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Emerging markets on trial

BlackRock Investment Institute | 09 April 2014

Gone are investor illusions the emerging world had miraculously grown into an all-weather source of returns. Gone is the easy money, exposing market complacency about emerging market (EM) risks. Against a backdrop of currency slides, yield spikes and chronic equity underperformance, we invited our EM experts to defend their asset class. The BlackRock Investment Institute had filed the following (trumped-up) charges:

1. Willful deception: Each EM market was supposed to behave differently in a crisis.
2. Reckless policy: The emerging world feasted on credit, delayed reforms and kept real rates too low.
3. Gross underperformance: Emerging assets have become perennial underachievers.

This was not a Soviet-style show trial. Experts had 10 minutes each to state their case with the help of two PowerPoint slides. They were allowed to speak during the subsequent debate. And nobody was carted off to the Gulag to do spreadsheet labour.

SUMMARY

- Growth in the emerging world is set to slow further as China rebalances its economy. Differentiation between countries, asset classes and sectors is key. Divergences are set to widen in 2014, and asset prices will likely reflect this.
- Currency movements come first, second and third in EM investing. They often make up the brunt of asset returns; they are the trigger for central bank actions; and they are the main mechanism for economic adjustment.
- EM borrowing was often unhedged and under-reported (via offshore subsidiaries). Currency volatility has cut off this channel, and created an unpleasant feedback loop. This can turn into a virtuous circle only when investors feel they are adequately compensated for risk and/or when evidence of EM growth and reform momentum re-emerges.
- Signposts for change in EM asset prices are a stabilisation or collapse in currencies; (market anticipation of) a turnaround or deterioration in economic momentum and corporate earnings; and China's economic trajectory.
- Quantitative easing (QE) helped dampen market volatility. As the liquidity tide ebbs, volatility could rebound like a coiled spring. This return to 'normal' means more risk

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– and greater dispersion of returns. EM contagion into the developed world appears unlikely – unless China's economy screeches to a halt and paralyses pan-Asian trade (which we do not expect to happen).

- Have we seen the worst of currency slides? Depreciations have gone pretty far. Yet real interest rates are still worrisomely low, and more rate hikes risk killing off growth. There is no stabilising EM central bank. Policy coordination is talked about a lot – but rarely happens.
- The good news? Unlike Europe, EM countries can use currency depreciation to improve competitiveness and trade balances. And sizable EM local debt markets these days do much of the economic adjustment (via rising yields).
- EM countries are in much better shape than in the late 1990s, we believe. Stronger safety nets include higher reserves, cooperation to build flood defences, floating currencies and deeper pools of domestic savings.

So what do I do with my money?

- **Cherry pick**: Emerging markets are diverging. Avoid blanket exposures and select the most attractive countries, currencies and assets.
- **Brace yourself**: Expect more volatility. Years of central bank largesse have lulled investors and issuers into a false sense of security.
- **Yield to value**: Hard currency EM debt has suffered collateral damage – and may offer juicy yields. Steer clear of the local variety until currencies stabilise.
- **Broaden your horizon**: Many EM stocks are only bargains versus developed equities. Focus on relative value, think long term and avoid market timing.

INTRODUCTION

Emerging markets have always been volatile. Yet a fire hose of liquidity from central banks boosted asset returns and dampened volatility in recent years, lulling investors into a false sense of security. Global factors such as QE were responsible for more than 60% of the capital flows into emerging markets from 2009 to 2013, the World Bank estimates.

The boom years covered up a multitude of EM sins. Necessary reforms were put on the backburner. Think economic rebalancing in China, land and labour reforms in India, and infrastructure investment in Brazil. This cosy state of affairs was shattered when U.S. Federal Reserve Chairman Ben Bernanke signaled an end to bond buying – and the era of easy money. EM currencies cracked. Debt and equity markets followed. Emerging markets are takers – not makers – of the global monetary system.

