

EM external accounts at the most resilient in two decades

By Gustavo Medeiros

The market is starting to price broad US dollar (USD) debasement. The ongoing rally in precious metals is just one symptom of growing mistrust in the Dollar as the world's main reserve currency. The Dollar is broadly overvalued relative to US fundamentals and the currencies of its large trading partners. In addition, US real yields have collapsed and US asset prices are expensive.

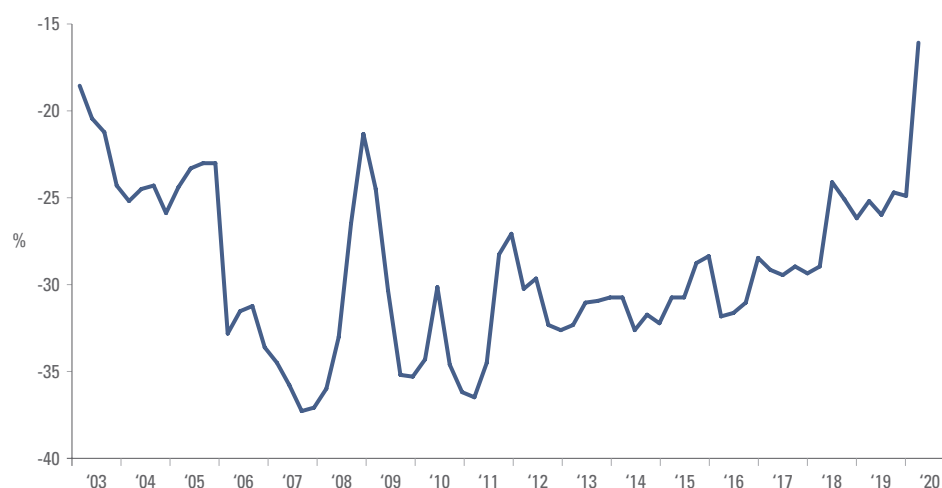
In sharp contrast, Emerging Markets (EM) currencies are cheap, while EM assets are generally extremely undervalued. The contrast between valuations of currencies and assets in the US and EM is particularly interesting, when taking into account that EM external vulnerabilities as measured by the net international investment position (NIIP) are now their lowest levels in nearly two decades, while US external vulnerabilities are at their highest.

This report examines the recent improvement in the NIIP of EM economies and explains the causes behind the adjustment. The implications for the Dollar are discussed. Our view is that EM local currency denominated assets, both equities and fixed income, are good ways to diversify unbalanced global portfolios away from overbought US assets. Greater exposure to EM local assets offers not only a hedge against the ongoing debasement of the Dollar, but also enables investors to rotate exposures from momentum assets towards value assets.

EM NIIP the strongest in two decades

EM countries' NIIP – the gap between a nation's stock of foreign assets and foreigner's stock of that nation's assets (see Appendix) – is at its strongest in two decades. At just 16% of GDP as of Q1 2020, EM's net liabilities have halved from 37% of GDP in Q1 2011 (Figure 1). The dramatic improvement in EM's NIIP makes EM countries far less vulnerable to external shocks.

Fig 1: GBI-EM GD weighted EM NIIP (% GDP)

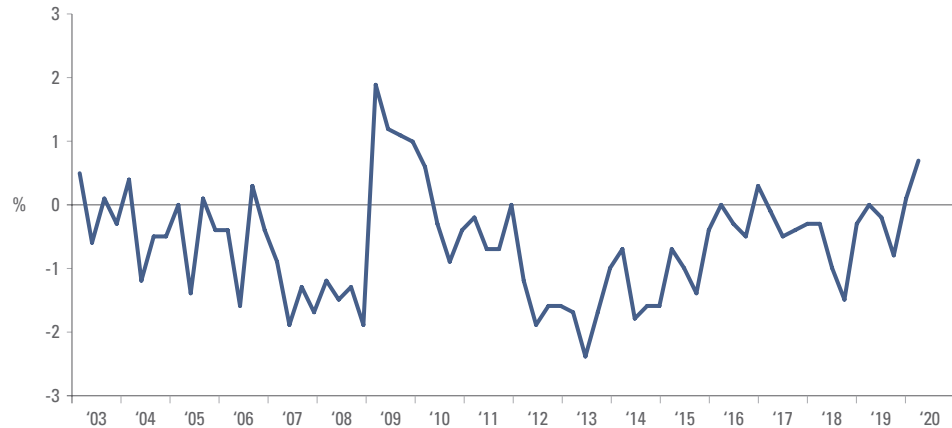


Source: Haver, JP Morgan, Bloomberg, Ashmore. Data as at Q1-2020.

