Emerging Market sell-off:
Contagion ahead?

Nordea Research, 29 January 2014

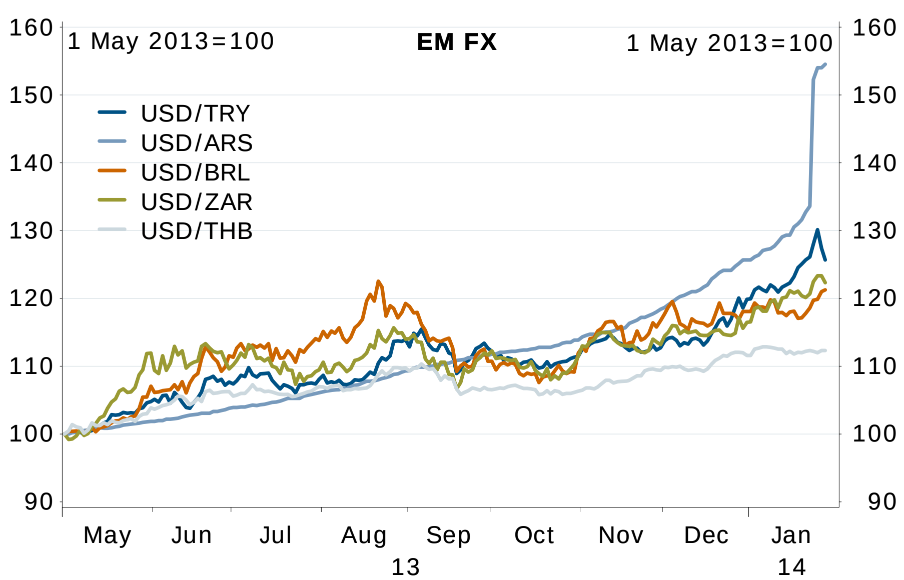
- Limited scope for contagion as EM issues are country-specific
- Major advanced economies should see little impact

How much should one worry about the recent sell-off in Emerging Markets? In our view, what we have seen is not the start to a new and general Emerging Markets crisis, as the drivers seem to be more country-specific weaknesses. Vulnerable countries like the "Risky 9", we look at in this piece, can easily see more trouble. Most of all, we do not expect China as the by far largest Emerging Market to be affected significantly. Domestic growth drivers and policies are much more important. And as long as that is true, the impact on the US, Japan and the Euro area should be very limited.

EM: the time of reckoning has come

Recently, Emerging Markets (EM) have come under renewed pressure, as investors worry about a potential hard landing in China amid the looming reduction in the Fed's stimulus. However, this is only part of the story. The EM countries have increasingly been plagued by domestic problems, which go well beyond China and the US. Several EM countries have been living above means during the years of excess liquidity – consuming rather than investing – which has resulted in large current account deficits and elevated inflation. So far, EM central banks have been reluctant to tighten monetary policy due to sluggish growth and resorted to intervention rather than reforming.

