-2002 vs 2020-2018 (index=100 at start of rally)**



Source: Ashmore, Bloomberg. Data as at 21 September 2018.

Vive la difference: differences from 2002

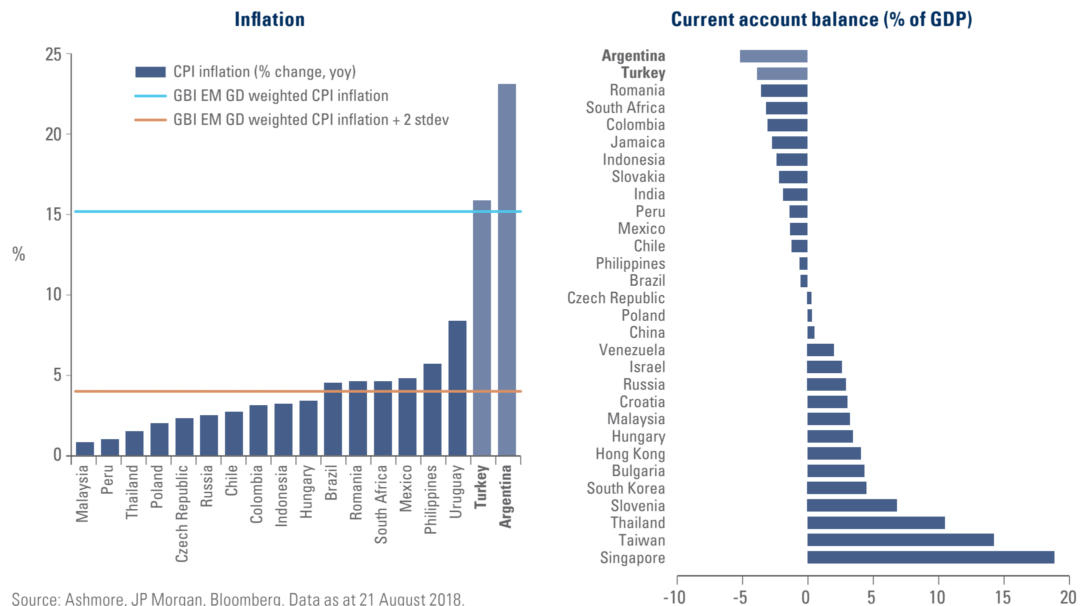
Despite the similarities, there are also important differences today compared to 2002, although, on balance, these differences are surely supportive of today's opportunity. Five differences flatter EM compared to 2002:

1. Different EM basket cases

Today's EM basket cases are few and highly atypical of most other EMs. Contagion fears are not warranted

Today's EM basket cases are obviously not the same as in 2002. Granted, Brazil is once again heading to the polls, but a Left-wing government does not induce quite the same terror as it did sixteen years ago. Besides, the likelihood is that whoever wins the election in Brazil will deal urgently with the key pension reform. Today Argentina and Turkey loom larger in investors' minds (Figure 3). Both countries have run bad macroeconomic policies for a number of years, so their inflation rates are more than two standard deviations higher than the EM average, while their current account deficits are not easily funded, because foreigners are selling and uniquely among the major EM countries, Argentina and Turkey have failed to develop domestic systems. As this year has shown, it is toxic to rely on external financing, while at the same time pursuing bad macroeconomic policies if sentiment toward EM turns negative. However, the good news is that none of the other established EM countries share this unfortunate combination of circumstances, wherefore contagion risks are close to nil.

Fig 3: **Argentina and Turkey versus the rest: inflation and current account balances**



Source: Ashmore, JP Morgan, Bloomberg. Data as at 21 August 2018.

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EM is stronger and more diverse than in 2002. as such, the differences between 2002 and today are broadly supportive of today's opportunity

2. The rest of EM is much stronger than in 2002

The rest of EM is far stronger today than in 2002. Figure 4 illustrates this point with reference to some basic economic and financial indicators.[1] To start with, EM GDP is more than four times larger (in USD terms) than in 2002 and EM's share of global GDP (in PPP-adjusted terms) has increased to 59% from 44%. EM per capita GDP, an especially important indicator of broad economic vulnerability, has nearly tripled since 2002. EM economies also have lower inflation rates, while EM central banks control three quarters of the world's FX reserves, or USD 8.6trn compared to 60% (USD 1.7trn) in 2002.