EM's net liabilities have halved from 37% of GDP in Q1 2011 to 16% in Q1 2020

The improvement in EM net asset liabilities reflects major adjustment in EM countries' external accounts. As Figure 2 shows, the EM current account position on an index-weighted basis adjusted from a 2.4% deficit in 2013 to a balanced position by 2017 and have now moved into surplus (0.7% of GDP as of Q1-2020). The adjustment started when the Fed raised the cost of funding by tapering Quantitative Easing (QE) in 2013 and continued after the Fed began to hike rates in 2015. During this period, commodity prices and EM currencies declined, while capital became scarcer and more expensive. The effect was to drive EM purchasing power lower, which in turn led to lower levels of goods and services imports.

Fig 2: **GBI-EM GD weighted EM current account balance: not seasonally adjusted (% of GDP)**



Source: Haver, JP Morgan, Bloomberg, Ashmore. Data as at Q1-2020.

EM current account position adjusted from a 2.4% deficit in 2013 to a 0.7% surplus in Q1-2020

Three phases of NIIP adjustment

Delving further into the dynamics of the improvement in the EM NIIP, it is clear that the adjustment took place in three distinct phases. The first phase from 2011 to 2012 was driven by the European Debt Crisis, which pushed Eastern European countries to deleverage. As foreign investors fled from Europe, countries with large international deficits, such as Poland, Hungary, and the Czech Republic were forced to adjust. For example, Hungary's net liabilities declined from 120% of GDP in Q4 2009 to 87% of GDP by Q4 2011 and just 41% GDP by Q1 2020 (Figure 3). The improvement in external balances was anchored by a structural improvement in Hungary's fiscal balance which, alongside the strength of the supply chain with Germany, allowed Hungary to run large current account surpluses for nearly a decade as shown in Figure 4. A similar pattern was observed in the other Eastern European economies.

Fig 3: **Eastern Europe NIIP – as % of GDP**

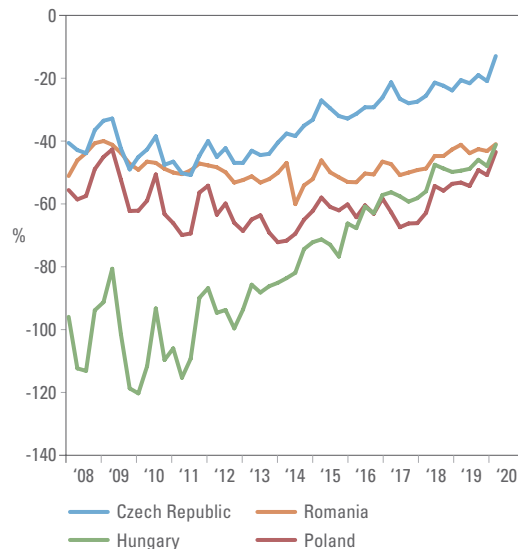
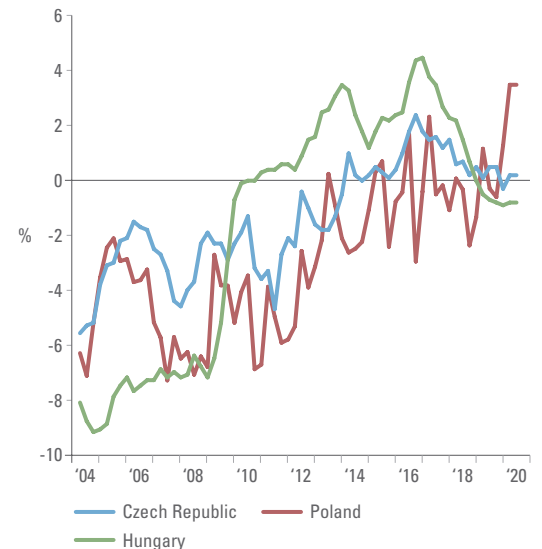


