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By Nikko Asset Management's Multi Asset team

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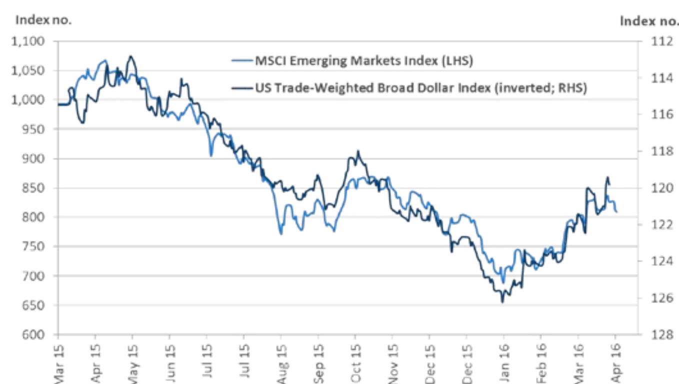
Nikko Asset Management

EMERGING MARKETS QUARTERLY: US DOLLAR WEAKNESS OFFERS RELIEF

Q1 2016 Insights

2016 began in complete panic, with risk assets including emerging markets (EMs) selling off deeply through the first few weeks of the year. This was then followed by the strongest rally since 2012, with EM equities up 20%. There has been much speculation on the reasons for the downturn, such as an impending hard landing in China, failed central bank policy, US dollar strength and even a US recession. Elements or combinations of these themes may well be true, but only one explains the strength of the relief rally—the US dollar. Chart 1 shows EM equities compared with the US dollar (inverted) and we can see that they have moved in virtual lock step, both to the downside and the upside.

Chart 1: US Trade-Weighted Broad Dollar Index (inverted) vs. MSCI Emerging Markets Equities Index



Source: Bloomberg 2016

The easing US dollar offers several channels of EM relief:

1. It has helped to lift commodities from multi-decade lows;
2. A weaker US dollar eases the pace of dollar debt deleveraging, returning much needed liquidity to the banking system to improve financial conditions; and
3. For those EM countries suffering from inflation attributed to foreign exchange (FX) pass-through, the easing US dollar reverses those pressures, potentially allowing for monetary easing later this year.

Of course, the US dollar will need to remain stable for these conditions to persist and ultimately translate into real growth, but so far the signs remain encouraging.

Asia remains at the top of our regional hierarchy, benefitting the most from easing liquidity conditions and minimising any near-term risk of a deeper China devaluation. We have lifted Latin America to second position in the hierarchy, partly due to stabilising commodities, but we are also encouraged by improvements in political capacity. Although Eastern Europe, Middle East & Africa (EMEA) also benefits from easing conditions, the region has fallen to the bottom of our hierarchy as political capacity remains low and stagnant.

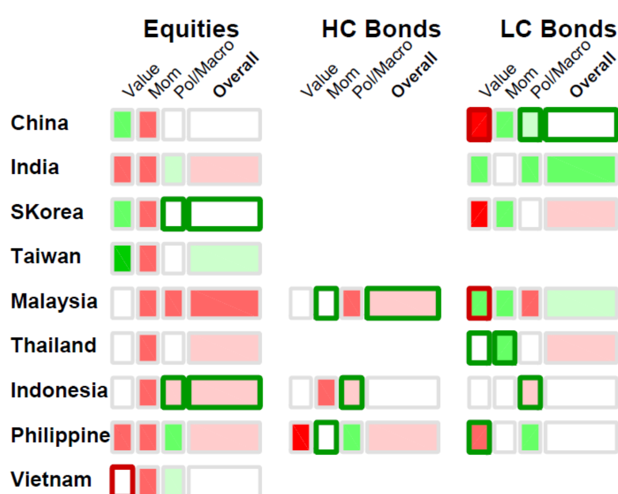
We have kept hard currency bonds at the top of the asset class hierarchy. Despite relief in EM currencies, volatility is still high and the direction of the US dollar remains uncertain. Local debt remains second in the hierarchy offering opportunities where real yields are attractive, with prospects for declining inflation and rate cuts. EM equities are at the bottom of the hierarchy; although there are interesting opportunities, they are more specific than broad-based.

