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GLOBAL INVESTORS

Emerging Markets – Resilient External Balance Sheets Support Attractive Currency Valuations

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Local currency emerging market debt (LMD) was under pressure in 2018 (along with a number of other asset classes), with the JP Morgan GBI-EM Global Diversified Index Hedged/Unhedged suffering its second worst quarterly return in 10 years in the second quarter of 2018. The index declined again in the third quarter before stabilising towards the end of the year, leaving the full year return for 2018 at -6.2% in USD terms (with the USD generally strengthening against most currencies in 2018, the return from LMD was notably better in other major currencies). These negative returns in USD have been accompanied by a spike in volatility and concerns around capital outflows, hence this is an opportune moment to take a step back and reassess valuations and financial stability in the local currency LMD universe.

Significant movements in financial markets are rarely the result of a single event, rather markets are continuously reacting to a multitude of events and constantly shifting perceptions about the future. Local currency emerging markets weakened last year due to idiosyncratic problems in a number of countries (e.g. Argentina, Turkey and Brazil, to name a few) as well as global trade tensions, a strengthening US dollar and higher US Treasury yields.

Global financial conditions tightened in 2018 reducing the availability of market financing and leaving countries with significant external funding requirements exposed. In an environment of increasing concern about capital outflows from emerging markets (either real or perceived), those with a reliance on foreign inflows are clearly going to be hit first and be worst affected. This proved to be the case in 2018.

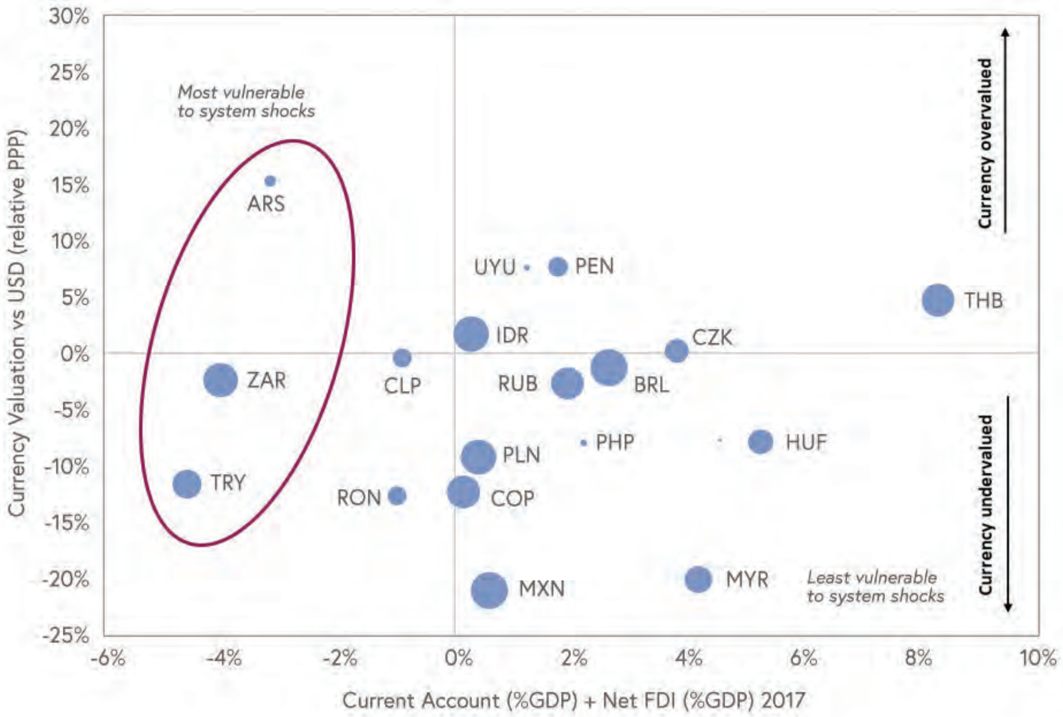
Argentina, Turkey and South Africa all started 2018 with a large reliance on international portfolio flows (see Figure 1). This exposure was compounded in Argentina by the large over-valuation of the peso in real terms relative to the US dollar at the start of the year (Colchester estimate). While domestic factors may have been the initial catalyst for the shock that occurred in both Argentina and Turkey in 2018, capital inflow subsequently dried up and their currencies experienced large depreciations. The Argentine peso declined by 26% versus the US dollar in August alone. Over the full year the Peso and Lira depreciated by 50% and 29% respectively – by some way the two worst performing currencies in the LMD investment universe (see Figure 2).