Fig 4: **Eastern Europe current account balance – as % of GDP**

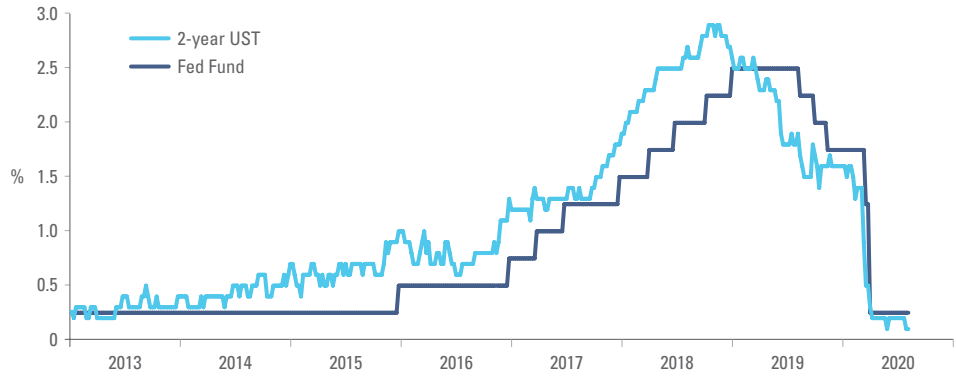


Source: Haver, JP Morgan, Bloomberg, Ashmore. Data as at Q1 2020.

The first phase of the NIIP adjustment was driven by Eastern Europe

The second phase of EM's NIIP improvement occurred between Q4 2014 and Q4 2019 when EM index-weighted NIIP narrowed from 32% of GDP to 25% of GDP. This period was heavily influenced by the Fed hiking cycle (Figure 5), which gradually drove capital away from the rest of the world into the US, not least due to a strong rally in the Dollar as investors prefer to invest money in places where currencies go up.

Fig 5: 2yr US Treasury and Fed Fund rate

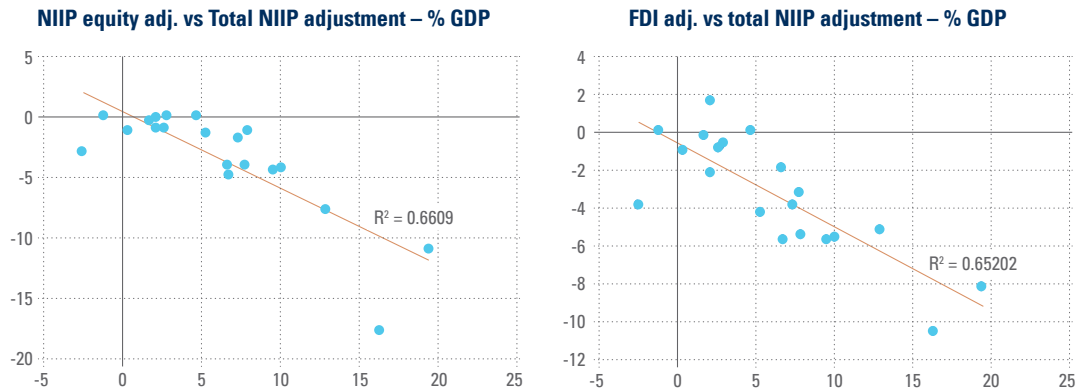


Source: Bloomberg, Ashmore. Data as at Q1 2020.

