23 August 2013

Strategy

Another Asian crisis? We don't believe so

In recent weeks, turmoil in Emerging Markets has accelerated with stock markets and currencies plummeting in a number of countries including Indonesia, India, Thailand and Turkey.

The flight of capital stems from a cocktail of adverse factors:

1. **Fed tapering is becoming real.** Investors are increasingly leaving countries with big current account deficits that have a greater reliance on external financing and liquidity. Turkey for example has a current account deficit of close to 10% of GDP and both India and Indonesia have seen rising imbalances over recent years.

2. **Growth disappointments.** Emerging Markets have disappointed badly in terms of delivering growth over recent years. Coming out of the financial crisis it was widely agreed that companies and investors should look to Emerging Markets for growth. Hence capital flew to these economies both in terms of direct investment and portfolio investments. Performance in EM has disappointed badly though and money has started to flow out of these markets and this capital outflow has accelerated over the past few months.

3. **Policy responses.** In times of financial turmoil, trust and good leadership becomes a key factor. Unfortunately what we have seen so far is bad leadership which is affecting trust among investors and has led to further capital flight. For example India has introduced small-scale capital restrictions. They are too small to have any real effect in stopping the flows. But they are big enough for investors to fear more capital restrictions coming – hence investors try to get out before that happens. In Turkey the central bank announced it would intervene in the currency market to stabilise the currency. This could very well prove counterproductive though – see *Flash Comment – Turkey: TRY inching closer to fair value*.

4. **Contagion.** Finally, as is normal in financial turmoil, contagion is a factor. Hence countries that don't necessarily 'deserve' to be sold are still getting hit because investors drop everything that just smells of EM risk. The decline in Thailand is partly a result of this as Thailand's fundamentals are not that bad.

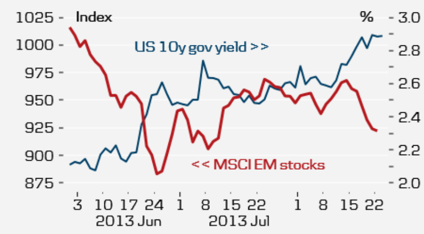
An underlying reason for the growth disappointments in Emerging Markets is the weak development in developed economies over the past three years. As private consumption and investment has slowed substantially in the West, the 'factories of the world' and the suppliers of commodities for production of these goods have suffered as well.

However, as demand growth rises slowly but surely in developed markets, growth should start to improve in Emerging Markets as well. When that happens, money should start to flow back again.

Some EM stock markets hit hard

Source: Macrobond Financial

Fed outlook and bond market sell-off pressuring EM



Source: Macrobond Financial

Current account balances

Source: Macrobond Financial

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Will the crisis escalate and threaten the global recovery?

The obvious comparison currently is with the Asian crisis in 1997/98 where turmoil in Asia was a significant shock to the world economy and led to a temporary slowdown. Although the current turmoil should be taken seriously, we believe there are some important differences as well.

- The **Asian crisis was about overheating** of many Asian countries as money had been flowing strongly to this region on a positive growth and catching up story. This time around, the problem in EM is not too strong growth but too weak growth. And current account balances are deteriorating not because of rapid increases in imports but because exports are failing due to recession in Europe and sub-trend growth in the US.
- In 1997/98 **most Asian countries had currency pegs to USD**. When fears of devaluation started, countries experienced a so-called sudden stop in capital inflows and money was flowing out fast. Funding of current account deficits was no longer possible and currency reserves were drained.
- The **currency reserves were also much lower** in 1997/98 and therefore were quickly depleted until the central banks had to capitulate and let the currencies go.
- With USD currency pegs **most countries also had USD-denominated debt**. This made the negative spiral worse once the pegs were left because it meant the value of the foreign debt rose significantly. Today most countries have well developed bond markets and much more financing in local currencies.
- Because the capital is less of a ‘sudden stop’ and more a gradual bleeding taking place the **systemic disruption is also not as big this time**. The outflow has so far taken many Emerging Markets assets to cheap levels when viewed with long-term glasses. For example P/E levels in several EM stock markets are lower than in developed markets and in some cases as low as at the peak of the Lehman crisis in 2008.

