Emerging Markets

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What is the outlook for other Emerging Markets?

How will the worsening circumstances in other emerging markets (ex-China) impact their growth prospects, and how significantly will this impact global growth?

While the US taper concerns clearly created volatility, we believe the fundamental reason behind EM asset price underperformance relative to DM is down to weaker than expected growth and slower growth prospects going forward. There are two main reasons for slowing growth in EM ex-China: a) lower commodity prices that hurt a number of commodity-producing EM countries and b) balance of payment issues in some fragile emerging markets that forced a tightening in monetary and fiscal conditions. Commodity supply conditions continue to create a persistent headwind for commodity prices. Commodity supply is expected to increase materially for key commodities such as copper, iron ore and oil following a significant boom in mining investment, new technologies, and the shale boom in the US. This has a direct impact on the GDP growth prospects of a number of the commodity producing nations in EM such as Brazil, Venezuela and Russia.

Countries such as Turkey and South Africa have relatively large amounts of foreign currency denominated debt which crimps their ability to stabilise their currencies in the face of capital flight. Both Turkey and South Africa raised interest rates recently in order to defend their currencies but this of course leads to lower growth prospects. Most of the investment world's focus has landed on the plight of what are being called "the Fragile Five" which includes Brazil, India, Indonesia, Turkey and South Africa. India and Brazil stand out for their size (6% of global economy together) and for their weak balance of payments problems only exacerbated by high government debt, high borrowing costs and resulting high fiscal deficits adding to current account deficits.

Studying the potential scale of contagion to the rest of the world from the plight of the Fragile Five, we conclude that the impact will be broadly spread across the world without triggering a Lehman Brothers like systemic event. Nor would we expect to see this crisis amount to the scale of previous EM currency crisis given the predominance today of floating rate currencies, the higher proportion of local currency denominated foreign debt and the more dispersed ownership of investments in EM. We will see more contagion affecting mostly European banks who have concentrations of debt from the Fragile Five, and mostly European corporation who on average derive 8% of their profits from the Fragile Five markets. Perhaps the most worrying consequence from this EM currency crisis is the extent to which is will exacerbate Europe's economic turnaround.

In summary, we believe that while the IMF has already discounted a great deal of bad news into their current EM growth rates, risks are still skewed to the downside for EM countries which are most vulnerable to falling commodity prices, those still running with current account deficits and those who face ongoing political uncertainty. Such countries include Brazil, South Africa, Indonesia and Turkey. We are not confident that the growth forecasts for Europe have contemplated the impact, albeit limited, European banks and exporting companies.

A. What happened last year and what are the key insights?

The disappointing performance of emerging markets (EM) over the last year (and earlier) was particularly noteworthy in the context of one of the best performing periods in recent history for assets broadly categorised as "risky" in developed markets (DM), such as equities, high-yield debt and even sovereign bonds of Euro area peripheral countries.

The simplistic explanation of this dichotomy has typically been to relate all EM underperformance to the decision by the Fed to taper its programme of buying US treasuries. The rationale is that as "financial repression" slowly came to an end in DM, capital that had fled to EM in search of better rates of return would be withdrawn and reallocated back to DM.

While the taper concerns clearly created volatility, we believe the fundamental reason behind EM underperformance is down to weaker than expected growth and slower growth prospects going forward.

There are two main reasons for slowing growth in EM ex-China: a) lower commodity prices that hurt a number of commodity-producing EM countries and b) balance of payment issues in some fragile emerging markets that forced a tightening in monetary and fiscal conditions.

While difficult to quantify precisely, new supply is still coming on to create a persistent headwind for commodity prices. Commodity supply is expected to increase materially for key commodities such as copper, iron ore and oil following a significant boom in mining investment, new technologies, and the shale boom in the US. This has a direct impact on the GDP prospects of a number of the commodity producing nations in EM such as Brazil, Venezuela and Russia.

A number of the countries in EM suffered from twin deficits in 2013 – a negative current account balance due to imports outstripping exports, and a negative fiscal deficit due to government spending exceeding revenues. These twin deficits were particularly severe in the so called “Fragile Five” – Brazil, Turkey, South Africa, India and Indonesia, and caused their currencies to depreciate significantly on the back of US tapering fears. The outflow of capital, coupled with the need to tighten fiscal and monetary conditions to shore up weak currencies acted as a further headwind for growth in these countries.