The second phase of NIIP adjustment was heavily influenced by the Fed hiking cycle between Q4 2014 and Q4 2019

The third leg of the adjustment took place under the coronavirus shock in Q1 2020, when EM net liabilities declined sharply from 25% of GDP to just 16% of GDP. Figures 6 and 7 illustrate the strong correlation (0.65-0.66) between the total adjustment in EM NIIP and the change of foreign equity portfolio and foreign direct investment (FDI) into EM economies. The FDI-related adjustment was brought about due to currency depreciation, which caused a decline in the value of local currency asset prices in USD terms, while equity positions adjusted due to a combination of outflows, negative mark-to-market and currency weakness.

Fig 6 & 7: NIIP adjustment versus equity and FDI stock adjustment (Q4 2019 to Q1 2020)

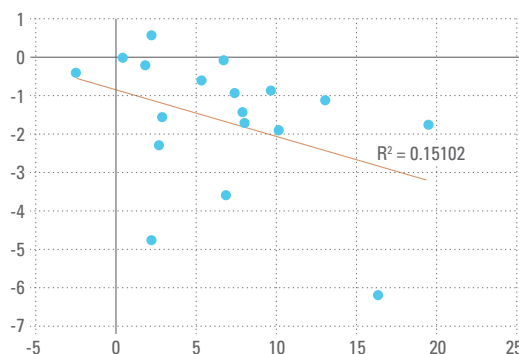


Source: Haver, Ashmore as of Q1-2020. Data as at Q1-2020

The coronavirus shock in Q1 2020 took EM net liabilities from 25% of GDP to just 16% of GDP

In contrast, the outflows from debt portfolios had a much smaller impact on EM NIIP balancing. The correlation between broad NIIP adjustment and foreign fixed income portfolio flows is only 0.15.

Fig 8: NIIP adjustment versus debt stock adjustment - % of GDP, Q1 2020 to Q4 2019

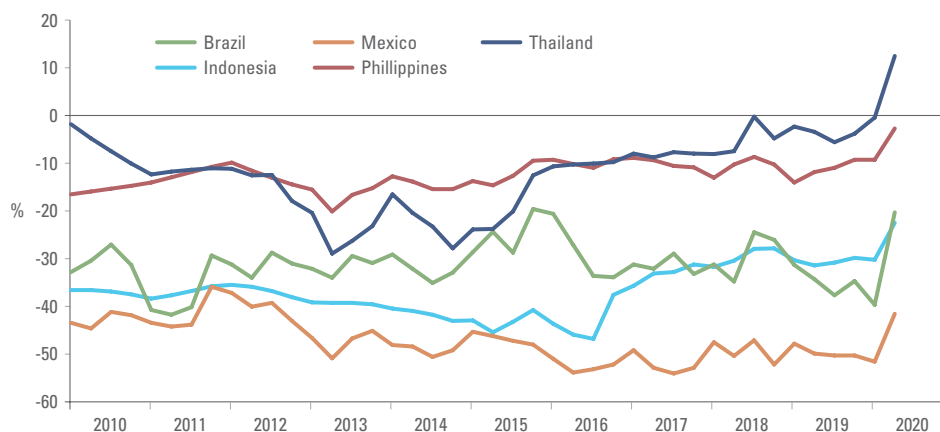


Source: Haver, JP Morgan, Bloomberg, Ashmore. Data as at Q1 2020.

Where has NIIP improved the most?

Figure 9 shows the countries in the GBI-EM GD with the largest adjustments over Q1-2020. The bulk of the improvement in NIIP happened in countries with largest foreign ownership of local equities and FDI.

Fig 9: Largest NIIP adjustments



Source: Haver, Ashmore. Data as at Q1 2020.

Countries where foreign investors had more than 20% of the country's GDP in equity exposure had the biggest NIIP adjustments

As Figure 10 shows, countries where foreign investors had more than 20% of the country's GDP in equity exposure as of Q4 2019 had the biggest NIIP adjustments. Foreign investors in Indonesia, Mexico, and Philippines held the equivalent of between 9.6% and 13.6% of GDP in local equities.

