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EM Under Fire – Deja Vu? Part I - Exposure

SPEED READ

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Can EM withstand higher yields? Not everyone, but some can. Here's our crude rule of thumb: **any EM central bank that can cut its policy rates today can also withstand higher US yields.**

The most exposed EM economies were fragile during the Taper Tantrum in both exposure and vulnerability – much has changed since then but the Fragile 2.5 just doesn't have the same ring to it. Exposure asks "are the external balance sheet and flows susceptible to a shock?" while vulnerability examines if the domestic economic can bear this shock. **Both have fallen enough** to satisfy us in *India, Indonesia, Russia and Brazil* (some vulnerability issues remain) and now *Colombia*? **Exposure is high in Malaysia which is heading towards a crisis** (Dutch Disease unwinding, foreign ownership, markets frozen), has fallen but still elevated in *Turkey, S. Africa* (good progress on savings, politics) and *Mexico* (vulnerability low).

In today's note, we make three points: (i) the EM story is about *productivity and endogeneity* – if productivity has stopped falling, higher yields can be endogenous; (ii) the *Taper Tantrum is the wrong playbook* –our Triple Unwind framework shows that only one of the three unwinds that were in full swing during 2013 is in action today; (iii) *which EM economies have done their bit* to reduce exposure? The good, the not-so-Bad and the still-Bad.

Market Implications Select equity markets more resilient due to better local investment, credit prospects (in next week's note); Receive rates, own local bonds in resilient economies; Pay rates rather than sell TRY, MXN due to policy action; Hard currency bonds in other exposed economies.

The EM story is and has always been a story about productivity and endogeneity It is a story about three surges - of capital flows, terms of trade, domestic fiscal and monetary indiscipline - that destroyed productivity. And it is a story about how a Triple Unwind of these surges is trying to resurrect that which it laid to waste.

Back then… When we, along with Joachim Fels, sounded the EM alarm in the summer of 2012, it was clear to us that the EM growth model was broken. *Falling productivity* was being masked by these three surges. That's why the Taper Tantrum was such a big shock - the Triple Unwind untied that mask and revealed the weak underlying economy. In that environment, higher global rates were a move in the opposite direction to what EM fundamentals needed – and hence *an exogenous shock*. There were *no winners, and nowhere to hide.*

…And now Last summer, we argued that the unwind of these surges had progressed far enough to see that first glint of optimism. A handful of key EM economies have discarded the broken growth model, and some even have a new, sustainable one. *If productivity now stops falling or even rises in these economies, higher global rates can be endogenous*. But this is not the case everywhere. Some parts of EM still have the bulk of the adjustment ahead of them. *There will be losers, but now there are winners too.*

Today, we address EM exposure (and vulnerability later this week) by asking three questions:

- Can EM withstand higher yields? We argue that some key economies can.
- Doesn't the Taper Tantrum playbook tell us that EM will suffer? It does - but its wrong playbook to use. Only one of the three unwinds from the Taper Tantrum are in play now.
- What has EM itself done to reduce its exposure? The good, the not-so-Bad, the still-Bad.

1. Aren't higher US yields an exogenous shock? Can EM withstand higher yields?

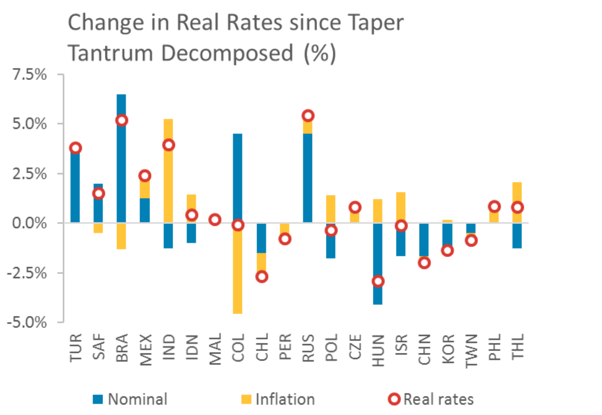
Economies can withstand higher US yields, if enough of an adjustment has been made. Our simple rule of thumb: an EM economy whose central bank can afford to cut policy rates can also absorb higher US yields.

This is a pretty bold statement It argues that the economies that wilted during the Taper Tantrum are strong enough to withstand a similar onslaught now. Historically too, higher US rates and USD have hurt EM growth and asset prices. Is EM going to buck that trend when trend growth in EM is at multi-decade lows?