Against this backdrop, it probably never made much sense to look at EM in aggregate. A recent paper by Ruchir Sharma highlights four common errors made in forecasting EM returns. First, and perhaps the most obvious, is that of generalisation, i.e., the tendency to lump together disparate countries and economies into catchy acronyms which tend to overlook fundamental differences in economic drivers. For example, even moving down one level from the aggregate EM level, the economies that make up the so-called “BRIC” countries have highly differing mixes of growth components, political structures and balances of payments. Second, as with many investment decisions, there is a tendency towards extrapolation. Forecasters often look as current trends and assume they will continue indefinitely, forgetting the inherently cyclical nature of economies and markets. Third, there is a tendency to focus on single factors. If a country with young demographics is doing well, then analysts look for other countries with young populations and expect them to do well, ignoring infrastructural, educational and other constraints. Fourth, political cycles are often as important as economic ones. Typically, difficult periods in both internal and external balances lead to market crises which then provide impetus for much needed reforms. These are followed by a period of recovery which often lasts as long as it takes for the next round of complacency to set in.

Above all, a key success factor is deep local knowledge of the key drivers in each economy, and where it is in its economic and political cycles. Even in the current context of broad underperformance, we believe there are particularly attractive opportunities within EM caused by the generalised selloff, and hence we skew our allocations in favour of those active managers best able to harvest them.

B. Which countries are still on the “emerging” track and will continue to contribute disproportionately to global growth? Which countries are not?

There are as many materially different circumstances for emerging countries’ economies as there are emerging countries. As investors, we care about emerging markets as a source of higher than normal returns on investment in part driven by that growth and in part driven by exploitable inefficiencies. There has been a tendency to bundle all small economies in one bucket and assessing that they are all on an unstoppable uni-directional journey toward becoming an advanced or developed market. History has shown us the model through Japan, Singapore, Korea and others. Low labour costs, growing populations, a supportively cheap currency, controlled inflation, improving infrastructure, political stability and a defensible competitive advantage other than just low labour costs all work together over time to see an economy emerge with not just fast real economic growth, but a rising GDP per capita that approaches that of developed nations. Successful examples always hit speed bumps along the way. Common “speed bumps” include commodity price down cycles and capital outflows caused by externally driven events such as the one just experienced on the back of expected tapering-related interest rate rises in the US. In 2013, Emerging markets experienced both challenges – a commodities down cycle and foreign capital outflows. So which emerging markets are best positioned to withstand these challenges and, over the long term, continue on a strong growth track? Does this universe constitute a sufficient subset of the overall EM such that we can continue to see EM pulling up global growth?

Exhibit 1 shows the key EM countries vulnerable to both commodity prices (vertical axis) and current account balances (horizontal axis called "basic balance" which includes net FDI and the current account balance).

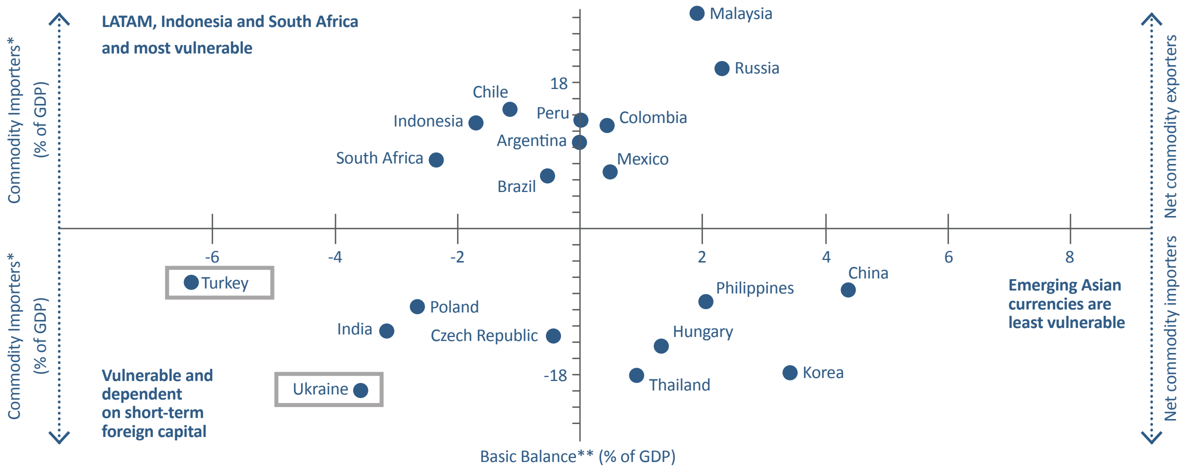
The most vulnerable countries are conceptually in the top-left quadrant as they are most dependent upon commodity exports and also have weak current accounts. Brazil, South Africa and Indonesia appear the most vulnerable based on these two factors. In addition, while India and Turkey are not export dependent, they are large countries that have significant current account deficits that make them vulnerable to currency weakness that in turn leads to growth-reducing tightening actions by the central banks. Furthermore, certain countries such as Turkey and South Africa have relatively large percentages of foreign currency debt to GDP (as shown on the adjacent page in Exhibit 2) which crimps their ability to stabilise their currencies in the face of capital flight. Both Turkey and South Africa raised interest rates recently in order to defend their currencies but this of course leads to lower growth prospects for them.