POLICY DILEMMAS

Tumbling currencies are part of the solution for emerging markets (they boost competitiveness). They are also part of the problem. Depreciation makes imports more expensive - and tends to fuel domestic inflation.

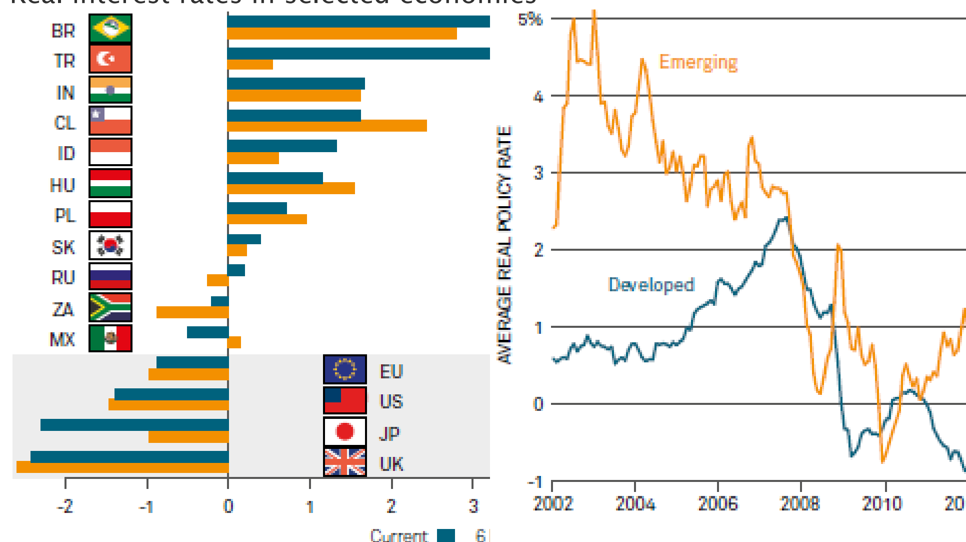
Many central banks built up hefty foreign reserves after the 1997-1998 Asian crisis. Some are now using this firepower to buy local currency to defend their exchange rates. The problem? It never seems to be enough. Capital controls are an alternative touted by policymakers who damned them in the late 1990s. (Investors have never liked the idea of locked-up capital.)

Raising rates looks like the best solution. Countries such as Turkey (belatedly) hiked interest rates. Yet real interest rates are still falling in other nations. See Figure 1, left chart. High inflation means EM real rates are still too low, averaging a paltry 0.8%. See Figure 1, right chart. This is a challenge for central banks in a year Brazil, India, Indonesia, South Africa and Turkey go to the polls (raising rates is typically not a winning election strategy).

Sizable EM local debt markets are doing much of the policymaking work these days: rising yields have a way of slowing credit growth (eventually). The risk: this bittersweet medicine stifles EM growth - at a time it is already slowing. EM economies expanded by 4.7% in 2013 - the slackest pace since 2009. The days of double-digit growth in EM locomotive China appear to be over. Yet not all is lost. China's growth is coming off an ever bigger base: its economy expanded by almost the size of Indonesia in 2013.

Figure 1: Getting real

Real interest rates in selected economies



Sources: Thomson Reuters, Consensus Economics and BlackRock Investment Institute, 11 February 2014. The left chart shows the economy's central bank policy rate minus 12-month forward consensus consumer price inflation. For India, wholesale prices are used. The right chart shows historic average real rates, using reported policy and

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inflation rates. For developed, core inflation measures are used.

