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The rout in emerging markets – is it another Asian crisis?

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Key points

> The rout in emerging market currencies and assets is indicative of a turn in the long-term secular cycle away from them. While an Asian crisis re-run is unlikely, the rout could have further to go and the risks have risen.

> Countries with current account deficits such as Brazil, India and Indonesia are particularly vulnerable. Surplus countries like Korea and China are better placed.

> For investors this means being cautious regarding emerging market assets for now. It also adds to the vulnerability of the $A.

Introduction

The past week or so has seen the pressure on emerging market (EM) assets, notably currencies, turn into a bit of rout. A basket of emerging currencies has fallen nearly 9% year to date, but India, Indonesia and Brazil have been particularly hard hit, with the Indian Rupee down 19% (reaching a record low), and the Indonesian Rupiah and Brazilian Real both down around 14%. This has prompted concern that we may see a re-run of the 1997-98 "Asian crisis" which ultimately affected much of the emerging world and briefly dragged down US and other developed country share markets.

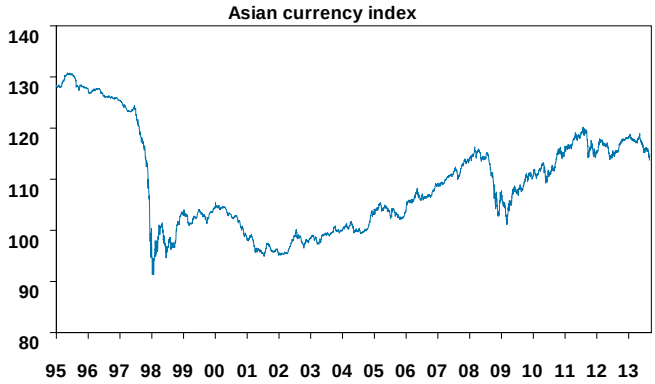
Our assessment is that another "Asian crisis" is unlikely. However, the problems we are now seeing in several emerging countries – notably India, Indonesia and Brazil - are indicative of an unfavourable turn in the longer term or secular cycle for emerging countries.[1]

Recap of the Asian crisis and its aftermath

In the mid 1990s there was much talk of an "Asian miracle". Growth in the "Asian tiger" economies was galloping along at over 7% per annum and their share markets were dramatically outperforming. Growth was thought to be assured by high savings and investment rates, strong export growth and a shift in labour from rural areas to cities (sound familiar?). However, excesses set in including a growing reliance on foreign capital, current account deficits, excessive debt levels and over-valued fixed exchange rates. Eventually foreign investors had doubts. Thailand experienced capital outflows which became a torrent and triggered a collapse in its currency – starting July 1997 – which then led investors to search for countries with similar vulnerabilities and then via a process that became known as "Asian contagion", the crisis spread across the emerging world ultimately contributing to Russia's debt default of 1998 and the LTCM hedge fund crisis that briefly dragged down US and developed market (DM) shares in August 1998.

By the early 2000s, Asian and emerging countries generally got their act together thanks to a range of productivity enhancing reforms, less reliance on foreign capital, low and floating exchange rates and high foreign exchange reserves and this along with the industrialisation of China and a related surge in commodity prices (which benefited South American countries and Russia) saw their growth rates improve. The enhanced perception of emerging countries and a secular slump in the traditional advanced economies of the US, Europe and Japan at the same time saw them once more come into favour big time amongst investors.

This reached a crescendo after the global financial crisis with talk of a "new normal" of poor growth in advanced countries and their rounds of quantitative easing encouraging capital flows to the "stronger" emerging markets leading in fact to talk of currency wars as EM currencies rose. The surge in the value of Asian currencies versus the $US over the last decade as a result of strong capital inflows can be seen in the next chart. Recent weakness has only reversed a small portion of the rally from Asian crisis lows.



Source: Bloomberg, JP Morgan, AMP Capital

Drivers of current concerns

Given this round trip it's natural to wonder whether Asian and emerging countries are largely back where they started in 1997. Certainly the recent falls in emerging market currencies suggest that this might be a risk. Several factors are driving the current rout in Asian and emerging markets:

- Talk that the Fed will soon start to slow its monetary stimulus has raised the prospect its closer to turning off and eventually reversing the flow of easy money, some of which has found its way into the emerging world. Given still fragile US growth this process is likely to be gradual. But transitions in Fed monetary policy often have implications beyond the US, eg the Mexican crisis when the Fed moved to tighten in 1994.
- This has occurred at a time when the flow of news in developed countries is improving as the US economy continues to grow and Europe and Japan emerge from recession, which has in turn reinforced optimism in the outlook for developed market assets.
- It has become evident that some emerging countries, such as Brazil, India and Indonesia, used the capital inflows that occurred as a result of quantitative easing in the US to finance budget and current account deficits. This was fine when the capital was coming in but when it starts to flow back out, as has been the case more recently, it exposes such problems. A bit like a receding tide exposing naked swimmers!