South Africa was not as negatively impacted as Argentina and Turkey in 2018. While its capital inflow needs were of the same order as the other two, its lower exposure to foreign currency denominated debt most likely cushioned the currency to some extent. Specifically, more than 80% of South Africa's total economy debt is denominated in local currency, while that drops to less than 60% in Turkey and to below 40% in Argentina. Furthermore, the South African rand commenced the year at a level slightly below fair value versus the US dollar in real terms.

What can we learn from this experience?

A number of metrics may be considered when assessing a country's external vulnerability. A particularly useful one is the sum of the current account balance plus net foreign direct investment (FDI). Effectively a deficit on the current account of the balance of payments implies a country is investing more than it is saving and the gap needs to be funded from outside the country. This funding may take the form of investors purchasing debt or equity issued by corporates or the government of the country in question, or it can be in the form of direct investment. FDI tends to be a more stable and long-term source of funding as it includes mergers and acquisitions, the building of new facilities, and the reinvestment of profits - all decisions that typically are not reversed quickly. A deficit on the current account after adding back net FDI, therefore suggests a country is relying on portfolio inflows or investor decisions with a potentially shorter investment horizon to finance the gap. As Argentina and Turkey found in 2018, this funding may not always be available, or may only be available at very high interest rates.

Figure 1. Argentina, South Africa and Turkey most exposed to a tightening in global financial conditions at the beginning of 2018;

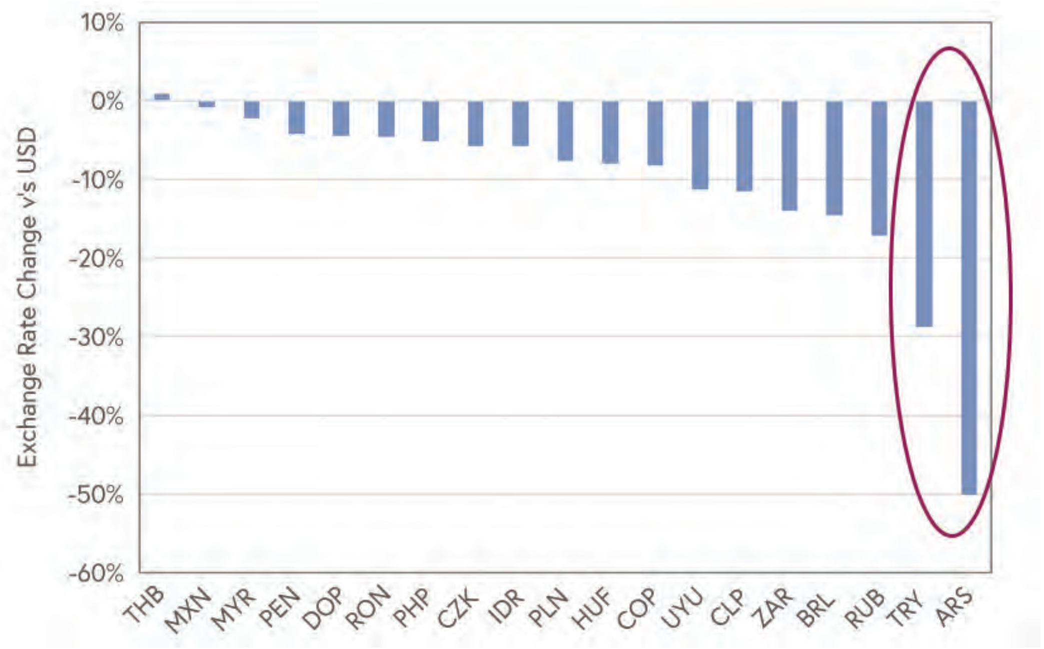


Source: IMF, Colchester Global Investors as at 31st December 2017.
Note: the size of each bubble equates to that market's weight in the JP Morgan GBI-EM Global Diversified Bond Index.

This metric is not the only one that can be used to assess a country's external vulnerability. The current account is a flow measure, so the stock of external liabilities must also be considered as well as the currency of denomination of debt. External liabilities in a foreign currency are a significant risk (unless offset by stable export earnings or dividend inflow in foreign currency), as they may give rise to a potential vicious circle between the exchange rate and the balance sheet. Currency weakness increases the size of the foreign currency denominated liabilities as a percent of GDP, negatively impacting on the country's credit quality, in turn making the currency less attractive.