Fig 4: **Selected EM macroeconomic and financial indicators (2002 and 2017)**

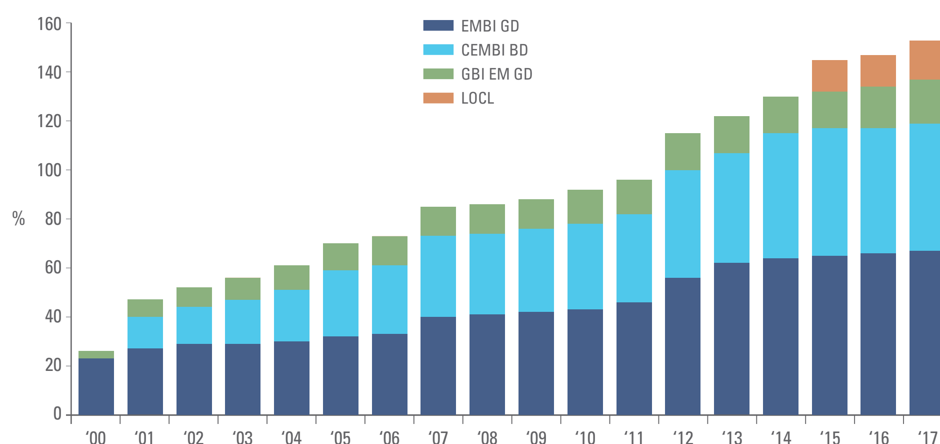
Indicator	2002	2017	Source
EM GDP	7.0	31.7	IMF
EM share of global GDP (PPP)	44.2	58.7	IMF
GDP per capita (current USD)	4,660	11,811	IMF
Inflation	6.5	4.0	IMF
Government debt (% of GDP)	52.1	49.0	IMF
EM fixed income universe	2.6	24.3	BIS
EM share of global fixed income	6.3%	22.2%	BIS
Local share of total fixed income	71%	87%	BIS
Number of index markets	52	156	JP Morgan, BIS
EM FX reserves	1.72	8.56	Bloomberg
Share of global reserves	60%	75%	Ashmore
Intra-EM trade (% of total EM trade)	26%	41%	IMF Direction of Trade Statistics

EM fixed income is ten times larger and three times more diverse than in 2002

3. Deeper, broader and more diverse EM financing landscape

The EM financing landscape has improved beyond recognition since 2002. At USD 24trn, the EM fixed income universe is now ten times larger than in 2002 and EM bonds make up 22% of the global bond market. Despite the rapid expansion in EM bond markets, the average EM government's indebtedness has declined from 52% of GDP in 2002 to 49% today. The number of EMs, which have become fully integrated into international capital markets has tripled from 52 to 156 (Figure 5).[2]

Fig 5: **Number of EM fixed income markets included in benchmark indices**



Source: Ashmore, JP Morgan, BIS, ICE. Data as at end 2017.

It is arguably even more important that EM countries have become dramatically less dependent on foreign capital. Domestic bond markets now supply nearly 90% of all financing for EM countries. Local pension funds act as buyers of last resort, which prevents yields from spiking to dangerous levels, when foreigners sell. Indeed, even when foreigners abandon EM altogether, EM countries can still finance at home. Local pension systems have broken the causal link, which

[1] We use year-end 2017 data in order to be able to compare full year data in both periods.
[2] We proxy global capital market integration by EM fixed income benchmark inclusion.

