Investment Event

7 September 2018
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Emerging markets in context

Federal Reserve policy tightening and concerns about global growth provide a common shock to EMs

But the impact on individual markets have reflected fundamental vulnerabilities or idiosyncratic factors

Our views

We remain overweight emerging market equities and bonds. While in the current environment we need to be wary of the risks, valuations suggest that investors are now being rewarded for taking on those risks

Emerging market inequalities

It has been a volatile summer for emerging market (EM) assets, particularly since early August. However, while all major EMs have depreciated against the USD in recent weeks, the scale of the sell-off has not been uniform. The Argentinian Peso (ARS), for example, has fallen by almost 30% against the USD since the end of July but the Thai Baht (THB) has risen slightly and a number of other EM currencies have declined by around 2% or less.

Our interpretation of recent events is that the more cautious and selective approach towards EMs adopted by investors is a response to policy tightening by the Federal Reserve due to strong US growth and gradually rising price pressures, which in turn has squeezed USD liquidity; and a perception that downside risks to global growth increased earlier in the year, reflecting factors such as China-US trade tensions. Economies that are more fragile in terms of structural and macro indicators, or that face idiosyncratic risks, have suffered greater losses.

Pressure on Argentina

In the case of Argentina, a **number of factors help explain why it has suffered** more than most in the current environment. It has one of the largest current account deficits among EM economies, meaning Argentina is heavily dependent on foreign borrowing. It also has a large government budget deficit. In addition, Argentina has a large stock of foreign currency denominated debt worth around 55% of GDP, the majority of which is issued by the government.

Argentina has also been **hurt by its high inflation rate**, which started the year at 25% and has since risen to over 30%. In July, the IMF noted that, against this backdrop, the central bank's decision to cut interest rates early in 2018 added to concerns over the strength of the policy framework in Argentina and the pressure on the peso.

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However, market turbulence has prompted the **Argentinian authorities to take remedial action**. The policy **interest rate has been hiked** to 60% from 27.25% in mid-April and a **new economic plan** has been put in place with the help of the IMF, which has demonstrated strong support for the Argentinian program (both in terms of plan approval and rhetoric). A key objective of the plan is to return the government budget (excluding interest payments) to balance by 2020, one year earlier than originally proposed. However, it will take time for these measures to bear fruit and, in the near term, recent market moves present upside risks to inflation and downside risks to growth. Finally, Argentina has a general election in October 2019, and any **austerity measures** are clearly going to be unpopular, but the government remains committed to the reforms.

Fundamentals matter

While few economies have the mix of vulnerabilities that Argentina faces, some have come under pressure. Those that have **underperformed have tended to display** at least one of the following characteristics: a larger-than-average current account deficit; an above-average level of foreign denominated borrowing; higher-than-average inflation; or a large exposure to the commodity cycle. This holds true for South Africa, Brazil, Chile and Colombia, which have all seen their currencies fall by 7% of more since end-July. There are, however, many EM economies that do not suffer from these vulnerabilities. Asian economies have limited current account deficits or large surpluses, relatively low levels of foreign-currency denominated debt and comfortable inflation rates.

Market considerations

While EM assets have been under pressure, losses have not been distributed evenly across countries. One of the likely causes of the volatility is the continued normalisation of US monetary policy. Given the strength of US growth, this process seems to have further to run, potentially limiting the prospects of wide-spread, near-term recovery in EM assets.

However, from a long-term valuation perspective, EM equities and bonds appear attractive; local currency debt, in particular, stands out. We express our positive view on EM assets through a preference for equities in Asia and local-currency government bonds in Latin America. While in the current environment we need to be cognisant of the risks, valuations suggest that investors are now being rewarded for taking on those risks.

The situation remains fluid and we continue to monitor the outlook.

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