This quarterly report summarises our current views and quarterly adjustments by region, with an asset class score summary followed by the key elements of our current thinking.

Asia inexpensive with improving growth prospects

Asia remains at the top of the hierarchy with improving growth prospects, mainly due to the weaker US dollar helping to slow the pace of deleveraging. Data remains weak, but there are prospects for improvement, including China stimulus, restocking following the collapse in trade late last year, and potential improvements in US consumption due to higher wages and energy savings. Commodities are cheap and still a tailwind. Reforms remain on track, with China striking a better balance between reform and growth, while India and Indonesia are overcoming political hurdles to push forward reforms. The principal risk is global trade (and demand) remaining weak, with still high debt levels, leading to further deleveraging and slower growth.

Asset Class Scores



Score Summary: For each country and asset class, scores are represented by colours where white is neutral, green is positive and red is negative. The overall score is shown to the right with the underlying scores – value, momentum and political/macro – shown to the left. The border shows gray for no score change, while green shows positive and red negative.

China bonds upgraded to neutral

We upgraded Chinese local bonds due to both improved macro and politics – but chiefly, to returning currency stability. Easing volatility is likely mainly attributable to a more dovish Fed and a consequently weaker US dollar helping to slow capital outflows. However, it is also important that China is now striking a better balance between continued reforms and maintaining growth, returning market confidence in the economy.

The US dollar strength that began in mid-2014 has been a significant source of stress, causing capital outflows mainly in the form of unwinding the USD 1.3 trillion carry trade. As shown in Chart 2, these outflows more than offset the current account surplus, requiring the People's Bank of China (PBOC) to spend significant reserves to hold the dollar peg.

Chart 2: USD Broad Money Index (inverted) vs. China FX reserves

Source: Bloomberg 2016

Government efforts to 'de-peg' from the dollar, starting with a devaluation in August 2015, only served to accelerate outflows—more than USD 100 billion a month. Fortunately, US dollar weakness alleviated deleveraging pressures to reduce outflows to USD 23 billion in February.

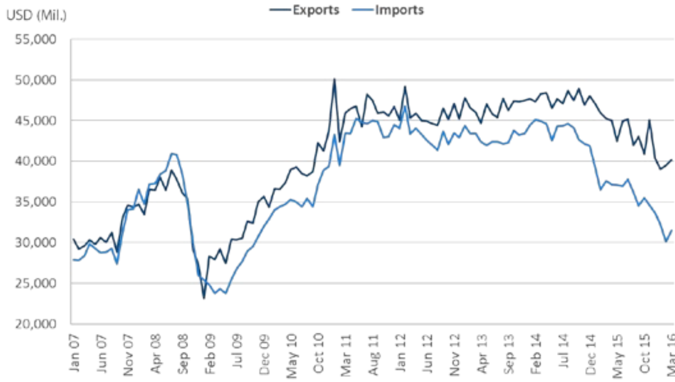
The slowdown in outflows replenishes bank liquidity and, at the same time, China continues to ease while pushing new fiscal stimulus and controlled credit expansion. China still has high levels of debt and walks a fine line in navigating its adjustment, but declining capital outflows and falling currency volatility largely removes the fat tail risk of a more significant devaluation.

South Korea equities upgraded to neutral

We upgraded South Korea equities to neutral based on improved macro prospects. We downgraded macro in August 2015 due to the elevated risks in connection with the China devaluation. Given the stability returning to the Renminbi and Korea's more competitive currency position (e.g. compared with Japan), we upgraded macro back to neutral.

The challenge for Korea is weak exports as reflected in Chart 3. From early 2015, exports fell sharply and imports even more so, indicating declining orders for even weaker exports in the future—all very bearish. However, we note a recent inflection point to the upside with exports increasing and imports also increasing, possibly reflecting better exports in the future. Of course, the series is volatile and it is too early to call for a reversal but, anecdotally, it makes sense given the likely restocking and the stimulus which is gathering pace in China.