Our rule of thumb An economy whose *central bank can continue to cut interest rates* in this environment has likely gone through a wrenching adjustment to reduce its external exposure and can now handle higher global rates. **Historically**, US interest rates have risen towards the end of an economic expansion, and EM economic activity has typically risen above trend too. By the time US rates rise, EM has typically over-extended itself and is ripe for a slowdown - higher rates act like an exogenous shock. Today doesn't resemble those historical episodes of overheating. EM growth and assets will face headwinds, but many won't be as fragile.

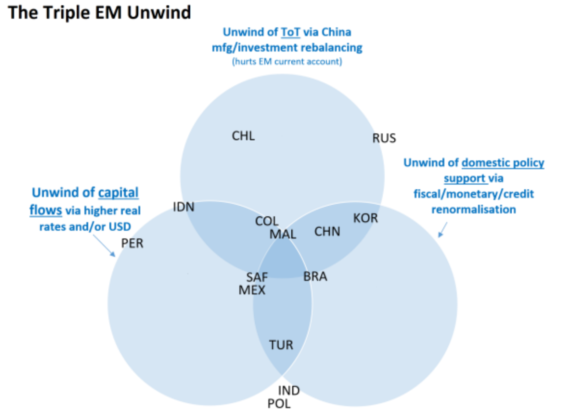
The biggest risk? The Achilles Heel of EM (foreign holdings of local bonds) remains in place: A sharp rise in US yields could reduce liquidity sharply as it did during the Taper Tantrum. Like 2013, contagion could then spread because investors who can't exit their local bond positions sell other local and EM assets.

Exhibit 1: **Like IND, IDN, will Real Rates now rise through Inflation in TUR, SAF, BRA and COL?**



Source: National sources, Talking Heads Macro; change since Mar'13; real rate is policy rate less CPI

Exhibit 2: **The Triple Unwind – When You Don't Want to be the 'Center' of Attention**



Source: Talking Heads Macro

2. Doesn't the Taper Tantrum playbook tell us EM will suffer? It does, but our 'Triple Unwind' framework shows it is the wrong playbook to use

All three legs of the Triple Unwind were in full swing in 2013, but only one of those unwinds is firing now.

Three Historic Surges and the Triple Unwind The Triple Unwind maps the reversal of the three surges (of capital inflows, terms of trade, and local fiscal and credit expansion) and the sensitivity of each EM economy to each unwind:

- *An unwind in the surge in capital inflows that impacts EM capital accounts* – typically triggered by higher US rates and/or a stronger USD;
- *An unwind of the surge in the terms of trade that affects EM current accounts* - triggered by a shock to China's manufacturing sector;
- *An unwind of the surge in fiscal/credit-induced spending that curbs EM domestic demand* – usually triggered by the external shocks above or simply by domestic entropy.

Now let's use this framework to compare the Taper Tantrum with the environment EM faces today.

The Taper Tantrum - The Triple Unwind in Full Swing The Taper Tantrum saw every leg of the Triple Unwind gripping, simultaneously. That's what led to the brutal, synchronised but salutary EM downturn.

- *Capital flows unwind - brutal:* For more than two years prior to the Taper Tantrum, EM was receiving about $10 billion per month, predominantly into fixed income assets. An interest rate shock sharply slowed down those inflows, illiquified the LCY bond market, and created a mini sudden-stop.
- *Terms of Trade unwind - intensified downside risks:* China macro uncertainty was high with SHIBOR spiking up to nearly 30% at times (remember that?) and housing under pressure. That put the commodity complex and all of EM under pressure too.
- *Domestic fiscal, credit unwind:* The downside was gigantic - fiscal positions and credit growth had been excessive, and real rates were negative. But even those were no longer able to generate adequate economic growth by the time we sounded the alarm. Current accounts and inflation were outside the comfort zone, meaning these economies had clearly overheated and needed pruning.

Today - Only One of the Three Unwinds is in Action

- *Capital inflows unwind – in action, but not as severe as 2013:* Capital has flowed into EM for most of this year and there is bound to be some reversal, but inflows have not pushed EM real rates and credit spreads close to historic tights we saw in early 2013 – there is not as much to unwind.
- *Terms of Trade unwind - no headwinds right now:* The next leg of China's slowdown will come from consumption rather than the manufacturing sector which has already hard-landed. This will hurt mostly North Asia (heavily plugged in to China consumption) and not the rest of the world (linked to China investment and real estate). China's data has become more mixed of late, but as long as China's macro environment remains stable and commodity capacity cuts continue, EM will face fewer headwinds.
- *Discarding broken growth models and consolidating credit - further in some places than others:* Exhibits in the chartbook section show that India, Turkey and S. Africa over-extended their economies through excesses on fiscal and monetary side. One of key properties of the Dutch Disease is that the terms of trade shock that boosts manufacturing also spills over into credit and then the local services sector (the strength in both of which pushes the real exchange rate higher). There has good progress on reducing these excesses. This is not true in Malaysia and Turkey, while the job is not complete in S. Africa or even in Brazil. Where progress has been made, we believe it will create a floor under falling productivity and help absorb higher yields.