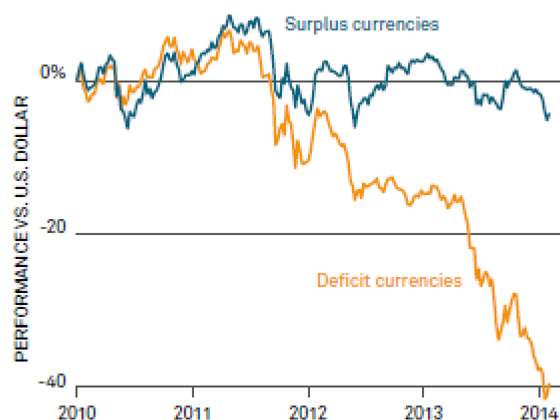
CURRENCY IS CRUCIAL

Currency swings are the first, second and third consideration in EM investing. They can swamp income gains from bonds and wreak havoc on equity portfolios. EM currencies have diverged starkly. Countries with current account deficits have been punished, while surplus nations have mostly weathered the storm. See Figure 2.

It is dangerous to rely on the kindness of flighty global investors for financing. The 64,000 (pick your currency) question: is the selling done? Our view:

- Depreciations of more than 30% are rare for floating currencies. This suggests the worst may be over.
- Many EM economies were still pegged to the dollar in the late 1990s. This left them vulnerable to speculative attacks, capital flow freezes and monster selloffs (a current example is the Argentine peso).
- Many EM central banks are hiking interest rates to stabilise their currencies. Rising yields in local debt markets help in this effort (these markets were too small to make a difference in the past).

Figure 2: The great divergence
Surplus and deficit currencies vs. U.S. dollar, 2010-2014



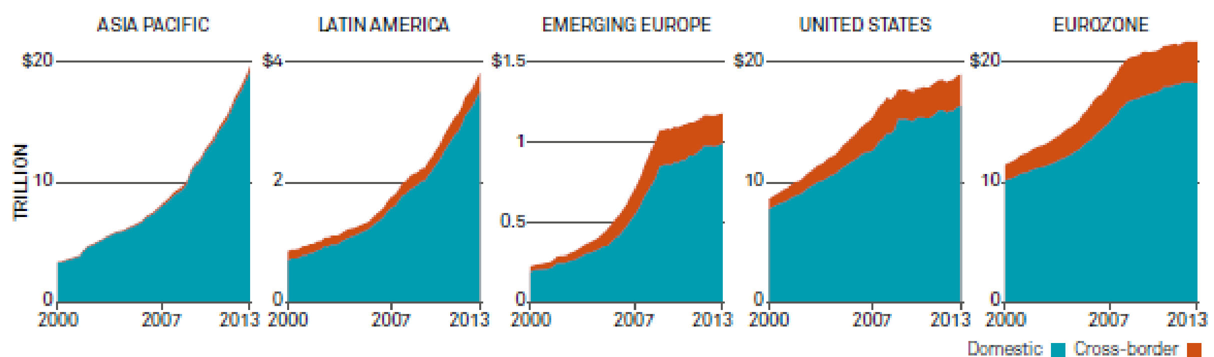
Sources: Thomson Reuters and BlackRock Investment Institute, 10 February 2014. Lines show equally weighted baskets of spot rates versus the U.S. dollar. Current account surplus currencies are the Hungarian forint, Malaysian ringgit, Philippine peso, Russian ruble and South Korean won. Current account deficit currencies are the Brazilian real, Indian rupee, Indonesian rupiah, South African rand and Turkish lira.

The counter argument? Some EM currencies may have to fall further to close current account

deficits. Global demand is weaker than before the financial crisis. This means EM countries likely get a smaller trade boost from depreciations, according to UBS research. Result: the adjustment in their external balance may come from a collapse in domestic growth (bad), rather than a boom in exports (good).

The financial crisis signaled the start of U.S. and European delevering, but the EM lending party went on. See Figure 3. The good news – much bank lending was domestic. Take China. External debt is negligible. Another reason the EM credit boom is not as scary as it looks: GDP has grown fivefold since 2000. This means the sixfold jump in EM corporate debt over the period has barely lifted debt-to-GDP ratios, according to Emerging Advisors Group research.

Figure 3: Emerging credit fest
Global bank lending by borrower region, 2000-2013



Sources: BIS, IMF and BlackRock Investment Institute, February 2014. The charts show total bank credit to non-bank borrowers (including governments).