The strongest countries conceptually are those in the lower right quadrant who are not dependent on exports and have strong trade balances. We can see a number of Asian economies including China, Korea and Taiwan who are in this quadrant and we know to be on much firmer ground.

The current account deficit situation in a number of vulnerable countries is not a static picture and their vulnerability depends on how quickly and effectively policy makers address structural weaknesses. For example, as shown in Exhibit 3, India has made significant progress in reducing its large current account deficit this year compared to countries like Turkey, and the rewards so far have been currency stability in the Indian Rupee compared to significant volatility in the Turkish Lira.

Exhibit 1: Sensitivity to commodity prices and current account balances

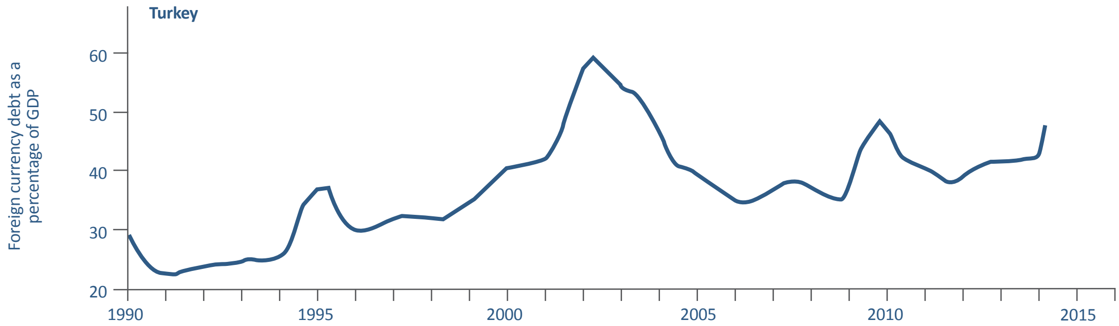
Source: MRB Partners Inc



* The ratio of commodity exports to GDP for net commodity exporters and commodity imports to GDP for net commodity importers
** Calculated as current account balance plus net foreign direct investment

Exhibit 2: Turkey and South Africa: foreign currency debt as a % of GDP (1990-2015, BCA Research forecasts)

Source: oxford economics, the last data point is BCA estimate based on current exchange rate devalution