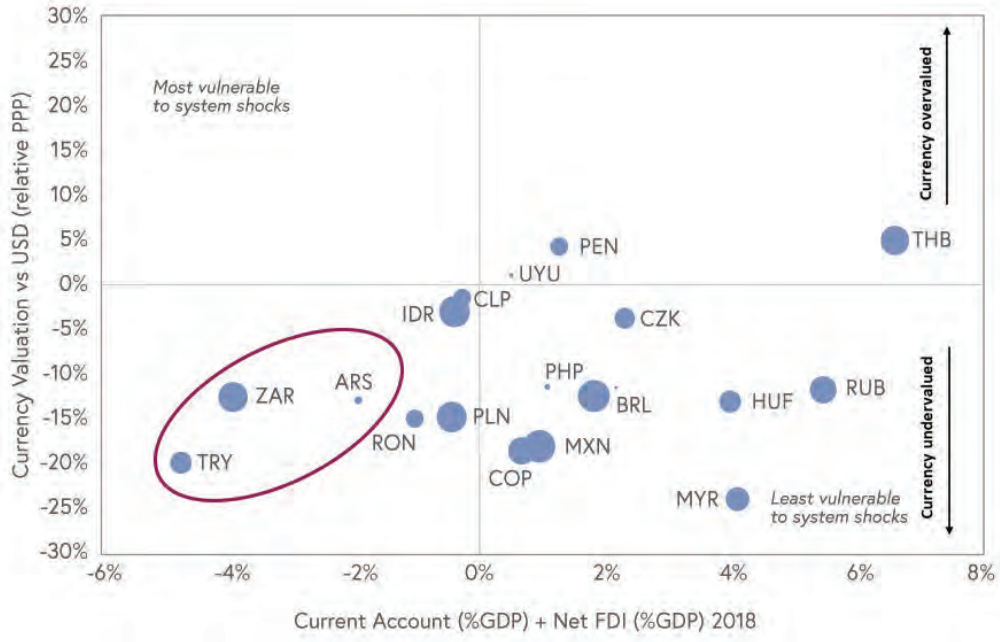
Combining all these metrics, it is useful to think of a currency's vulnerability as a function of (i) its foreign capital financing need, after adjusting for long term capital inflows (FDI); (ii) the stock of debt and its currency composition; and, (iii) its real valuation. In general terms, a currency of a country with a large stock of debt that is primarily denominated in foreign currency, that has a large demand for foreign capital and possesses an overvalued currency in real terms, is clearly more vulnerable than a currency with the opposite characteristics.

Figure 2. Exchange Rate Change versus US dollar - 2018



Source: Reuters

Figure 3. Over the course of 2018 most markets have shifted towards the bottom right i.e. valuations have improved and external vulnerabilities have reduced



Source: IMF, Colchester Global Investors as at 31st December 2018.
Note: the size of each bubble equates to that market's weight in the JP Morgan GBI-EM Global Diversified Bond Index.

Figures 1 and 3 capture two of these elements and provide a useful insight into the potential exposure of various LMD currencies. Clearly the most vulnerable are those in the upper left, and the least vulnerable in the lower right quadrant. A review of these charts suggests emerging economies may not be as vulnerable as is perhaps widely assumed and their position has improved over 2018. Most EM countries shown in the charts are near balance or are exporting capital – in other words, they have little, or no need, for foreign capital. Turkey, South Africa and to a lesser extent, Argentina are the exceptions. Similarly, the currency depreciation that many countries experienced over 2018 has made their currencies more attractive and is likely to further improve their external balances going forward.

Currency fluctuations allow an economy to adjust to a changed economic environment. An undervalued currency that may arise in the aftermath of currency depreciation may be a catalyst for real economic shifts. Specifically, an undervalued currency makes a country's exports more competitive and domestic assets more attractive for foreign investors as well as making imports more expensive. Assuming the currency depreciation does not prompt inflation that subsequently erodes the competitiveness gain, the depreciation may partially alleviate the external vulnerability that triggered the currency sell-off in the first place. If we look at Turkey as an example, the current account has rapidly swung from deficit to surplus as the Lira weakened. The economy posted its highest current account surplus on record in October last year and the expectation for the full year 2019 is a deficit of only 1.4%, a significant improvement on the deficit of 5.6% of GDP in 2017. As a result, the Current Account plus Net FDI level in Figure 3 may currently be overstating the vulnerability of Turkey going forward.

What does it say about the future?

Whilst emerging markets are having to adjust to a less favourable global environment with continued uncertainty about the pace of monetary tightening in the US and elsewhere, rising volatility and concerns around growing trade protectionism, the volatility and currency depreciation seen last year should not be seen as a harbinger of systemic crisis. On balance, most emerging markets should be able to withstand these more difficult conditions, especially those economies with flexible exchange rates, credible macroeconomic policies and independent institutions.

All of the currencies in the index with the exception of the Thai baht, weakened against the US dollar in 2018 (see Figure 2), leaving the weighted average real exchange rate of the index some 11% undervalued relative to the US dollar as at the end of December, compared to 6% undervalued at the end of 2017 (Colchester estimate). This has reduced their 'external' vulnerability, pushed more currencies down into the lower righthand quadrant of the preceding charts and made them more attractive (all else being the same).

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