3. Where has EM reduced exposure? The Good, the not-so-Bad, the Still Bad

The good: India, Russia, Brazil, Indonesia and maybe Colombia – watchful in Indonesia (local bond market liquidity) and Brazil (NPLs, fiscal consolidation). *The not-so-Bad*: S. Africa (lower fiscal excesses), Mexico (exposed, not vulnerable). *The still-Bad*: Some improvements in Turkey, but Malaysia could enter a crisis.

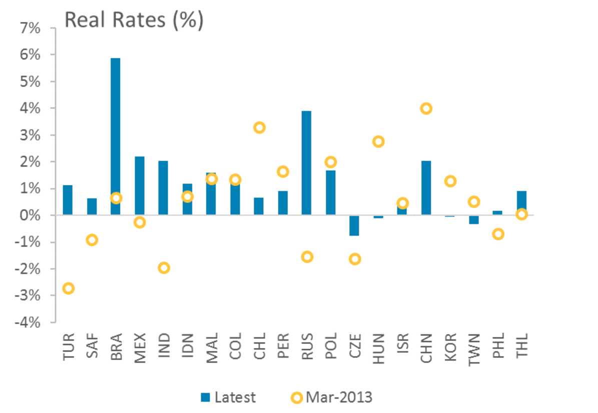
Have EM Economies Done Their Bit To Reduce External Exposure?

	Origins of Exposure	Adjustment Needed?	Have they delivered?
The Good: Where Exposure Has Fallen			
IND	CAD, high inflation due to from fiscal, monetary/credit expansion	Real rates, fiscal, credit	Convincingly: Credit weaker, NPL recognition higher, better fiscal story, CAD close to zero
RUS	Dutch Disease raises consumption, services inflation and worsens non-oil CA deficit	REER, real rates	Past the trough. Positive geopolitics, REER crashed, rates spiked; sanctions, oil price collapse, CBR slowed domestic demand and inflation
BRA	Dutch Disease related CAD, inflation; worst quality credit expansion in EM; Fiscal balance now among worst in EM. At crossroads again?	REER, credit	About 2/3. REER weakened by ToT and recession, low political headwinds; But no NPL recognition, fiscal position troublesome but need to avoid austerity
IDN	(Modest) Dutch Disease related CAD and inflation, credit expansion	REER, credit	Past the trough on macro: Credit weak, CAD lower; But local bond market still a worry
COL?	Dutch Disease unwinding - inflation thanks to slow down in domestic demand	REER, real rates	Adjustment might be at its inflection point, which could take Colombia back to its clean starting point
The Not-So-Bad: Exposure still high but some offsets too			
SAF	CAD due to fiscal transfers; High inflation + low savings, but NOT a Dutch Disease story	Real rates, fiscal; not FX	Still exposed, but recent progress government savings rising; political dynamics less detrimental
MEX	Foreign Ownership of MBonos, V. liquid MXN market, Moderately exposed on all metrics	No need to adjust macro	Exposed, fiscal adjustment underway but the underlying macro economy is not vulnerable
The Still-Bad: Not enough progress or outright regression			
MAL	Crisis risk: Dutch Disease adjustment underway, High foreign ownership LCY bonds, markets frozen	REER, credit	Not really. CA surplus down sharply, low inflation - real rates rising; freezing markets will backfire
TUR	CAD, high inflation due to excessively lose monetary policy/credit expansion, chronically low national savings	Real rates, credit; not FX	Not really. Credit growth slowed but picking up again; Monetary stance still loose and credibility low due to political dominance, mismanagement

The Tantrum Tantrum playbook isn't the right one and some EM economies *can* now withstand higher rates. Half of the most exposed EM economies have adjusted, but 'the Fragile 2.5' just doesn't have the same ring to it. To understand EM better, just looking at exposure is not enough – we need to look at vulnerability as well. That's exactly what we intend to do later this week.