Fig 10: Equity adjustment in Dollar and as % GDP versus foreign equity holdings (% of GDP)

| Country | Foreign Portfolio Equity Q4-2019 (% of GDP) | Foreign Portfolio Equity Q4-2019 (USD bn) | NIIP – Equity Adj. (USD bn) | NIIP Adjustment (% Total) | Currency |
|----------------|---|---|-----------------------------|---------------------------|-------------|
| Argentina | 1.7% | 7.7 | -3.9 | -51% | -7% |
| Brazil | 21.3% | 379.5 | -197.1 | -52% | -23% |
| Chile | 8.5% | 23.3 | -8.3 | -36% | -12% |
| *China | 9.6% | 1,344.4 | -185.8 | -14% | -2% |
| Colombia | 2.0% | 6.0 | -2.9 | -48% | -19% |
| Czech Republic | 3.4% | 8.5 | -3.1 | -37% | -9% |
| Hungary | 12.4% | 19.8 | -7.4 | -37% | -10% |
| India | 5.2% | 148.9 | -14.1 | -9% | -6% |
| Indonesia | 9.6% | 108.0 | -45.8 | -42% | -15% |
| Malaysia | – | – | 0.0 | – | -5% |
| Mexico | 11.9% | 149.2 | -53.8 | -36% | -20% |
| Peru | – | – | 0.0 | – | -3% |
| Philippines | 13.6% | 51.7 | -15.6 | -30% | 0% |
| Poland | 8.2% | 48.5 | -11.3 | -23% | -9% |
| Romania | 1.6% | 4.0 | -1.1 | -28% | -3% |
| Russia | 12.4% | 211.5 | -77.4 | -37% | -21% |
| South Africa | 43.1% | 150.1 | -62.1 | -41% | -21% |
| Thailand | 21.0% | 114.1 | -41.8 | -37% | -9% |
| Turkey | 4.3% | 32.6 | -10.7 | -33% | -10% |
| Uruguay | 0.2% | 0.1 | 0.0 | 5% | -13% |
| Average | 10.5% | | | -33% | -11% |

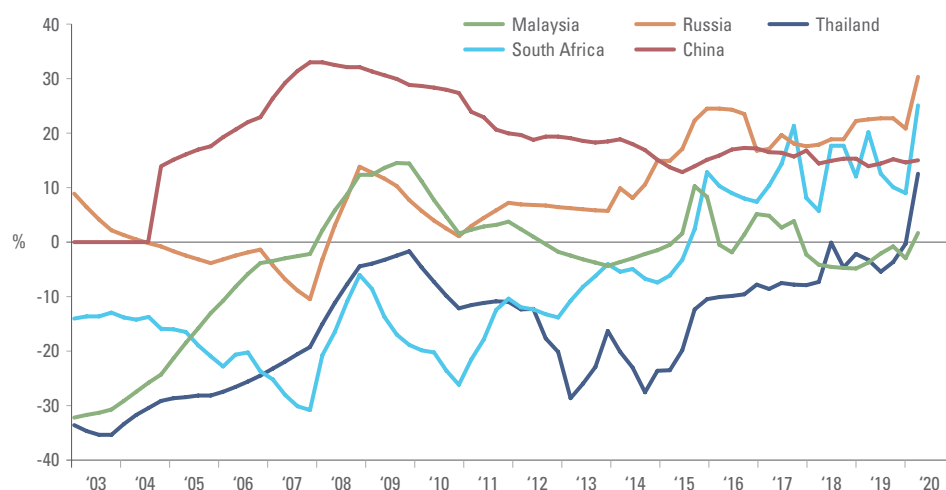
*China: HK + Mainland

Source: Haver, Bloomberg, Ashmore. Data as at Q1 2020.

Which EM economies now have the strongest external positions?

After the three phases of NIIP adjustment, five out of the eighteen countries in the GBI-EM GD now have outright external account surpluses (Figure 11). Malaysia has returned to surplus and Thailand's NIIP has moved into surplus for the first time. Russia, China, and South Africa have now been running structural capital surpluses for five years.

Fig 11: The EM 'Surplus Club'



Source: Haver, Ashmore. Data as at Q1-2020.