[1] See "The world turns – from developing to emerging markets", Oliver's Insights, July 2013

- More subdued growth in China has taken its toll on the emerging world generally by putting downwards pressure on commodity prices and dragging on the demand for imports from the Asian region.
- More fundamentally, the boom years of the last decade allowed several emerging countries to go easy on necessary structural reforms. Poor infrastructure, excessive regulation and restrictive labour laws are key problems. The end result has been inflation and trade imbalances and reduced potential growth rates. Again Brazil, India and Indonesia stick out on this front. While during the boom it was common to talk of Brazil's potential growth rate being around 6% pa, it is now probably closer to around 3 or 4% and this year looks like being around 2%. Similarly for India, its potential growth was talked about as being around 8% pa a few years ago, but it now looks more like 5 to 6%, with possibly just 3 or 4% this year with the very real risk of a recession.

The end result of these forces has been a sharp increase in capital outflows from emerging to advanced countries which in turn has resulted in falling asset prices and currency values for much of Asia and the emerging world.

While the authorities in some countries have announced measures to defend their currencies, such as controls on the ability of locals to take money out of the country, the largely superficial nature of such measures – dealing with symptoms and not the causes – have served to only further scare foreign investors. In particular, foreign investors have worried that capital controls will be placed on their own ability to repatriate their funds.

Attempts to support currencies are resulting in a tightening in monetary conditions in some emerging markets – Brazil and Indonesia have already raised interest rates and India has announced a monetary tightening. This is serving to further slow economic growth making the investment outlook in such countries even less enticing for foreign investors.

Put simply, there is no easy way out for countries with current account deficits when foreign investors start to withdraw their capital. Domestic spending must fall and interest rates must rise and exchange rates fall to bring this about. The only way out is to reform their economies.

Not 1997, but the risks have increased

So how vulnerable is the emerging world? The next table compares the state of current account deficits, foreign exchange reserves and inflation today with the situation before the 1997-98 Asian/Emerging Market crisis began.

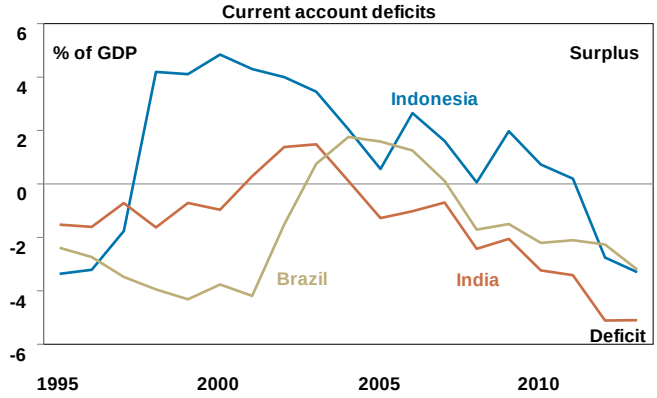
Not as vulnerable as in 1997, but…

	Current account, %GDP		FX reserves, $USbn		Inflation rate, %	
	1996	Now	1997	Now	1996	Now
Indonesia	-3.2	-3.3	17	99	7.9	8.6
Thailand	-7.9	0.1	27	171	5.9	2.0
India	-1.6	-4.5	20	288	9.0	9.6
Korea	-4.4	3.5	20	326	5.1	1.4
Taiwan	3.9	11.7	84	412	3.1	0.1
Malaysia	-4.4	5.8	15	137	3.5	2.0
Singapore	13.8	19.0	73	260	1.1	1.8
HK	3.9	0.9	93	304	5.9	6.9
China	0.9	2.1	140	3516	8.3	2.7
Brazil	-2.7	-3.2	58	374	9.6	6.3
Russia	2.8	2.5	25	514	21.8	6.5

Source: IMF, Bloomberg, AMP Capital

In contrast to 15 years ago, the overall position of Asian and emerging countries is stronger today. Current account balances are generally in better shape, central banks have much higher foreign exchange reserves, exchange rates are floating rather than fixed and not as high as they were before the Asian crisis (see the first chart) and inflation is lower.

However, some countries look vulnerable, particularly Brazil, India and Indonesia where, partly reflecting persistent budget deficits, current accounts have moved heavily into deficit indicating a now heavy reliance on foreign capital inflows.



Source: IMF, AMP Capital

This explains why these countries seem to be at the centre of the current turmoil. Other emerging markets that are vulnerable thanks to current account deficits and hence a reliance on foreign capital inflow are Turkey, South Africa and Chile.

At the other extreme, while contagion is a risk it is clear that China, South Korea, Taiwan and Russia with large current account surpluses, are far less vulnerable.

Overall, while we don't see a re-run of the Asian crisis the risks have clearly increased particularly for countries that now have large current account deficits. And until such countries can reform their economies to make them more productive and less reliant on foreign capital it is too early to say the current rout has run its course. More broadly, the period of relative underperformance in the emerging world likely has further to run.

Implications for investors

There are several implications for investors:

First, while emerging market shares are relatively cheap it's too early to reweight towards them.

Second, emerging market woes are unlikely to drag developed market shares down as badly as they did in the second half of 1998 as the latter are not overvalued as they were back then when they were towards the end of the long term secular bull market.

However, the emerging market currency rout adds to the worry list which includes the US debt ceiling, the replacement of Ben Bernanke at the Fed, the Fed's taper decision, the coming German election, Italian political instability and Syria in pointing to the risk of a further short term correction in share markets generally.

Finally, the $A is likely to remain under downwards pressure as a result of less growth in commodity intensive demand from Asia. It may also suffer collateral damage as investors often sell the $A as a proxy for less liquid Asian currencies. Ultimately I see it heading down to $US0.80.

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