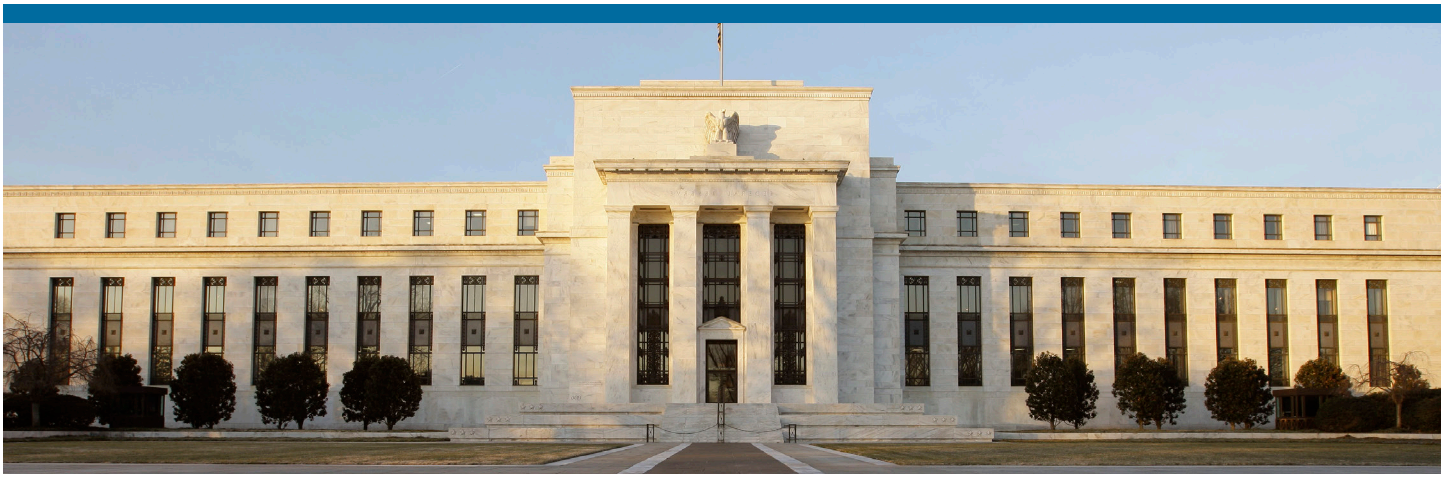
insightpaper

SHOULD EMERGING MARKET INVESTORS FEAR THE FED?

APRIL 2015



Various episodes throughout recent history tell us that investors in emerging markets should be wary of interest rate hiking cycles in the US. Capital outflows from emerging economies during such episodes precipitated financial crises in 1982 (the Latin America debt crisis) and 1994 (Mexican currency crisis).

However, not all financial crises are precipitated by US interest rate increases. The Asian Financial Crisis (AFC) followed a period of relatively stable US interest rates. That particular crisis followed a period of high capital inflows into the East Asian economies, the reversal of which was precipitated by the collapse of the Thai Baht in July 1997. Panic ensued which was exacerbated by policy mistakes by the affected Governments.

Later this year we expect the latest US interest rate hiking cycle to begin. The uncertainties around this cycle are greater than usual. In particular, the global economic environment remains fragile and vulnerable to shocks. The initial rate increase will also be the first US interest rate increase since 2006 and will follow seven years of zero interest rates.

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However, it is the reform agenda which followed the AFC that sees many emerging economies better placed to withstand higher US interest rates during this next cycle. While some have embraced reform more vigorously than others, in general exchange rate regimes are more flexible, external debt levels are lower, foreign reserves are higher and banking sectors are better capitalised than in the late 1990s. For some emerging economies growth has therefore become less reliant on unsustainable fiscal and external imbalances funded by capital inflows that are vulnerable to reversal.

This improvement in the financial positions of emerging economies which adopted these reforms saw those economies better able to respond to the Global Financial Crisis by adopting larger budget deficits.

REAL EFFECTIVE EXCHANGE RATES

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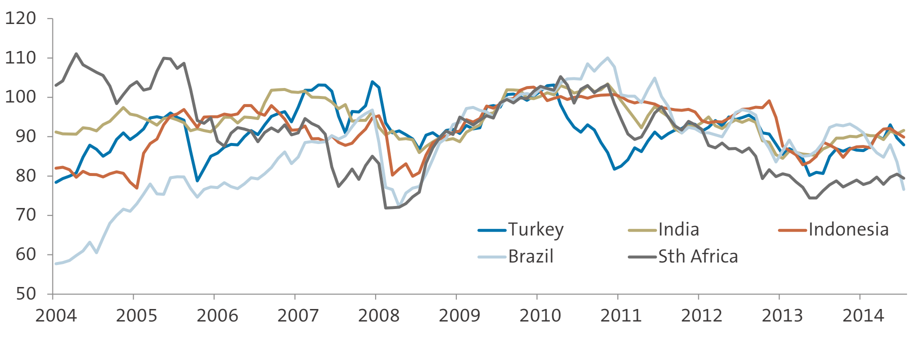