Five out of the 18 countries in the GBI-EM GD now have outright external account surpluses

Implications of EM's strong NIIP

1 Greatest resilience to external shocks in two decades

Stronger net investment positions implies lower net external liabilities and hence greater resilience to external shocks. It is notable that the currencies of countries with strong net foreign asset positions, such as JPY and CHF, typically trade as 'safe haven' currencies, meaning that they strengthen during negative market events. When risk appetite declines and volatility spikes, Japanese and Swiss portfolio managers sell foreign assets in a bid to de-risk their portfolios resulting in selling of foreign assets and repatriation to buy domestic assets. Japan holds a positive net external asset position of USD 3.5trn, or 70% of its GDP, while Switzerland has a net external surplus of USD 775bn, which is equivalent to a staggering 440% of Swiss GDP. The opposite occurs in countries with large net foreign liabilities. They suffer capital outflows when volatility increases. This is why the record low net liability position for EMs today should be consistent with much lower vulnerability to external shocks.

2 Room for inflows

EM ought to run structural net liability positions. Japan and Switzerland are mature advanced economies with old populations, wherefore stocks of savings are large. By contrast, EM countries generally have younger populations and ought to be investing in infrastructure and other areas, given their earlier stages of economic development. It is therefore natural that mature economies with large saving rates invest in developing countries, channelling their savings into investments there.

The recent improvement in EM's NIIP means that there is now plenty of room for such inflows. Moreover, with interest rates anchored at very low levels across all the developed economies and equity prices sitting at extremely elevated levels, there is all the more reason to pursue the higher yield available in EM. EM bond yields are currently about 9x higher than the yield on US government debt.¹ Following their macroeconomic adjustment over the past decade, EM countries can absorb foreign investment at a faster pace than GDP growth for a long time before they start to accumulate large external imbalances.

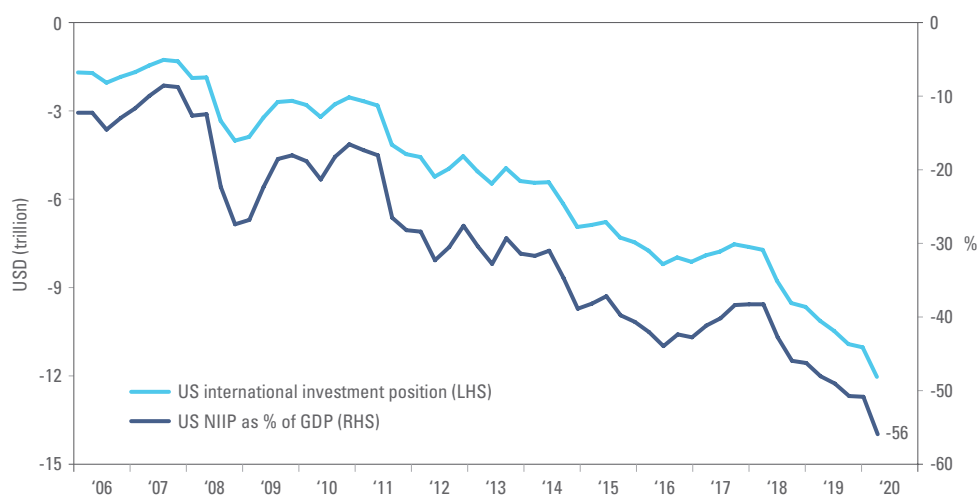
The record low net liability position for EMs today should be consistent with much lower vulnerability to external shocks

¹ See: *'Is 9 times more yield enough for you?'*, Weekly investor research, 27 July 2020.

3 US NIIP the most vulnerable in decades

In sharp contrast to the improvement in EM NIIP and the NIIP position of countries, such as Japan and Switzerland, the US economy has been accumulating net liabilities at breakneck speed. Between Q3 2007 and Q1 2020, US net liabilities moved from USD 1.4trn to a staggering USD 12trn, which is equivalent to 56% of US GDP (Figure 12). This is the largest negative NIIP in US history. It is likely that the US net liability position will deteriorate further in Q2 2020 as the economy is expected to contract by more than 30% (qoq ar) compared to Q1 2020.

Fig 12: US NIIP (USD and % of GDP)



Source: Ashmore, Haver. Data as at Q1-2020.

