Strong Dollar - Weak Emerging Markets?

July 2018

On May 21, 2018, the Wall Street Journal (WSJ) published an article in the Markets Section titled "Rising Dollar Sparks Tumult in Emerging Markets." The opening sentence was, "A resurgent dollar is exposing weaknesses in the developing world, pushing investors to unwind long-held bets on emerging-market stocks, bonds and currencies.[1]" On May 25, 2018, in the Heard on the Street Section, the WSJ's Richard Barley titled his article, "It's Too Early to Give Up on Emerging Markets." In his article he wrote:

> "The problem for emerging markets right now is mostly about the rising dollar and higher Treasury rates, exacerbated by signs of softening growth outside the U.S. The mind-set for investors has moved from thinking about the opportunities for stronger growth and higher returns to the threat that tighter financial conditions pose.
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> However, the experience of recent years in emerging markets has led to efforts to reduce vulnerabilities. Current account deficits have narrowed. It seems policy makers remain aware of the risks posed by the global economy, even though emerging market inflation has been mostly well-behaved.[2]"

That was followed by an article titled "Emerging Markets Have a Dollar Problem" in the Journal Reports: Funds & ETFs section on June 3, 2018, and "Emerging-Markets Rout Boosts Contagion Fears" in the Economy section on June 10, 2018. There were many more articles on emerging markets in June as the financial press grappled with the first domino-like sell-off since 2015. Are these concerns justified?

Starting from the "fundamentals" of emerging markets, the answer is a resounding No. As Mr. Barley points out, after living through repeated crises and growth setbacks, many countries adopted prescriptions formulated by entities like the IMF and other development minded institutions. These changes include, among others, independent monetary authorities, budget deficit controls, incentives for growth in domestic capital markets, improvements in transparency, and professional debt management. Economic globalization forced emerging nations to recognize the importance of having competitive economies and markets. A key component of these changes included flexibility in currency management and liberation of capital accounts.

These changes mean that markets (and authorities) can adjust to conditions, including a strong dollar and rising rates. Borrowers without a natural revenue hedge, generally protect themselves against foreign currency fluctuations. Similarly, monetary authorities raise rates to contain currency runs and defuse inflationary pressures, and fiscal authorities modify incentives to retain capital flows. Altogether, mechanisms are in place to help economies protect against worsening financial conditions, particularly at times of global stress.

Prior periods of emerging market weakness in the face of dollar strength were associated with mediocre to poor economic conditions in the rest of the world. In 2008, the U.S. led the world into a deep recession. In late 2011, U.S. government debt was downgraded and the European periphery was in danger of default. In 2014, Russia invaded Ukraine and energy prices began a steep and prolonged decent. In 2015, Europe was in crisis and much of the developing world was in recession. By contrast, in 2018 the world is growing healthily led by the U.S. and rates are rising in a process of