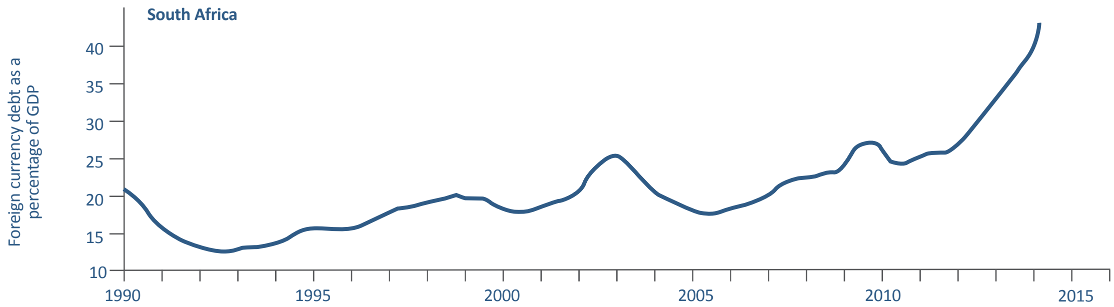
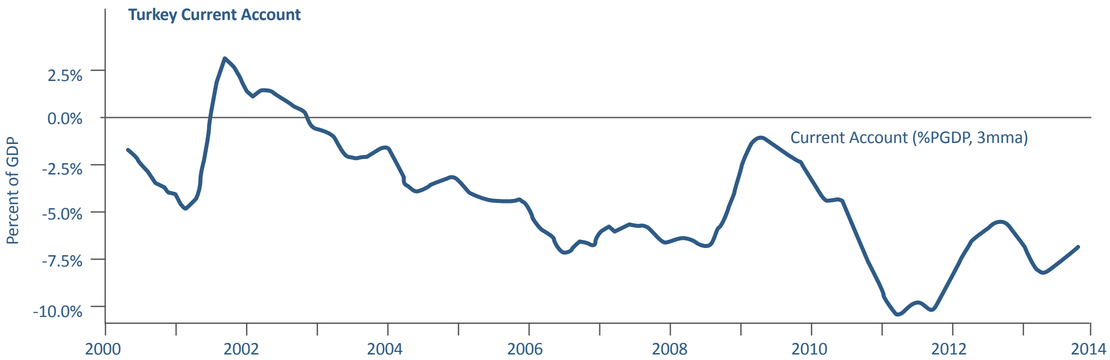
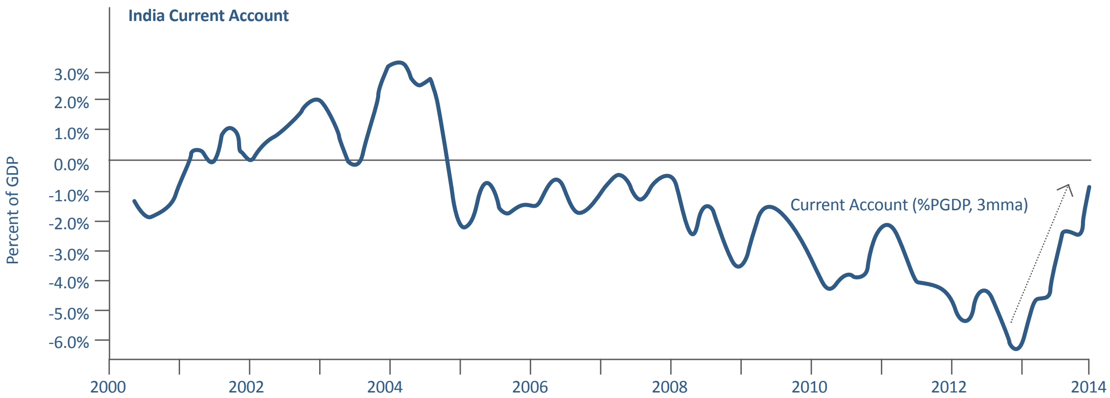


Exhibit 3: Turkey and India: Current Account as a % of GDP

Source: Oxford economics





A key issue for effective policy making is a strong government that is politically stable. It is a crucial election year in a number of key EM countries including Brazil, South Africa, Turkey, India and Indonesia. Exhibit 4 summarises Deutsche Bank's assessment of the risks and status of each election.

Any one of these political events could be create significant turmoil leading and stagnant policy making that could postpone investment and derail growth prospects.

Summarising our analysis of the key issues above, we now comment on EM growth prospects for the major countries by using IMF growth forecasts and commenting on whether we believe risks to the growth outlook are skewed to the upside or the downside.