Chart 3: Korean exports versus imports



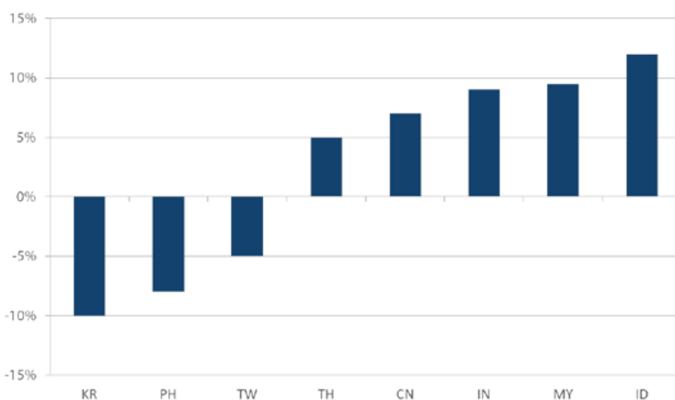
Source: Bloomberg 2016

Indonesian equities upgraded to neutral-negative

We upgraded Indonesian equities due to improving macro and politics. There were high political hopes for Jokowi when he was elected President in 2014—at the time, he was sometimes compared to Prime Minister Modi in India. However, being a relative political outsider, his efforts were largely stymied, with little appreciable progress. However, a cabinet reshuffle last summer and a broader coalition achieved in the autumn have served to strengthen his political capacity to push through reforms.

In addition, the growth outlook is improving. Inflation peaked in early 2015, with three rate cuts since January this year. Fiscally, there has been a substantial pick-up in infrastructure spending, which lifts both near-term growth and long-term growth potential. The macro sticking point is the rate of leverage build-up in the banking system. Chart 4 shows that bank leverage growth in Indonesia is the highest in Asia. The loan to deposit ratio is 110% and comparatively lower than others in Asia, but the rate of credit expansion can be a warning sign for non-performing loans in the future. We look for better visibility on bank earnings.

Chart 4: Asia five-year growth in loan-to-deposit ratios



Source: UBS 2016

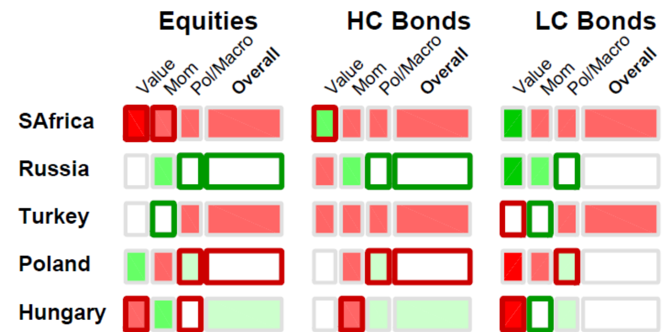
Malaysia hard currency bonds upgraded to neutral-negative

We upgraded Malaysia hard currency bonds due to momentum shifting from negative to neutral. For now, a negative view on macropolitics keeps the overall score at neutral-negative.

EMEA finds relief, but politics remain problematic

Although conditions have improved in EMEA, we have moved the region to the bottom of the hierarchy due to more significant improvements in Latin America. Our primary concern is lack of political capacity to push through necessary reforms to rebalance the respective economies.

Asset Class Scores



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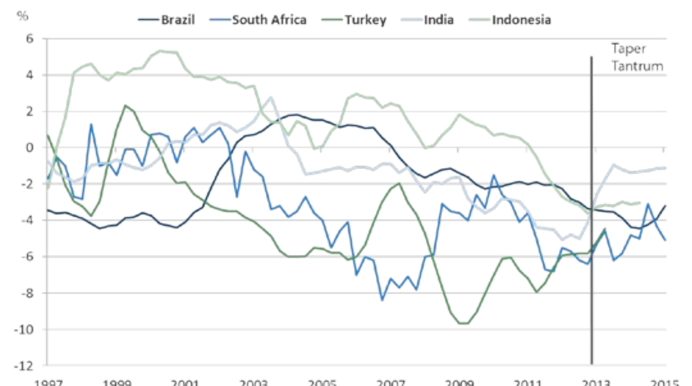
South Africa local bonds downgraded to negative