US net liabilities moved from USD 1.4trn to a staggering USD 12trn, which is equivalent to 56% of US GDP

4 Dollar risks

The large net liability position for the US economy makes it vulnerable to a pull-back in capital flows and points to a much weaker Dollar over time. Currency devaluations are often self-fulfilling prophecies, which are triggered by fears of a weaker currency, which then leads to outflow and in turn yet more depreciation. The depreciation of the Dollar began last quarter and now appears to be accelerating. The long term negatives for the Dollar include inflated valuations, low US productivity growth, and high levels of government debt. More recently, other factors have been added, including:

- Lower US interest rates:** The real interest rate for US 10-year inflation-linked bonds recently declined to multi-decade lows around -0.90% due to low nominal interest rates anchored by aggressive Fed policy and rising inflation expectations.
- Lower negative carry:** Low US rates imply a smaller negative carry for gold, thereby encouraging greater speculative positions in precious metals. Silver, platinum and even some industrial metals like copper are rallying strongly, aided in part by constrained supply after years of dwindling investment.
- Rising money supply:** The Fed's balance sheet has expanded sharply to fund an increasingly unsustainable fiscal deficit. The supply of money in the economy is increasing much faster than the economy itself, leading to higher prices relative to GDP growth (stagflation). While stagflation fears were misplaced in the aftermath of 2008/2009 when QE did not result in greater credit growth in the economy, this time the massive fiscal deficit of 25% or larger may do so. The longer the US takes to control coronavirus, the harder it will be for fiscal consolidation to be achieved.
- Alternatives to the Dollar:** The euro has rallied following European Union (EU) approval of a EUR 750bn fiscal package. The new European bond market offers a scarce 'safe haven' asset and improves the EU's capacity to deal with shocks. The trend in EURUSD is likely to have more legs as investors seek to diversify away from USD.
- 'Capital war risk':** The disputes between the US and China over trade, technology, and diplomacy is increasing the risk of a 'capital war', that is, a situation where China stops funding the US current account deficit and closes its borders to US corporations that sell products in China. At the same time, China would promote trade settlement in RMB. While this is not our base case, it is also not a zero probability and it would be very disruptive for the Dollar's status as a global reserve currency.

The large net liability position for the US economy points to a much weaker Dollar over time

Capital flows can generate momentum which feeds on itself

5 How big is the Dollar move going to be?

It is difficult to quantify the magnitude of currency moves on an ex-ante basis, since currencies are not only driven by fundamental factors, but also from flows of financial assets. Capital flows can generate momentum, which feeds on itself. This is why currencies are often taken far away from their fair value.

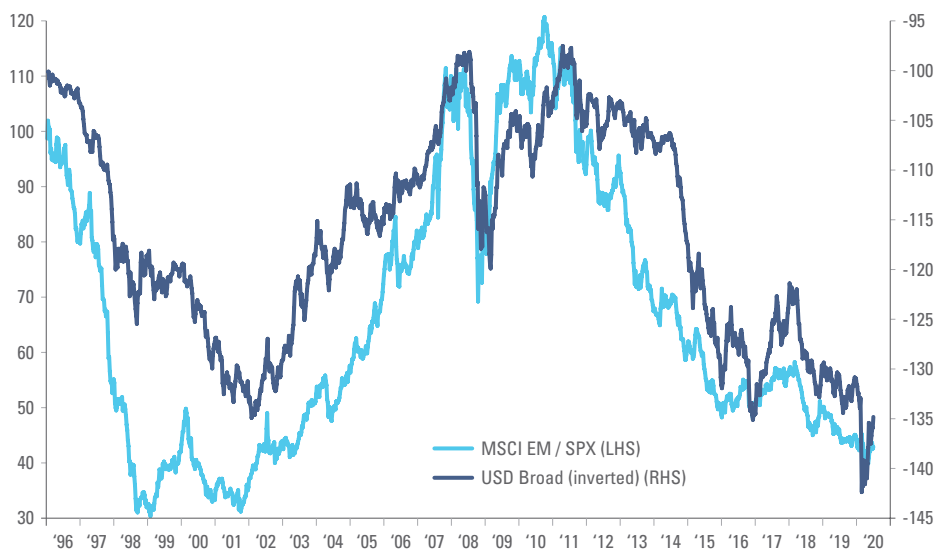
Nevertheless, over the long run real effective exchange rates (REERs) should provide some guidance to the eventual destination of currencies. The US REER is a weighted average of the Dollar versus America's largest trading partners, adjusted for inflation. If the Dollar were to weaken back to its simple average since 1994 then it would have to decline by at least 9% versus its main trading partners, assuming no self-fulfilling currency dynamics that lead to overshooting.