Exhibit 4: Details of upcoming political elections in the Fragile Five emerging markets

Source: Deutsche Bank

Countries	Main Candidates	Risk	Current Status
South Africa (April - July)	Jacob Zuma, ANC (I) Mamphela Ramphele, DA Julius Malema, EFF	Low	**Expect ANC to retain power, but with lower share of the vote** • ANC has dominated every election since the end of apartheid • Likely to see fall in its share of the vote as a dissatisfied electorate drifts towards the opposition, including a number of ANC-breakaway parties
India (April - May)	Candidate TBD, Congress (I) Narendra Modi, BJP	Medium	**Anti-incumbency and pro-governance sentiment will define the election** • Incumbent Congress Party is facing criticism about weak growth, high inflation, slowing of reform momentum, and lapses in governance • Narendra Modi's candidacy has at once galvanized opposition BJP while raising concerns among some about the associated rise in sectarian tensions • Recent victory of the one-year old Aam Aadmi Party in the Delhi legislative assembly polls suggests voters seeking to reward anti-corruption platforms
Indonesia (April - July	Joko Widodo, PDI-P Prabowo Subianto, Gerindra Aburizal Bakrie, Golkar	Medium	**Joko Widodo, current governor of Jakarta, is leading in the polls** • No candidate has a clear economic policy agenda; legislative polls in April could lead to a fragmented parliament, causing uncertainty in July's presidential polls • Widodo's major asset is his reputation of being honest. He is yet to obtain full backing of his party (PDI-P) which suggests possible difficulties ahead
Brazil (October)	Dilma Rousseff, PT (I) Marina Silva, PSB Eduardo Campos, PSB Aecio Neves, PSDB	Low	**Joko Widodo, current governor of Jakarta, is leading in the polls** • No candidate has a clear economic policy agenda; legislative polls in April could lead to a fragmented parliament, causing uncertainty in July's presidential polls • Widodo's major asset is his reputation of being honest. He is yet to obtain full backing of his party (PDI-P) which suggests possible difficulties ahead
Turkey (March - August)	Recep Erdogan, AKP (PM) Abdullah Gul, AKP (I) Kemal Kilicdaroglu, CHP	High	**PM Erdogan's bid to become Turkey's first directly-elected president in doubt** • Major political crisis triggered by an ongoing corruption probe as Erdogan faces opposition from the Gulen movement • Support for AKP remains strong but Erdogan's supremacy could be challenged • Local elections in March shaping up to be referendum on Erdogan's future

Exhibit 5: Emerging market country divergence: clearly emerging, potentially emerging and retreating economies

Source: IMF; Worldbank

Country	2012 % of Global GDP	Actual 2008–13 Annualised GDP Growth % (IMF)	Expected 2014–18 Annualised GDP Growth % (IMF)	% Contribution to 2014–18 GDP Growth	Contribution to average annual growth rate	Growth Forecast in line with fundamentals	Summary Rating Growth Category
Emerging Markets							
China	11.4%	8.8%	7.0%	20.2%	0.80%	In Line	Clearly Emerging
Brazil	3.1%	2.6%	3.2%	2.5%	0.10%	In Line	Potentially Emerging
Russia	2.8%	1.1%	3.4%	2.4%	0.10%	In Line	Potentially Emerging
India	2.6%	6.4%	6.3%	4.0%	0.16%	Downside?	Potentially Emerging
Taiwan	0.7%	3.2%	4.2%	0.7%	0.03%	In Line	Clearly Emerging
Mexico	1.6%	1.8%	3.5%	1.5%	0.06%	Upside?	Potentially Emerging
Korea	1.6%	3.0%	3.9%	1.6%	0.06%	In Line	Clearly Emerging
Indonesia	1.2%	5.8%	5.9%	1.8%	0.07%	Downside?	Retreating
Turkey	1.1%	3.7%	4.2%	1.2%	0.05%	Downside?	Retreating
South Africa	0.5%	1.9%	3.3%	0.4%	0.02%	In Line	Potentially Emerging
Top 10 EMs	26.6%	5.3%	5.2%	36.2%	1.44%		
of which are Fragile Five	8.5%	4.3%	4.6%	9.9%	0.39%		
Rest of EM	**16.2%**						
Total Emerging Markets	**39.9%**	**5.3%**	**5.4%**	**53.9%**	**2.1%**		
Total World	**100%**	**2.9%**	**4.0%**	**100.0%**	**4.0%**		

Note: Saudi Arabia, Iran, Poland and Argentina come ahead of south Africa among the largest 10 economies, but we have included #13 South Africa in the top 10 given the focus it has had in the recent "EM currency crisis." GDP % are based on spot exchange rates, not purchasing power parity;