A caution: EM entities are increasingly bypassing banks and tapping capital markets for funds. Outstanding EM local currency debt has almost doubled to $9.1 trillion since 2008, the Bank for International Settlements (BIS) estimates. Nonresident ownership has roughly doubled to 27% over the same period. This creates risks. Foreign investors flocked to EM assets partly on lofty growth expectations – and these expectations are now deflating.

Other risks are lurking in the EM corporate world. Many companies have borrowed in foreign currency (unhedged). Almost half the $800 billion borrowed from 2009 to 2013 was via overseas affiliates (and hidden from official statistics), the BIS estimates. Some companies may have used their FX stash to buy domestic assets (generating cash flows in local currency). Such mismatches can be dangerous. If EM currencies take another tumble, these companies may have trouble refinancing.

It is crucial to differentiate among emerging markets. Economies, political systems and financial markets are developing at different speeds, as detailed in What's Developing in April 2013. This is the age of EM cherry picking.

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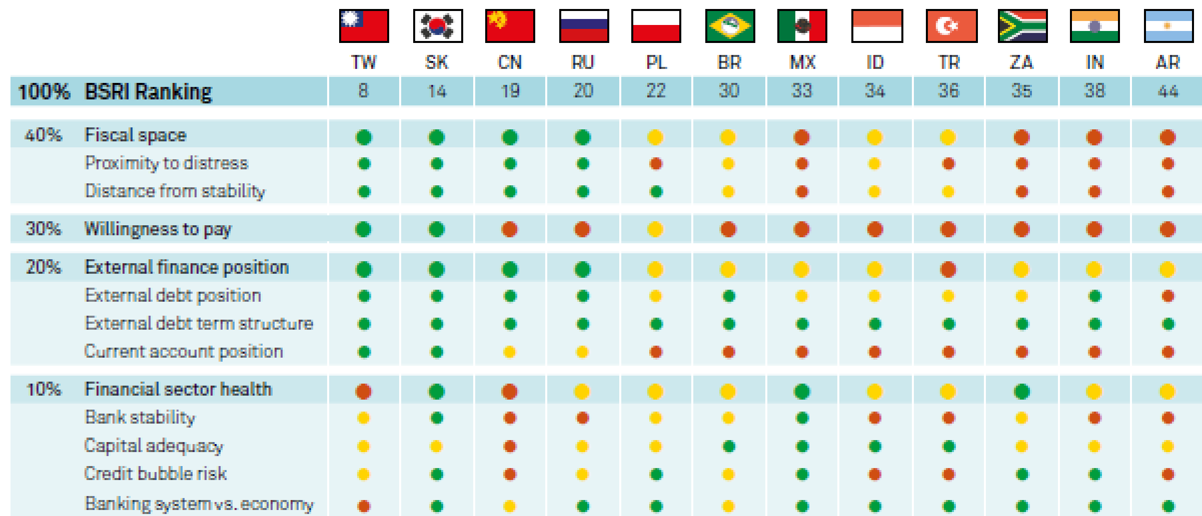
The divergence is illustrated by the dispersion of EM rankings and the variation in their component scores in our BlackRock Sovereign Risk Index, as Figure 4 shows.

Figure 4: An emerging world of diversity
BlackRock Sovereign Risk Index (BSRI) EM ratings, January 2014



Source: BlackRock Investment Institute, February 2014. The chart shows the top-12 emerging markets by GDP, ranked by their overall score in the 50-country BSRI. Orange dots signify a BSRI score of less than -0.25, green dots signify a score of more than 0.25. Scores in between are coloured in yellow. Major BSRI components Fiscal Space, External Finance Position and Financial Sector Health are broken down by their subcomponents.