Source: Bank for International Settlements (BIS)

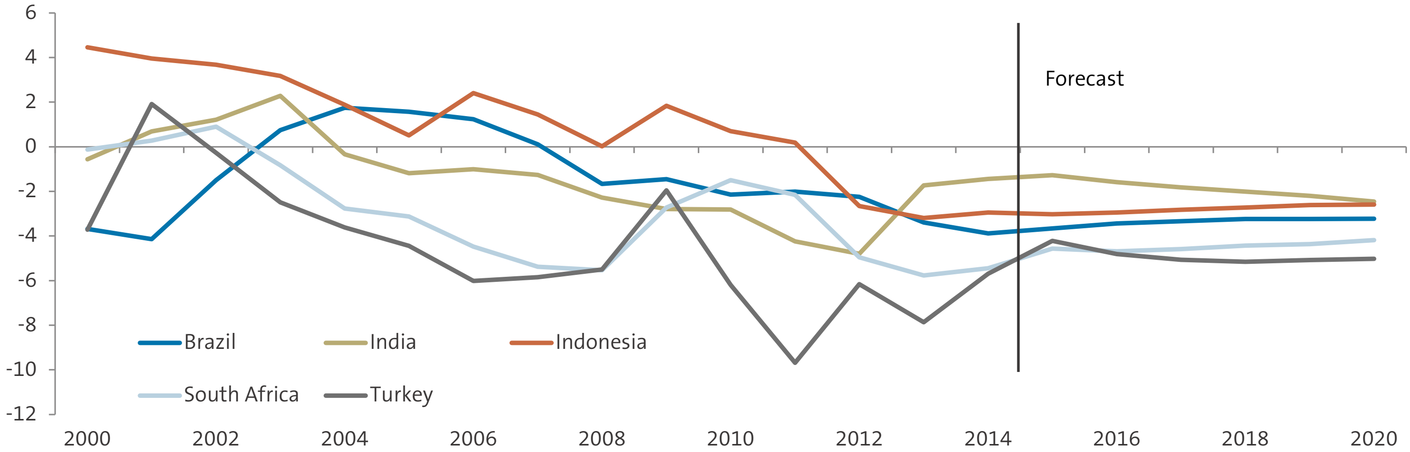
In a forerunner of the upcoming US tightening cycle we saw the 'taper tantrums' of 2013. The fear was that, as the US Federal Reserve (the Fed) reduced its pace of asset purchases, reduced global liquidity would make it more challenging for emerging economies with large current account deficits to fund those deficits. This saw a group of countries including India, Indonesia, Brazil, South Africa and Turkey dubbed the "fragile five".

We don't worry about current account deficits per se in emerging economies. In countries with low wages and low savings rates, current account deficits are necessary to fund investment necessary for development. But we do need to worry about the sustainability of those deficits.

India and Turkey have come through the 'taper tantrums' with improved current account deficits, thanks to the depreciation in their real exchange rates (that was already well underway before mid-2013) and the fact that both have a relatively high share of manufactured exports as a proportion of total merchandise exports. India, along with Indonesia, has also benefited from newly elected governments with pro-reform agendas.

CURRENT ACCOUNT BALANCES: FRAGILE FIVE

% of GDP



Source: International Monetary Fund

Brazil remains in a more vulnerable position given its greater exposure to weak commodity markets and its recently weakened fiscal position, despite stronger growth in the first half of this decade. Outside the fragile five, Argentina and Russia have also squandered recent periods of high commodity prices and remain in structurally weak positions.

We are keeping a close eye on China which has also benefited from strong capital inflows in recent years that remain vulnerable to reversal. While there seems little risk of a balance of payments crisis in China, capital outflows remain a risk to the growth outlook.

Data from the Institute of International Finance shows that capital flows into emerging economies declined from a record high of US$1.35 trillion in 2013 to US$1.1 trillion in 2014. That's not a bad outcome given the various challenges faced by the emerging economies in 2014, including the slowdown in growth and the Russia-Ukraine conflict.

It seems likely that capital inflows will reduce again in 2015 as growth slows further and as the Fed begins to raise interest rates. However, given the generally stronger macro-economic backdrop we are not expecting a collapse. That said, growth has become highly divergent across the emerging economies with those that are struggling, including Brazil and Russia, more vulnerable than the stronger performers.

At the same time, growth is highly divergent among the key developed economies, resulting in divergent monetary policy. Risks to emerging economies around higher US interest rates are mitigated to some extent by continued quantitative easing by the Bank of Japan and the European Central Bank.

Furthermore, interest rates are rising in the US because growth is becoming fundamentally stronger. And while their central banks are still easing, growth is also improving in Europe and Japan. This will assist in stronger global trade and an expected recovery in emerging market growth into 2016. From a post-Global Financial Crisis low of 4.4% this year, we see average emerging market growth gathering upward momentum to 4.9% in 2016.

The end result is that we are taking a cautious approach to emerging markets in our asset allocation strategy. Despite our models showing valuations on the cheaper side of fair value, we hold a neutral position to emerging markets across the diversified portfolios.

CONTACT US

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