EM FX sell-off



Source: Nordea Markets and Reuters Ecowin

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Contents

EM countries still vulnerable to indiscriminate selling

Not a new Emerging Markets crisis in the pipeline

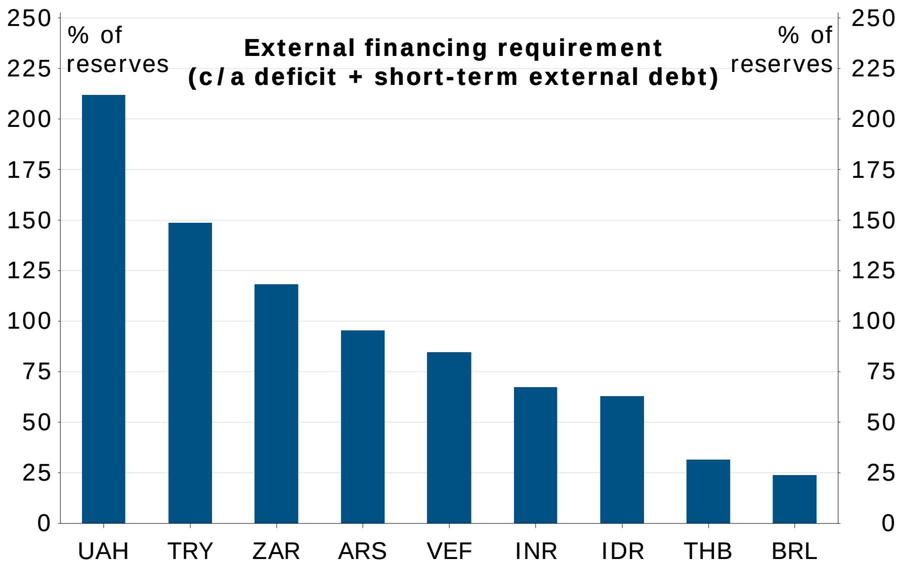
Last week's EM currency rout was partly triggered by a deepening of the political and economic crises in Turkey and Ukraine, but accelerated with the decision of the Argentine government to devalue the peso – and spread throughout the EM universe with few exceptions. The Turkish lira and the South African rand plunged to new lows, while the Mexican peso and the Brazilian real reached levels similar to those during the August sell-off. The Russian rouble weakened beyond 34 per dollar. Exactly this broad-based weakening of EM currencies has prompted market observers to (once again) question the resilience of the EM region as a whole, and in particular whether a new phase of EM crises awaits just around the corner.

Still stronger EM fundamentals compared to the 1990s

To start with, we do not expect to see financial crises in EM comparable to those observed in the 1990s as many EM countries have significantly improved their economic and financial fundamentals. There has been a general shift away from fixed exchange rates regimes towards more flexible ones, a reduction in external debt levels and a shift towards longer-term financing and domestic funding coupled with a build-up in international reserves (see Charts at the end of this paper).

That being said, it is important to stress that while EM fundamentals have changed, investor behaviour towards the EM region might not, meaning that investors still do not discriminate between weak and strong EM countries. If they panic, they will sell – regardless of fundamentals. In our view, this is the biggest near-term risk.

The "Risky 9" EM countries



Source: Reuters Ecowin and Nordea Markets

Who are the risky ones?

We have identified the EM countries that – judging by fundamentals – appear the most vulnerable, namely Ukraine, Turkey, South Africa, Argentina, Venezuela, India, Indonesia, Thailand and Brazil: the "Risky 9". These economies all have large external financing requirements and are thus particularly vulnerable to an adverse shift in investor sentiment. In addition, Turkey, Ukraine and Thailand are struggling with political unrest, Brazil's fiscal outlook has deteriorated significantly, while Argentina and Venezuela are both on the verge of a full-blown balance of payment crisis.

Markets will increasingly differentiate the bad EM from the good

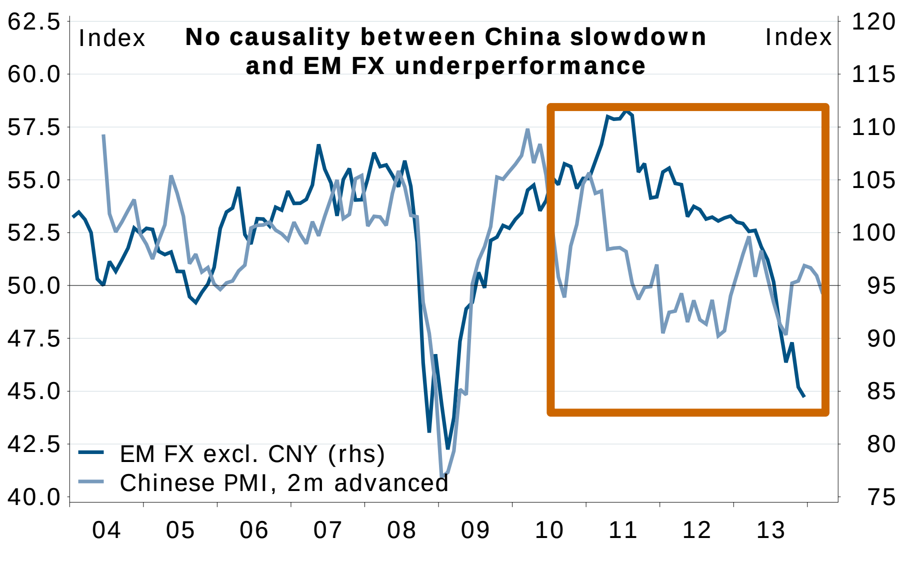
Looking ahead, we expect to see more EM sell-offs during periods of financial distress, but also more discrimination during periods of calm – which should benefit those EM countries with strong fundamentals such as the Philippines and Mexico, while economies such as Turkey and South Africa will likely continue to remain under pressure.