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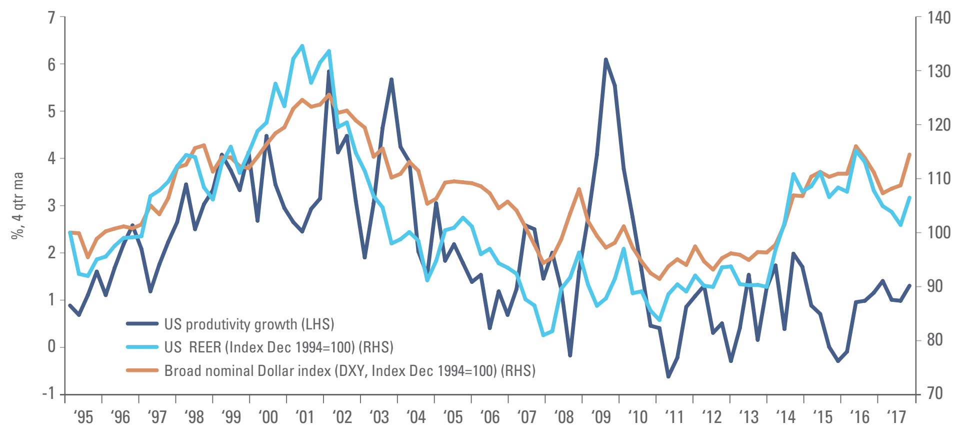
used to exist between market volatility and fundamental stress. Only countries, which mismanage their economies and fail to develop domestic pension systems, such as Turkey and Argentina, are at serious risk when investor sentiment turns sour.

Unlike in 2002, the recent Dollar rally has not been supported by productivity growth

4. A very different eight year itch for the Dollar

The 1994-2002 Dollar rally differs sharply from the 2010-2018 Dollar rally, because the former was justified by rising US productivity growth, while the latter has taken place against a backdrop of stagnant productivity growth (Figure 6). What, then, has pushed the Dollar higher since 2010? The answer is portfolio allocations by institutional investors, who sought Dollar exposure to express a bullish view on the US recovery after 2008/2009.[3] The US Fed is now slowly unwinding Quantitative Easing (QE) and the Dollar and US stocks have become very expensive, but most institutional investors remain very long Dollars. Lacking fundamental support and technically vulnerable, the Greenback is becoming a hot money trade on the back of an unhealthy combination of monetary tightening and very loose fiscal policy. Argentina followed this precise policy mix in the run up to its currency debacle earlier this year.

Fig 6: **The recent Dollar rally versus the 2002 Dollar rally**

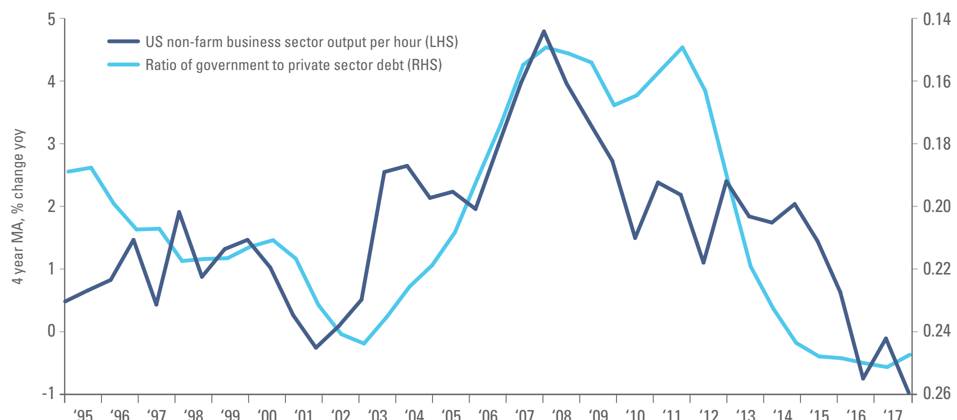


Source: Ashmore, BIS, Bloomberg. Data as at 21 September 2018.

5. Other longer-term issues weighing on the Dollar

US productivity may actually get worse in the coming years due to the expected increase in government debt. Government bonds usurp for unproductive uses, which would otherwise be available for investment in the highly productive US private sector. This is why rising levels of government debt are so closely associated with declining productivity growth (Figure 7). These trends look set to continue.

Fig 7: **US government share of debt and productivity**



Source: Ashmore, US Treasury, Bloomberg. Data as of June 2018.