Most EM countries get poor marks in our *Willingness to Pay* category (which measures a government's perceived effectiveness and factors such as corruption), as detailed in Maturities Matter in April 2013. Yet big differences exist elsewhere. Compare Mexico with China. The first has budget challenges (*Fiscal Space*) whereas China's Achilles' heel is its financial system (*Financial Sector Health*).

Divergence played out in EM asset prices in the past year – to a large extent. Emerging markets with current account surpluses and/or reform momentum (the likes of South Korea, Taiwan and Mexico) held up, but their markets did get a chill from the overall downdraft.

This shows contagion risks within the emerging world remain. Suppose a key EM currency were to unravel. Markets would likely look for the next weakest link. Liquid assets typically suffer first in such a scenario, and the spectre of an EM funding crisis could rise.

Would any emerging flu infect the developed world? This is hard to see – unless China suffers a material slowdown, drags down trade and raises a global deflation risk. We believe this scenario is unlikely.

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LOOK UNDER THE HOOD

Taking advantage of divergence goes beyond selecting the right geography, industry or security.

- **Exhibit 1**: China's growth slowdown has caused much angst among EM investors. Yet the country's effort to rebalance to a consumer economy is likely to affect each emerging market differently.

  We see Chinese wages as well as imports of food, machinery and consumer goods keep rising: a boon for countries and industries competitive in these areas. Chinese demand for raw materials will likely peak in coming years, hurting countries and companies dependent on the resource trade (although China will still be a voracious consumer of raw materials).

  When will this happen? Follow the money. Keep a close eye on trends in China's fixed investment, both its growth rate and changing composition. See Figure 6 below.

- **Exhibit 2**: EM exposures are not always in emerging markets. Economies and companies are becoming increasingly global. Companies in the MSCI World Index derive one-third of their revenues from the emerging world, yet only 13% of the index consists of EM companies, according to Credit Suisse.

  At the same time, many EM stocks are tied to the developed world. Think India's business services firms. Bottom line: It pays to look under the hood of indices, industries and individual securities. Take your time.

DEBT: HARD CURRENCY RULES

EM worries have thrown up compelling opportunities in fixed income. Hard currency (U.S. dollar- or euro-denominated) sovereign debt has suffered collateral damage. These (mostly investment grade) bonds average 6% yields. Even if you were to strip out hard-hit countries such as Argentina, Ukraine and Venezuela, EM hard currency debt still comfortably yields more than 5%.

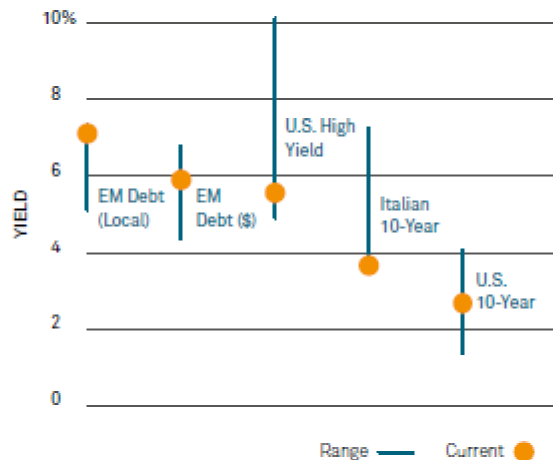
This compares favourably with (lower rated) U.S. high yield and other government debt. Italian 10-year bonds have yielded less than 4% this year – the lowest in recent history. U.S. 10-year Treasuries offer less yield with more interest rate risk (EM hard currency debt has an average duration of 6.5 years). See Figure 5 below. It is a low-yield world: around 80% of bonds in global bond indices yield below 4% and almost half below 2%, our analysis shows.

Bottom line: EM hard currency debt looks attractive, we think, in a world where the hunt for yield is still on. The sweet spot? Look for countries with investment grade ratings, low debt-

to-GDP ratios yet juicy yields. Brazil, Russia, Indonesia and South Africa fit the bill.

Figure 5: Find the deal

Yield range for selected assets, 2010-2014



Sources: Thomson Reuters and BlackRock Investment Institute, 10 February 2014.