For now, we do not see much scope for contagion as the current drivers seem to be country-specific issues.

Is China a leading indicator for EM?

China has received its share of blame for the recent risk aversion towards Emerging Markets. The most recent round of EM sell-off came after the Chinese PMI for January dipped below 50. In our opinion, the prospect of a structural slowdown in China will drive the bearish sentiment towards EM in the near term, but the market will increasingly differentiate between EM countries on the background of their domestic fundamentals.

No causality between China slowdown and EM FX underperformance



Source: Reuters Ecowin and Nordea Markets

Smaller influence from China than headline suggests

Markets are driven by both facts and sentiment. As a matter of fact, the Chinese HSBC/Markit PMI has not had a close causality with EM FX performance since 2010. Furthermore, the EM countries' export dependence on China is limited. For instance, exports to China only represent 0.3% of the Argentine economy and 0.4% of the Turkish economy. Even for large commodity exporters such as Brazil and South Africa, the share is only 2.3% and 2.9% of GDP, respectively. Of course, Brazil and South Africa are also hurt through lower commodity prices. Compared to the boom years, we expect the commodity demand from China to continue falling, a bad news for the commodity-exporting EM countries.

China drives the sentiment

When it comes to sentiment, many asset managers have no doubt taken the weaker Chinese economy as a reason to reduce their EM exposure. This trend is likely to continue for a while, especially as credit risk has heightened in China's shadow banking sector. But eventually the market will realise that domestic issues in these EM countries weigh much more heavily than the external effect from China.

China: small fishes for a big pond

Chinese economy will unlikely be hurt by the EM sell-off

China has the largest export exposure to the "Risky 9" countries among the major economies in our table, but still it is no more than 2.5% of GDP. Compared to total exports' share of GDP of 27%, lost demand from these countries can hardly be seen as a game changer for the Chinese economy, which has become much more driven by domestic policies.

In addition, China's relatively closed financial markets protect it from external fluctuations. The EM selloff in May 2013 was excellent proof. The Chinese equity markets have been basically flat since last Friday and only minor movements have been observed in the CNY and CNH.

Trade ties between the "Risky 9" and the major economies

		Exports from							
		United States		Japan		China		European Union	
Exports to	GDP in % of global GDP	% of GDP	% of total	% of GDP	% of total	% of GDP	% of total	% of GDP	% of total
Brazil	3.1	0.3	2.8	0.1	0.7	0.4	1.6	0.3	2.1
South Africa	0.5	0.0	0.5	0.1	0.5	0.2	0.7	0.2	1.3
Indonesia	1.2	0.0	0.5	0.3	2.5	0.4	1.7	0.1	0.5
India	2.6	0.1	1.4	0.2	1.3	0.6	2.3	0.3	2.2
Turkey	1.1	0.1	0.8	0.0	0.3	0.2	0.8	0.6	4.4
"Fragile 5" total	**8.5**	**0.6**	**6.1**	**0.7**	**5.4**	**1.8**	**7.1**	**1.4**	**10.5**
Argentina	0.7	0.1	0.7	0.0	0.1	0.1	0.4	0.1	0.5
Venezuela	0.5	0.1	1.1	0.0	0.1	0.1	0.5	0.0	0.4
Thailand	0.5	0.1	0.7	0.7	5.5	0.4	1.5	0.1	0.8
Ukraine	0.2	0.0	0.1	0.0	0.1	0.1	0.4	0.2	1.3
Total "Risky 9"	**10.4**	**0.8**	**8.7**	**1.5**	**11.2**	**2.5**	**9.9**	**1.8**	**13.5**
China	11.4	0.7	7.2	2.4	18.1	-	-	0.9	8.5

Source: Nordea Markets and Reuters Ecowin

US: little impact of EM sell-off

The link goes from EM to China and then to US

US exports to the "Risky 9" Emerging Markets, which recently have seen a major sell-off, account for less than 1% of US GDP (see table). Hence, as long as the crisis doesn't spread to a bigger country like China, which we expect it will not, we continue to believe that the US this year will see GDP growth of around 3¼%, exceeding the current consensus forecast of 2.8%.