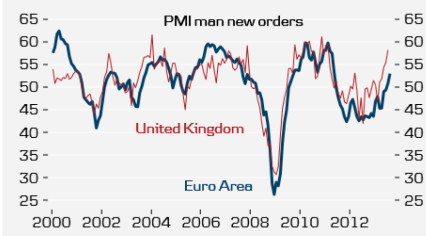
There are of course also some differences that are less favourable. The developed economies are only just rising from the dust and are still fragile. The stock of capital in EM is probably also bigger this time around, meaning the potential total flow may be bigger this time. EM and developing economies now constitute around 50% of the global economy compared with 35% in 1997/98. And they pull 75% of global growth compared with around 50% during the Asian crisis.

Overall we believe the EM financial turmoil is not big enough to have a meaningful impact on the global economy. **And we do not expect it to become big enough shock for this to happen.** An important reason for this is the strengthening recovery we see in the US, Europe and Japan which should start to spill over to EM soon. We saw further confirmation of this in the past week with strong euro PMI and decent readings for US PMI, jobless claims and home sales. However, as with all financial turmoil, it should be watched closely as panic can have its own dynamic and can become self-fulfilling.

G3 consumption vs EM exports

Source: Macrobond Financial

Europe finally recovering – a big drag on EM is fading



Source: Macrobond Financial

Chinese PMI could give important support to EM markets

On a positive note we saw an important improvement in the Chinese PMI in August, suggesting that the Chinese slowdown is stabilising and growth might even improve in the second half of the year. It is important in several respects. First, it makes it less likely that Chinese growth will slip even further and result in a hard landing. More commentators and analysts have argued for this – or at least highlighted the risk of it – which has justified higher risk premium in the Chinese stock market. This risk premium should come down now. Second, it is positive news for other EM countries which have China as a main buyer of their commodities and other goods.

Is Fed tapering fully priced?

There may also be some light regarding the other main factor pressuring EM: Fed tapering and rising US bond yields. On Thursday, we saw another day of quite decent data. US jobless claims showed another solid reading at 336k – only slightly up from last week's six-year low. And although very slightly higher than the consensus expectation of 330k, the deviation is negligible given the volatility in the data. The number gives further evidence that the US job market continues to improve and hence should increase the likelihood of Fed tapering.

Nevertheless, US 10-year treasury yields actually fell slightly following the claims data. It is probably too early to conclude that Fed tapering is fully priced. But it is still a little light in the dark for risk markets in general – and not least EM.

We believe the treasury market is now pricing close to as many rate hikes as is possible and look for a stabilisation in bond yields soon. A first hike is priced in March/April 2015 which seems fair in our view. But from June 2015 to June 2016 rate hikes of 120bp are priced. Although not implausible, it has historically been difficult to price a steeper rate path than this two years in advance. We therefore believe that the bond market will soon stabilise.

Peripheral bond markets in the euro area continue to perform and hence have not really been affected by the general risk aversion in markets related to Fed tapering. Fundamentals are improving in these countries as signs of recovery are materialising. **We look for continued yield spread compression in peripheral markets in the medium term** based on improving fundamentals, ECB keeping rates low for a very long time and search for yield.

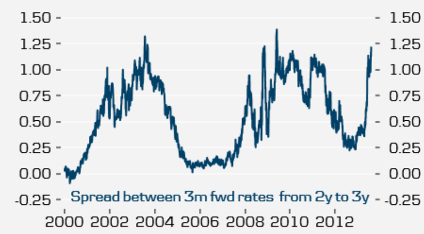
Stock market corrects – we're still bullish in medium term

Stock markets corrected further over the past week in response to a further rise in bond yields and uncertainty over Fed tapering. As we argued last week, the tapering issue will add volatility in the short term. It feels very much like a replay of the market anxiety in June when the outlook for Fed tapering in the autumn was first more clearly signalled by the Fed. Stock markets corrected but recovered again in the US to make new highs in early August.