How about local currency EM debt? Our take is simple:

- Yields of 7% may not be high enough to compensate for the risk of more currency declines at this time.
- Local currency debt is a useful diversifier for long-term strategic investors. The local currency share of EM debt issuance is set to grow due to ageing EM populations and growing pools of domestic savings.

A word of advice for those who want to try their hand at picking the bottom in EM currencies: Avoid falling pianos. There are two options:

- Pick countries with current account surpluses or reform momentum. No major thrills here, but at least a good night's sleep knowing these currencies are unlikely to get hit.
- Wade cautiously into places where currencies look cheap and central bank policy appears to be on the right track. Gird yourself for a wild ride.

THE GREAT SLOWING SOUND

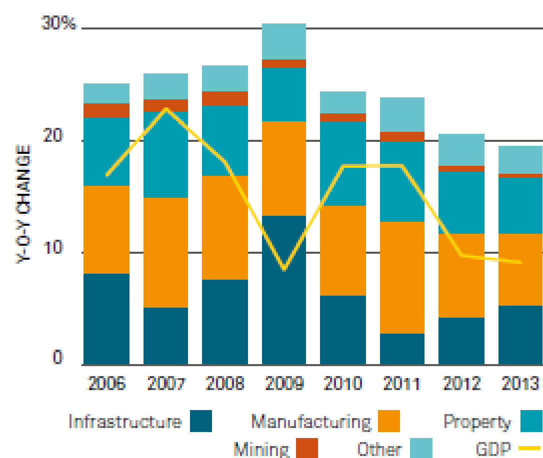
China is slowly rebalancing its economy. A gentle downward drift in the (still phenomenal) growth of fixed asset investment tells the story. See Figure 6. China's new leadership is determined to reduce its dependence on investment and boost consumption. Doomsayers predict this will trigger an economic implosion. Even some China bulls concede growth is

likely to slow to around 5% by the end of the decade.

Our concern: many state-owned enterprises are struggling with overcapacity, rising environmental costs and (crucially) mountains of debt. Japan's zombie companies illustrate the problems caused by failure to write off bad debt. We also worry about the maturity mismatch in loans sold to domestic investors and the underlying assets: this proved a recipe for disaster in the financial crisis. The good news? More than half of new credit now flows to the private sector, where jobs and profitability are on the rise, according to CLSA research.

Figure 6: Slowly but surely

China fixed asset investment and GDP growth, 2006-2013



Sources: CLSA, Thomson Reuters and BlackRock Investment Institute, February 2014. All figures are nominal growth. Fixed asset investment before 2011 is urban only.

EQUITIES: PROS AND CONS

EM equities started the year in a now familiar fashion: by underperforming developed market stocks. See Figure 7, left chart. Is another year of under achievement likely? Historically, it is not. EM stocks had a 3% higher earnings yield than developed stocks at the end of January. At those levels, emerging stocks have typically outperformed in the next 12 months. See Figure 7, right chart.

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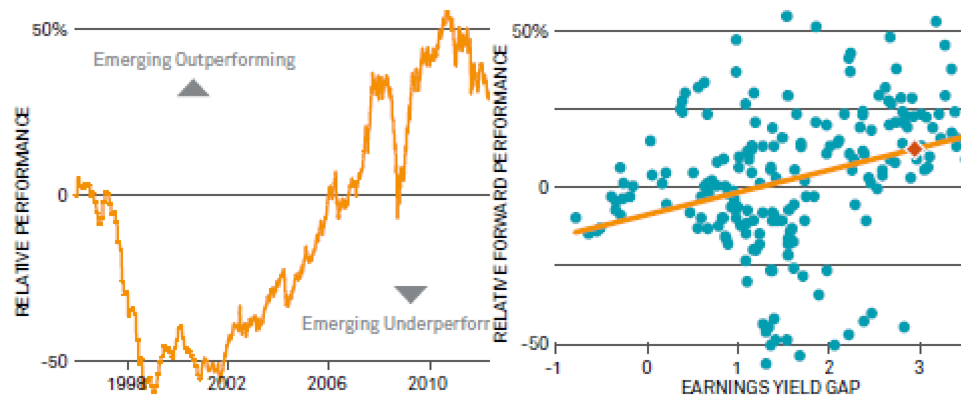
Figure 7: A performance issue