For now, the main negative impact on the US economy of the new Emerging Market sell-off is being felt in US equity markets. Thus, the S&P 500 is down 3% so far this year, but that follows an almost 30% increase last year. As the same time, US interest rates have been falling, with 10Y Treasury yields now at 2.78% after starting the year near 3%. Hence, overall US financial conditions are still extremely easy.

More generally, we believe that stronger US economic fundamentals, rather than weak fundamentals in certain Emerging Markets, will set the tone on US equity markets, similar to the pattern we saw last year.

Against this background, we believe the Fed is likely to stay on course with its plan to scale back its asset purchases, taking a second step in that direction at this week's FOMC meeting, which concludes tonight.

Euro area: no dramatic impact

Euro area has a relatively larger exposure than US

In our view, the Euro area could be more affected by Emerging Market events than the US. First, because the economy is in less good shape and only just starting to recover. And secondly because exposure to troubled countries is somewhat higher. That said, it is not high. As we don't expect a full-blown Emerging Markets crisis, we consider the risk of the recovery being derailed as low.

Goods exports account for 20% of the Euro area's GDP. 30% of exports go to non-euro EU countries, 12 % to the USA and more than 10% combined to other advanced economies like Switzerland and Norway. The Euro area's top three export destinations among Emerging markets are China (6.4% of exports in 2012), Russia (4.8%) and Turkey (3.2%). As long as particularly the US and the UK economy are expanding at a healthy speed, the external environment for the Euro area remains supportive. To put things into perspective: the Euro area's exports to Brazil, India, Turkey and South Africa combined are only about one third as large as exports to the US and UK combined. And private consumption is about three times as large as goods exports. If something goes wrong with the Euro area recovery, volatility in Emerging Markets is not the most likely reason. We also do not think that bad news from smaller Emerging Markets can dampen sentiment significantly.

As always, it would be wrong to be complacent about risks. But then, a risk for one country could be beneficial for others. Should, for example, Russia slow down because of falling oil prices – not our main scenario – that would have positive effects for energy-importers like the Euro area. If Emerging Markets slow down severely – again: not our core scenario – the direct impact would be below EU average for France, Italy and Spain, but above average for Germany and the Netherlands, according to a study done by the European Commission.

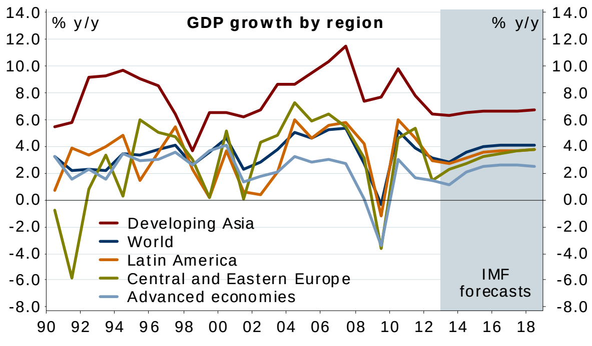
Japan: Abenomics not jeopardised

Japan is also likely to stay protected from the current sell-off

Japan's exports to the "Risky 9" countries represent only 1.5% of its GDP (see table). Just like in the US and Euro area, as long as the panic does not spread to China, which we expect it will not, the contagion impact on the Japanese economy is limited.