[3] QE itself did not involve Dollar buying, but investors across the world ended up buying Dollars in order to add to positions in US equities on the view that the combination of bank recapitalisation, zero interest rate policies, massive fiscal stimulus and QE itself would lead to a strong economic recovery. In other words, QE induced a huge shift in global capital into the US, thus pushing up the Dollar.

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The lurch into protectionism in the US creates Dollar risks of its own. Tariffs support the Dollar in the near-term, but undermine productivity in the longer-term by pushing up costs for US consumers and businesses. Tariffs can also be inflationary if they cut American producers off from cheaper inputs from overseas. In other words, tariffs may force the Fed to raise rates more than expected, with obvious negative implications for growth.

Finally, protectionism marks a broader shift away from rules to discretion in US global leadership. The Trump Administration is now undermining the pillars of its own global governance framework (NATO, WTO, IMF, the World Bank, the UN and so on) at the fastest pace ever. The quid-pro-quo for US rules-based leadership is the global reserve currency status for the Dollar. As Trump replaces rules with discretion, he undermines trust in US institutions and investors will be less willing to use US-sponsored systems in order to reduce exposure to the associated risks.

If we are wrong on the Dollar…

The outlook for the Dollar in the medium term is negative for the reasons outlined above. However, currencies are notoriously volatile and move for a million reasons. A US productivity miracle, which, say, pushed the US real GDP growth rate to, say, 4-5% per annum on a sustained basis, would clearly usher in a further Dollar rally. Why? Because high productivity means the real exchange rate no longer challenges US exporters, strong growth eliminates the debt problem and solid earnings draw in fresh capital to stocks. However, the current US policy mix is not suggestive of an imminent productivity miracle. In fact, recession may be the more likely at this late stage in the business cycle. All the money parked in the Dollar in the last eight years would then be in the wrong place, because it went into the Dollar on a bullish view of the US economy. Recession is very Dollar-negative. Quite aside from this, the Fed can only cut 225bps if recession strikes, which is not enough to extract the economy from recession (the average rate cut in past recessions is about 500bps). The US government has already expended itself fiscally and additional fiscal spending would push the government debt burden into outright unsustainable territory. Like in the 1970s, inflation and devaluation would then be the only remaining routes back to economic health for the US economy.

Valuations in EM local markets suggest that investors can expect returns similar to 2016 and 2017 next year

What can you make in EM in the next few years?

The Dollar began a multi-year decline back in 2016. The massive US fiscal stimulus and concerns over protectionism interrupted it in 2018, but these shocks are temporary and mostly priced in. EURUSD has adjusted sharply. EM FX is oversold. US growth peaked at 4.2% in Q2 2018 and should slow to 2.5% growth in 2019 and just 1.9% growth in 2020, according to the consensus collected by Bloomberg. The flattening US yield and weaker housing both point to downside growth risks. Fed Chairman Jay Powell successfully shifted the dots higher in April, but markets are discounting the dots for 2019. The last remaining support for the Dollar is fear over protectionism, but Congress' fondness for tariffs may fade after the mid-term election, when members shift their focus to avoiding unnecessary risks to growth leading up to the 2020 presidential election. In short, we expect normal service – a lower Dollar – to resume in 2019.

Valuations in EM local bond markets have returned to levels, which prevailed before the strong rallies of 2016 and 2017. Yields are well above 6.5% and inflation excluding Argentina and Turkey is close to 3%. Relative growth expectations for EM and developed countries as well as real exchange rates suggest EM FX upside of about 20% over the next five years. This upside is not a great as the 30% upside for EM FX between 2003 and 2008, but bonds should additionally pay some 30% over the next five years for a total return of about 50% in USD terms.

Conclusion

Macroeconomic shocks in a small number of EM countries are commonplace and do not constitute a good reason to liquidate the entire asset class. Contagion fears are fuelled by the Dollar rally, but credit conditions remain benign in EM. The EM sell-off this year may closely coincide with the resumption of a longer period of Dollar decline. If so, this entry point becomes very sweet indeed. It is déjà vu, 2002.

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