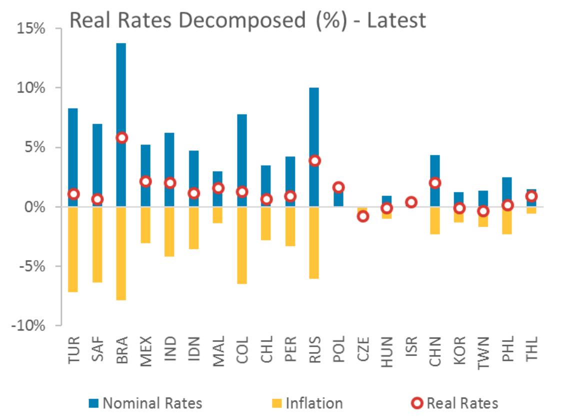
CHARTBOOK: EM Under Fire – Déjà Vu? Part I - Exposure

Exhibit 3: **Real Rates Higher, But Policy Tighter?**



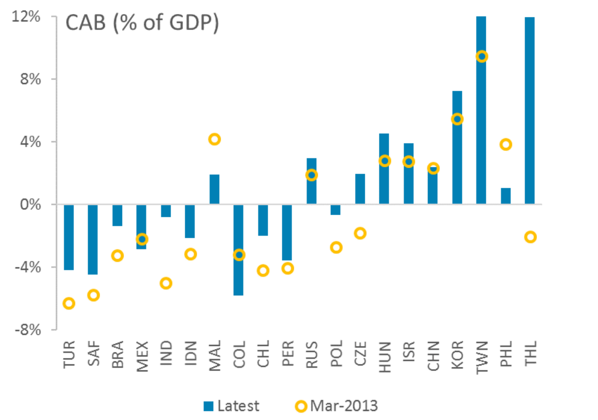
Source: National sources, Talking Heads Macro; Policy rate minus CPI; Average O/N interest rate for TUR

Exhibit 4: **Inflation Declines will Drive Real Rates**



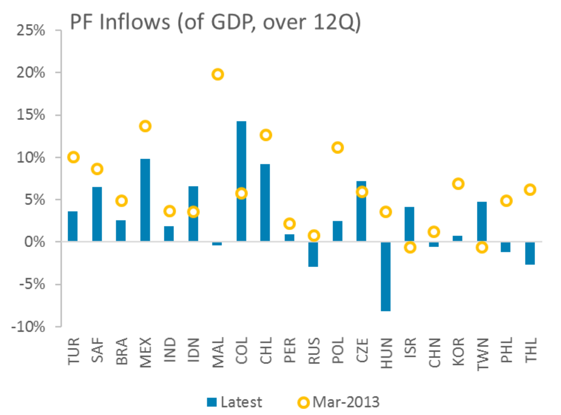
Source: National sources, Talking Heads Macro

Exhibit 5: **CA balances have narrowed**



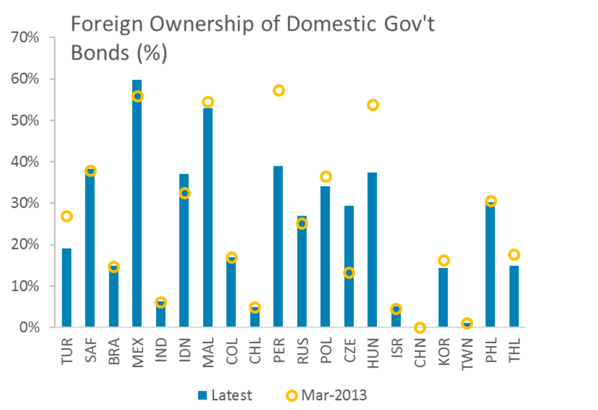
Source: National sources, Talking Heads Macro

Exhibit 6: **PF Inflows in 2016 are Unwinding**



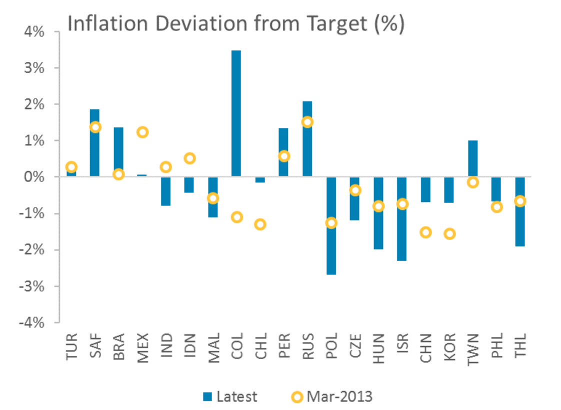
Source: National sources, Talking Heads Macro

Exhibit 7: **Foreign ownership Still High**



Source: National sources, Talking Heads Macro; MBonos in case of Mexico

Exhibit 8: **Inflation Above/Below Comfort?**



Source: National sources, Talking Heads Macro; Upper end of the range used for TUR and BRA, long term average where target NA

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