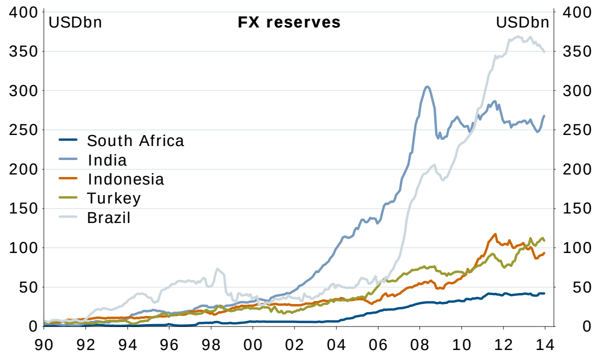
However, the potentially negative impact comes from a stronger yen. Being a safe-haven currency, the JPY has always strengthened when the market becomes risk averse. That would turn around much of the positive momentum in Japan that was lifted by a sharp yen weakening. The EM sell-off may cause the JPY to gain in the coming few months, but longer out, doubts about Abenomics will keep the yen on the weak side.

Different growth rates in EM



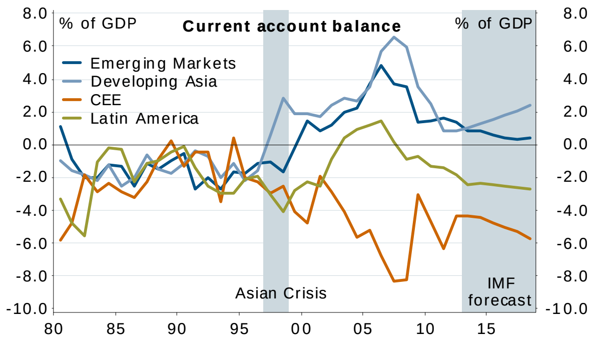
Source: Reuters Ecowin, IMF WEO and Nordea Markets

Accumulation of FX reserves



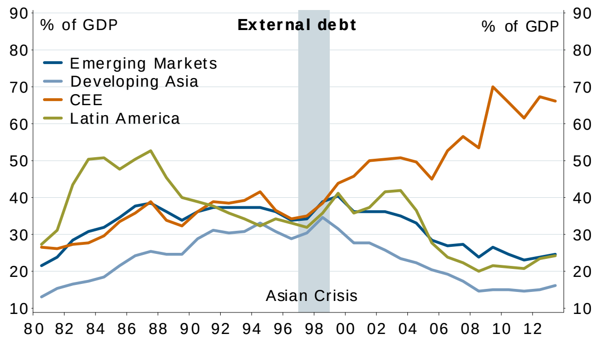
Source: Reuters Ecowin and Nordea Markets

Declining current account balances in EM



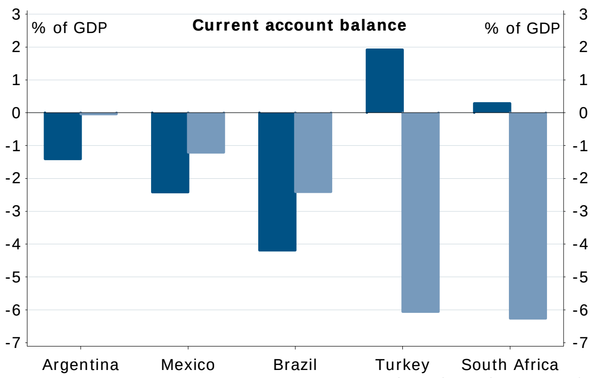
Source: Reuters Ecowin and Nordea Markets

Some EM have reduced external debt



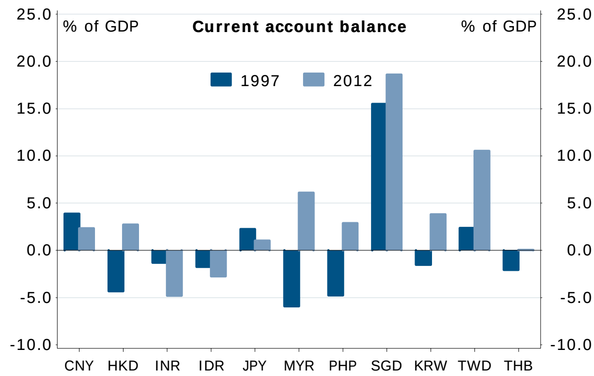
Source: Reuters Ecowin and Nordea Markets

Turkey and South Africa most vulnerable



Source: Nordea Markets and Reuters Ecowin

It is India and Indonesia in Asia



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