Emerging vs. developed equity performance and valuation, 1996–2014

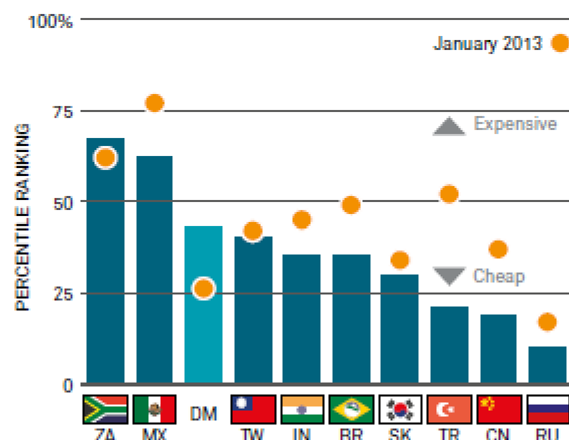


Sources: MSCI, Barclays Capital and BlackRock Investment Institute, 10 February 2014. Dots on the right chart show the one-year forward relative performance of emerging versus developed equities at various levels of the earnings yield gap between the two (developed earnings yield minus emerging earnings yield). The analysis is based on monthly data from 1996 through January 2013.

The problem? Emerging stocks only look like bargains compared with developed stocks. Against their own history, most look just okay. See Figure 8 below. Other reasons for scepticism: The few quality stocks look rich. EM equities are expensive by one gauge that matters when liquidity dries up: free cash flow. A stronger U.S. dollar (which we are counting on) has traditionally been bad news. An earnings and margin turnaround is not yet in sight.

Figure 8: Discounted but no bargain

Equity valuations by percentile vs. historic norms, January 2014



Sources: Thomson Reuters and BlackRock Investment Institute, February 2014. Equity valuations are an average of percentile ranks of earnings yield, cyclically adjusted earnings yield, trend real earnings, dividend yield, price to book, price to cash flow and forward 12-month earnings yield in the period

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1995 to 2014. DM stands for developed markets.

The other side of this argument:

- Valuations better reflect the reality of slowing growth.
- Investors are likely to become enamoured with the EM growth story again. Warning: equities of fast-growing countries can get overheated, similar to high-flying growth stocks. See Risk and Resilience of September 2013.
- The benign effects of currency declines are crystallising: improving trade balances and competitiveness.
- The significance of EM equity outflows is likely overstated. Our research shows they are meaningless in explaining stock performance beyond 60 days.
- Investor sentiment is below freezing: a good time to buy. This made EM equities our top contrarian pick for 2014. See Squeezing Out More Juice of December 2013.

After spirited debate, the BlackRock Investment Institute ruled on its own charges as follows:

- **Willful deception**: Not guilty. Currencies diverged markedly. We note some disappointment with the level of divergence between other EM assets.
- **Reckless policy**: Decision put on hold. Currency depreciations are helping the emerging world rebalance. The question: can policymakers avoid a populist pivot in an EM election year?
- **Gross underperformance**: Guilty. We believe the tide will turn but see few catalysts for an immediate reversal.

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This paper was authored by Russ Koesterich BlackRock's Global Chief Investment Strategist, Jeff Shen, Head of BlackRock Emerging Markets, Sergio Trigo-Paz Head of BlackRock's Emerging Markets Fixed Income Team, Sam Vecht Head of BlackRock's Emerging Markets Specialist Team, and Ewen Cameron Watt Chief Investment Strategist, BlackRock Investment Institute.