Exhibit 5 sets out the 5-year expected GDP growth of the global economy with estimated contributions from selected EM countries. We have discussed the implications of a slowdown in Chinese growth in the previous section. Focusing on the so called "Fragile Five" countries, Brazil, South Africa, Turkey, India and Indonesia account for 8.5% of global GDP and collectively grew by 4.3% p.a. in the last 5 years and the IMF expects them to, as a group, carry on at approximately this growth rate, or 4.6%. This represents a contribution of 0.39% (39 basis points) towards the overall 4.0% expected global growth rate over the next 10 years, or 10% of global growth. So as we think about the impact of the Fragile Five crises, a 50% shrinkage in their growth rates would see the world growing 0.20% per annum slower, ignoring any contagion affects.

We believe that while the IMF has already discounted a great deal of bad news into their current growth rates, the IMF forecasts appear to have appropriately forecast more downside for countries which are most vulnerable to falling commodity prices, those still running with current account deficits and those who face ongoing political uncertainty. Compared to the IMF's 2012 published 2014-17 forecast, the latest forecasts reflect reduced growth for Brazil (-18%), South Africa (-11%) and Indonesia (-14%), but have left Turkey's forecast unchanged. Our own examinations of all of the macroeconomic statistics surrounding these 5 countries suggest that India may be less fragile than the other four.

Brazil is the largest of the Fragile Five accounting for 3.1% of the global economy. It has a 57% net debt to GDP ratio and high borrowing rates leading to at least a 4.5% debt service burden turning a 1.5% primary surplus into a 3.5% deficit. 26% of this debt is denominated in US$, with 21% in foreign hands. Brazil is experiencing slower than normal growth of between 2-3% in 2014, continues to suffer from high inflation and poor policy making and overall fading credibility.

In contrast, India would appear to be a country with the potential to continue on a long term growth track with Dr. Raghuram Rajan playing a key role as the Governor of the Reserve Bank of India. The IMF forecasts 6.3% average annual growth over the next 5 years which is almost exactly the same as India's actual growth rate over the last five years. However, this forecast reflects a reduction from their forecast (since their 2012 estimate) which was 7.5% pa. We see some downside for India, given a good outcome for India is highly contingent upon having a stable central government capable of enacting tough growth enhancing reforms. If BJP party leader, Narendra Modi, gets a clear majority this May, many experts believe this will translate into upside for India's economy.

If downside risks do materialise in the more fragile EM countries, what is the risk of contagion to other EM and DM countries and what impact could this have on global growth?

The contagion question is most simply addressed by looking at the size of linkages in terms of trade and asset ownership. A recent article by one of our highly respected macro mangers went to great lengths to quantify these linkages, in particular the debt holding of foreign banks (and related impact on bank share prices), the profits that foreign corporations earn from these five countries and the equity holdings of DM institutional investors, such as insurance companies.

During the Latin American debt crisis in the late 1980's, the large US banks had between 300% to 500% of capital allocated to EM sovereign loans. Today, there is $1.2T of credit exposure to the Fragile Five held by large banks around the developed world, which represents 56% of bank capital on average. The UK, Spain and Greece have the largest percent of bank capital exposure at 87%, 151% and 151%, respectively. A few individual banks like Santander have over 200% of bank capital exposed to the Fragile Five. Our manager believes that the "building crisis is likely to create significant losses for lenders." They illustrate a balance of payments crisis could have certain (not all) Spanish banks hit the worst, recording losses of over 40% of capital and certain British banks hit with losses of over 20% of capital.

The average DM corporation has 4% of revenue and 5% of profits derived from the Fragile Five, in contrast to the 8.5% of global GDP represented by them. Europe is more skewed toward these five, with 8.4% of profits attributed in contrast to 2% for the US. Even in the worst case, these profits will not disappear, but there must be downside in DM EPS from this exposure.

Finally, turning to contagion from EM equity holdings, estimates suggests that the average institutional investor has 6% of their total portfolio exposed to emerging markets. Given the Fragile Five are 1.2% of this 6%, based on the 20% of overall EM GDP they account for. We have already seen the Fragile Five equity markets decline by approximately 15% in USD terms since the beginning of 2013, taking away 18bps of portfolio performance. As a worst case, we could see a similar impact to the extent portfolios have not already cut exposure to these five markets.