During the taper tantrum in 2013, the so-called 'Fragile Five' were singled out as countries with unsustainable external imbalances. Chart 5 shows the current accounts of these five countries and while three have made improvements, South Africa and Turkey are now the 'Fragile Two', lacking the political capacity to push through necessary reforms. Russia is not exposed to the same imbalances, but it similarly lacks political capacity to adjust for the long term as its economy remains too dependent on energy.

Chart 5: 'Fragile Five' current account deficits



Source: Bloomberg 2016

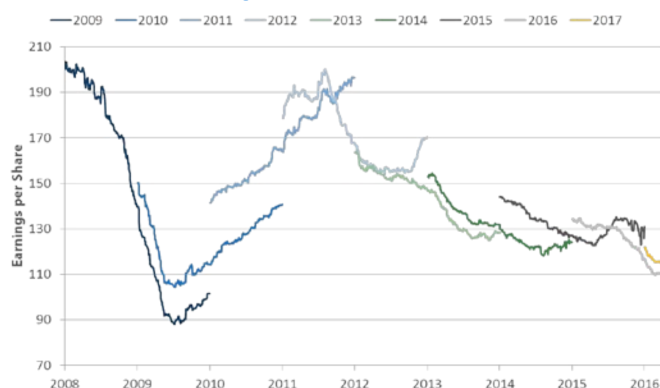
Russian equities and hard currency bonds upgraded to neutral

We upgraded Russian equities and hard currency bonds based on improving macro, which follows the upgrade of local bonds last quarter mainly for declining political risk. Stabilising oil has helped to put a floor under the fiscal deficit, while offering scope for growth upside. Real wages, retail sales and industrial production have all bounced from the lows set in late 2015, which is reflected both in reported and estimated earnings that continue to stabilise. Stability supports Russian assets over the near term, but lack of reforms and utter economic dependence on oil still leave Russia vulnerable over the long term.

Polish equities and hard currency downgraded to neutral

We downgraded Polish equities and hard currency bonds due to deteriorating macro and politics. With GDP growing more than 20% since 2008, Poland is by far the greatest economic success story in Europe since the crisis. However, the uneven distribution of wealth has led to disenchantment and now new leadership is pushing a more populist agenda. Prospects for new taxes and forcing banks to absorb consumer losses on mortgages have caused earnings expectations to decline quite significantly. As shown in Chart 6, earnings expectations for 2017 are actually below 2015 estimates. Poland remains stable and strong as an economy, but risks are to the downside over the longer term.

Chart 6: Poland earnings estimates

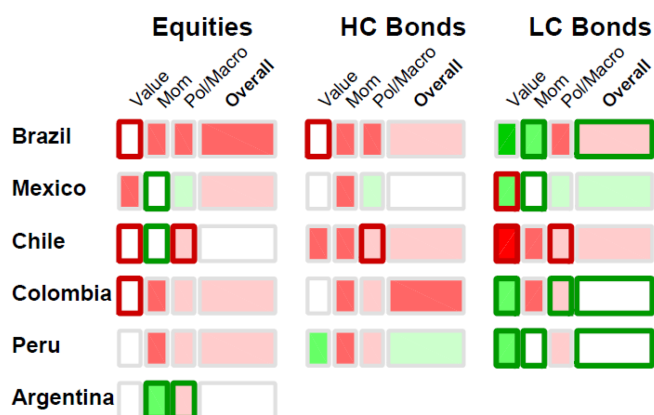


Source: Bloomberg 2016

Latin America finding commodity stability and improved political capacity

We upgraded Latin America from the bottom of the hierarchy to above EMEA, although we remain highly selective both among countries and within asset classes. We don't know whether commodities have bottomed, particularly as supply-demand dynamics remain imbalanced. However, given recent US dollar stability and perhaps increased demand prospects, the environment has improved. More importantly, the painful adjustment has served to instigate political change for the better, which is the main reason to upgrade Latin America over EMEA.