Chinese PMI and EM stocks

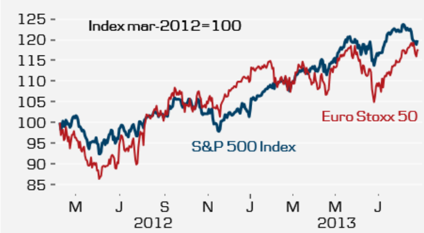
Source: Macrobond Financial

Rate hike path from June-15 to June-16 very steep now



Source: Macrobond Financial

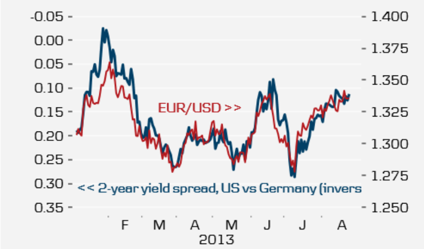
Another stock market correction, but Europe more resilient this time



Source: Macrobond Financial

While the short-term picture is still a bit mixed given the uncertainty in EM markets and Fed tapering approaching, **we believe the medium-term outlook for equities is strong**. Stock markets can generally go higher in two ways: (1) risk premia coming down and hence prices go up without earnings growth, or (2) earnings grow and justify a higher price for given risk premium. So far most of the rally has taken place through declining risk premia due to lower uncertainty and expectations of decent earnings growth in coming years. In this regard, the US is a bit ahead of Europe in terms of falling risk premia. Higher earnings growth is not needed we believe to give further impetus to US stocks. We do expect this to materialise but it takes time to really see it in earnings reports. In Europe there is still scope for further decline in risk premia on top of a pick-up in earnings growth. Hence we favour Europe over the US in equity space. EM is a separate issue. Risk premia are quite high now as mentioned above but uncertainty is also bigger. With a very long-term horizon it looks attractive given valuation but the short-term picture is very blurred.

EUR/USD in high end of range as short euro



Source: Macrobond Financial

EUR/USD stabilising

We saw the first signs of stabilisation in EUR/USD this week after the recent increase. At just below 1.34, the cross is trading in the high end of the trading range seen this year. **We believe the trading range will hold over the coming months** and have a three-month target of 1.31. Currently the strong euro data and performance of euro peripheral bonds have given support to the euro. However, as we move further into Fed tapering area, the USD should slowly start to be the performer of the two currencies.

Global market views – 3-6M horizon

Asset class	Main factors
Equities	
We remain bullish on equities.	US and euro recovery to gain more traction. Fed tapering short term headwind Earnings revisions to gradually be positive driver. Fixed income to equities rotation has still some way to go
Bond market	
Core bond yields move gradually higher, but short-term pause	Global recovery, Fed tapering has been priced.
US to underperform Germany in the short end	US economic outlook strong, Fed tapering, ECB on hold for very long. Long end is priced for this.
Peripheral spreads to tighten gradually	Ample liquidity, search for yield, improving fundamentals
Credit spread to tighten gradually	Ample liquidity, search for yield, strong corporate fundamentals
FX	
EUR/USD - range trading for now. Lower next year.	Fed exit moves closer, but no strong downtrend before Fed rate hikes are in sight.
USD/JPY - further upside	BoJ to continue monetary easing and Fed exit. Market sentiment.
EUR/SEK - medium and short-term lower	Strong fundamentals and no rate cut from the Riksbank.
EUR/NOK - gradual move lower, but short-term jitters	Strong fundamentals, but risk of rate cut from Norges Bank and positioning an issue.
Commodities	
Oil prices stable in H2, lower in 2014	Massive supply shock from US shale and OPEC over-production to weigh
Metal prices - downside risk on EM worries	Copper to stay volatile, aluminium to head lower as energy costs come under pressure
Gold prices to correct lower still	Part of the bubble now eliminated but more declines in store on Fed tapering
Agricultural risks remain on the upside	Stabilisation in the near term but extreme weather events remain a key challenge

Source: Danske Bank Markets

Disclosure

This research report has been prepared by Danske Reseach, a division of Danske Bank A/S ("Danske Bank"). The authors of the research report are Allan von Mehren, Chief Analyst.

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