In the 1990's EM turmoil, we got a taste of contagion across emerging markets. In the 1990's, many emerging countries had exchange rates pegged to the US dollar which allowed them to borrow large amounts of cheap funds from developed countries while the Federal Reserve was lowering rates. This created huge foreign capital inflows and fuelled a large inflationary boom across the developing world. When the Fed began to raise rates in 1994, capital inflows dwindled and the pegged exchange rates became a repayment burden. As pegs were abandoned and currencies collapsed, so did the value of EM debt and equity, triggering even more capital outflows. The situation was resolved gradually over time, as countries switched to floating currency regimes, strengthened exports and addressed their current account deficits.

From a macroeconomic perspective, it would appear that today's situation is different in two fundamental respects. First, very few fixed-exchange rate regimes remain (China is a notable exception, but maintains a huge current account surplus). This allows currencies to fall gradually without draining foreign exchange reserves, while helping to stimulate growth. As a result, despite some problem countries, current account balances are generally healthier than in the decade of the '90s. Exhibit 6 shows that the overall current account balance for EM (ex-China) as a whole went from a low of 2.0% deficit in 1997 to a high just over 2% in 2003. Since then we have seen a fairly consistent decline in the current account down to a -1.0% deficit where it sits today. This decline is not widely spread across EM countries, but rather mostly attributed to the "Fragile Five" including Brazil, India, Turkey, Indonesia and South Africa. Offsetting this worsening trend, we see a more positive trend in the proportion of EM foreign debt that is now denominated in local currency, which avoids the cash squeeze created when domestic income and assets are valued in a depreciating local currency and national debt is held in an appreciating foreign (usually USD) currency. Exhibit 7 shows that the proportion of EM foreign debt that is still denominated in foreign currency has fallen from 47% in 1999 to 36% of all EM foreign debt today
(excluding China).

Hypothetical return expectations are based on simulations with forward looking assumptions, which have inherent limitations. Such forecasts are not a reliable indicator of future performance.

Exhibit 6: Current account balance for EM (ex China)

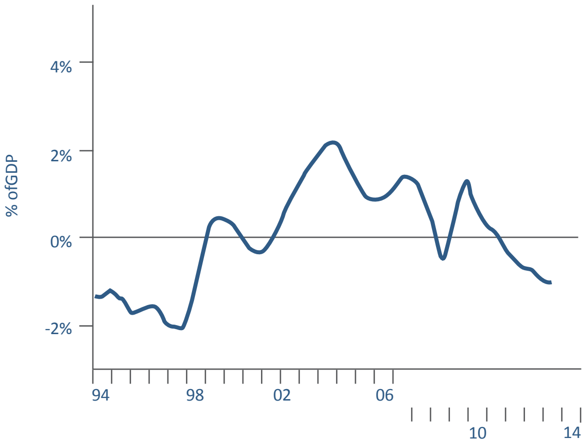
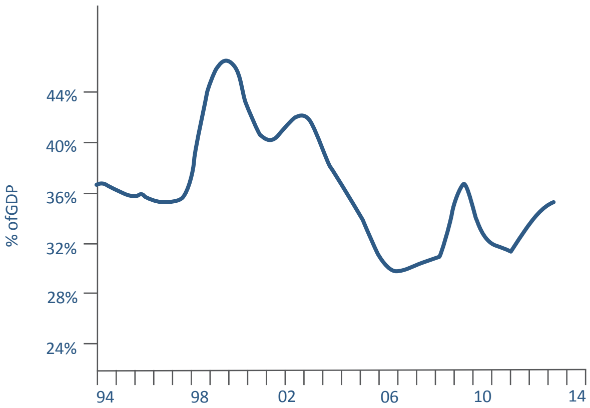


Exhibit: 7: Proportion of EM debt denominated in foreign currency (All EM ex China)

Source: BCA research



Source: BCA research

In summary, the broader linkages today between EM and DM countries also implies that any turmoil in EM countries will be felt across the world, albeit to an extent that will not spark a serious systemic event. We would not expect to see this crisis amount to the scale of previous EM currency crisis given the predominance today of floating rate currencies, the higher proportion of local currency denominated foreign debt and the more dispersed ownership of investments in EM. We will see more contagion from the EM currency crisis as described above and this will exacerbate Europe's turnaround the most.

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