If investors were to lose confidence in the Dollar as a global reserve currency then it could decline by a much greater 22% to test its lowest level in real effective exchange rate terms since 1994. The declines would be ever larger against high beta currencies. Of course, if the Fed was to be forced into expanding its balance sheet even more to fund ever larger unsustainable fiscal deficits then the depreciation of the Dollar could be much larger still.

6 Why the Dollar matters to EM bonds and stocks and fundamentals

A weaker Dollar would push up non-dollar earnings in USD terms, so investors with their assets mostly in Dollar assets would want to diversify. The urge to diversify would lead to USD outflows, leading to yet more Dollar weakness. The pace of USD depreciation is important, because very sudden moves can be highly disruptive for capital flows. A gradual depreciation of the Dollar would be best for markets and the rest of the world, as can be seen from the relationship between the Broad USD index and the ratio of EM equities (MSCI EM) and the S&P 500 (Figure 13) which can also be seen as proxy to momentum assets versus value assets. However, even in a scenario, where the Dollar decline is disorderly US assets would still clearly underperform the rest of the world as investors would still seek to diversify away from the dollar, only in a more panicky way.

Fig 13: Broad US dollar index versus MSCI EM/S&P 500



Source: Bloomberg, Ashmore. Data as at 24 July 2020.

A weaker USD would push up non-dollar earnings, so investors with their assets mostly in Dollar assets would want to diversify leading to yet more USD weakness

Appendix

What is NIIP and how does it relate to the current account

Balance of payments and NIIP

A country's external accounts measure all transactions with the rest of the world. When someone purchases goods or services overseas, the entity or person has to buy foreign exchange in order to settle the transaction. Hence, for every importer buying Dollars, there must be an exporter or remittance from locals living abroad, or overseas borrowing. The balance of payments is thus the accounting ledger for all cash flows with the rest of the world.

A foreign currency surplus on the current account will always lead to a deficit (or remittances) on the capital account, or the accumulation of reserves. Conversely, a deficit on the current account will demand funding via the capital account, or the depletion of reserves. Reserves can be accumulated either in the public sector (via central bank reserves, savings in state-owned companies, or sovereign wealth funds) or in the private sector by companies or households. Figure A1 summarises these relationships.

Figure A1: **Balance of payments**

| Balance of Payments (Flow): Exports – Imports of: | | |
|---|-------------|--|
| Current Account | Goods | Cars, airplanes, agriculture, healthcare |
| | Services | Financial, legal, insurance services |
| | Income | Overseas income remittances |
| Capital Account | Portfolio | Debt, equity, funds |
| | Banks | Loans and deposits overseas |
| | Companies | Direct investment |
| | Real Assets | Real estate, land, infrastructure |
| Residual | Reserves | Central Bank, Sovereign Wealth Fund |

Source: Ashmore.

The flows through the balance of payments accumulate over time. A country running a current account deficit will have to borrow from abroad to fund imports, thereby accumulating a foreign liability. The net international investment position (NIIP), depicted in Figure A2, measures the stock balance of the capital account over time.

Figure A2: **Net International Investment Position (NIIP)**

| Net International Investment Position (stock) assets – liabilities: | |
|---|-------------------------------------|
| Assets | Liabilities |
| Portfolio investments overseas | Foreign investments in local assets |
| Direct investments overseas | Foreign direct investment |
| Foreign exchange reserves | Sov. / Corp. debt issued abroad |

Source: Ashmore.

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