Asset Class Scores



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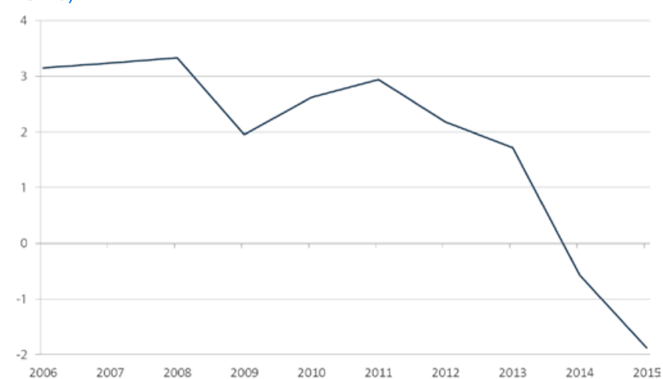
The political risk pendulum is showing signs of swinging back from extreme populism to more sensible, business friendly policies for self-sustaining growth. Mexico has instituted significant reforms and, more recently, Argentina has shifted tack since Macri became president in mid-December and has already made significant reform progress, aiming to undo economic damage inflicted by decades of extremely poor policies. Cuba is opening up to the US and now Brazil holds promise for a change in leadership and improved policies as well. These are encouraging developments, but they are not (yet) game-changers given the many significant challenges that lie ahead. Like Asia and EMEA, Latin America is confronted with high levels of debt and still low levels of growth, so significant risks remain.

Brazil local bonds upgraded to neutral-negative

We upgraded Brazilian local bonds due to improving momentum, reinforced by positive political developments. Brazil is a standout for the speed of political change, where significant developments occur weekly if not daily. In short, the Lava Jato corruption investigations escalated to the top, directly implicating former President Lula da Silva, and subsequently breaking down political alliances and significantly increasing the odds of President Rousseff's impeachment within coming weeks. Markets have reacted very positively on the prospect of new leadership and (hopefully) reforms, especially to address the large fiscal imbalances.

Chart 7 shows just how sharply the fiscal account has deteriorated, driven by declining revenues from a very poor economy coupled with political incapacity to cut spending. With debt levels already very high and politics highly fragmented, we see many reasons to remain very cautious on Brazil and the potential for political change.

Chart 7: Brazil primary surplus / deficit (% of GDP 12-month flows)

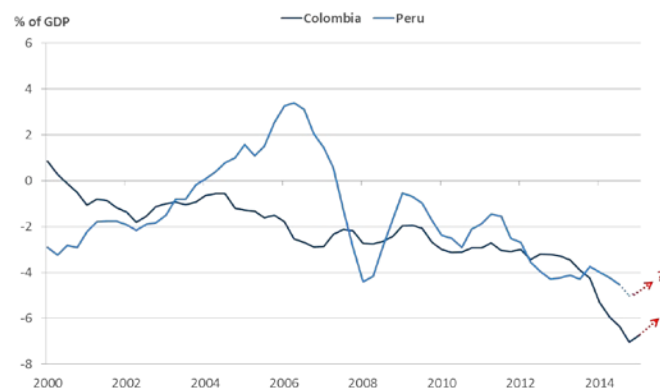


Source: Bloomberg 2016

Colombia and Peru local bonds upgraded

We upgraded Colombia local bonds due to improving valuations, reinforced by a subsequent macro upgrade. Peruvian local bonds were upgraded in early April due to momentum shifting from negative to neutral, while valuations remain attractive. Colombia and Peru are similar in terms of the economic importance of commodity exports. Chart 8 shows the deterioration of their respective current accounts, driven by the collapse in commodity prices.

Chart 8: Peruvian and Colombian current account deficits



Source: Bloomberg 2016

The recent improvement does not necessarily mark an end to the challenges these countries face, but given the degree of negative sentiment priced into commodity related assets, there is significant upside potential with returning stability.

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