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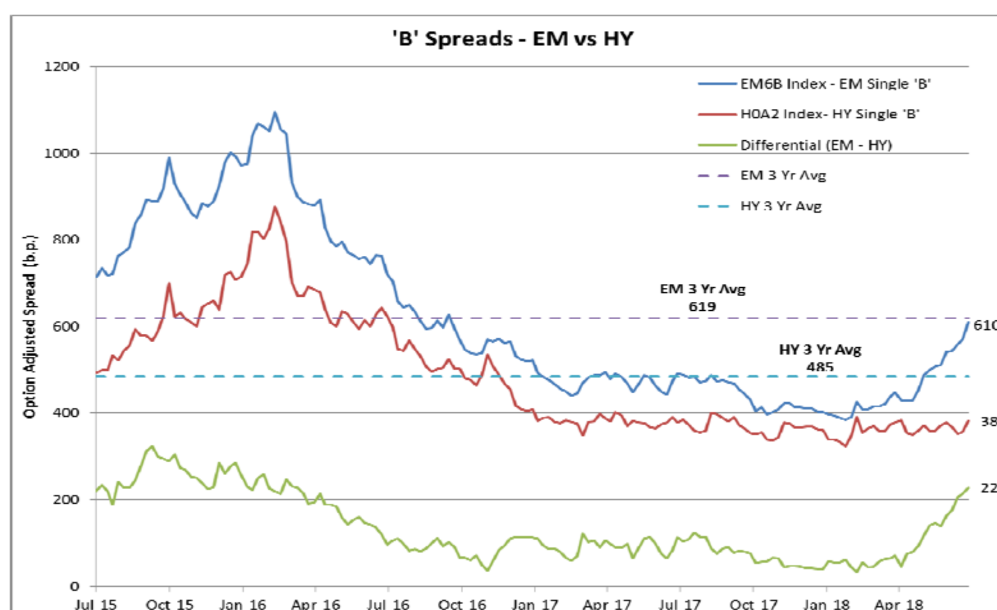
[1] Ira Iosebashvili, Josh Zumbrun and Julie Wernau, "Rising Dollar Sparks Tumult in Emerging Markets," The Wall Street Journal, May 21, 2018

[2] Richard Barley, "It's Too Early to Give Up on Emerging Markets," The Wall Street Journal, May 25, 2018

normalization after years of developed market subsidization. Conditions are hardly comparable and data on earnings, economic performance and consumer confidence confirm the differences.

It may be illustrative to focus on corporate credit, a sector burdened by the poor performance of currencies and sovereign debt. The graph below shows the spread differential between B rated emerging market credits, as reflected by the ICE BAML B rated EM index and B rated U.S. high yield credits. During the second quarter of 2018, the spread widened by 180 basis points. On an absolute basis, emerging markets Bs widened by 182 while high yield Bs widened by 2. The magnitude and speed of the move suggests emerging markets corporations face proximate defaults or meaningful ratings deterioration.



On May 22, 2018, J.P. Morgan published a report titled EM Corporate Fundamentals Checkup, subtitle, "Best year since 2011." The highly complimentary report references 2017 earnings data for its aggregate commentary, including improvements in revenue, EBITDA, debt metrics and outlook. However, a summary bullet point states, "With the bulk of 1Q2018 earnings in hand, we continue to expect a favorable fundamental backdrop for EM corporates in 2018 that is characterized by modest default rates and still improving leverage metrics.[3]" Other points include:

- "We believe top and bottom line gains should improve further in 2018.
- Our expectations include a decline in gross leverage of around -0.2x to 2.5x, a level last seen in 2013.
- The improvement in EM net leverage last year exceeded that for DM IG counterparts, while it modestly lagged on the HY side.
- In HY, EM net leverage moderated -0.1x to 2.7x which was a more modest rate of improvement than in US HY (-0.2x to 3.6x), nevertheless, the absolute levels of net leverage remain significantly lower in EM.[4]"

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[3] J.P. Morgan, "EM Corporate Fundamentals Checkup," May 22, 2018
[4] Stet

While the data behind J.P. Morgan's report and comments relate primarily to 2017, we did not see any meaningful deterioration in first quarter 2018 earnings or full year guidance from corporations we follow.

So, what caused a nearly 200 basis point widening in emerging market B rated credit spreads? We believe investors were over-exposed and over-reliant on the global growth narrative as 2018 began. Just as the ebullient U.S. equity market cracked in February, emerging markets cracked in the second quarter. In a July 2, 2018 EM Corporate Weekly Monitor, J.P. Morgan's analysts wrote, "Compared to our 2018 outlook, overall technicals and fundamentals for EM corporates evolved as we expected but currency volatility has been the main factor driving deviation in performance.[5]" In other words, as a well-known risk factor deviated from expectations, investors recalibrated their entire EM positioning and sold indiscriminately. One-sided trading and poor bond market liquidity exacerbated the price moves. With the global growth picture still looking supportive, and the "shock-absorbing" benefit of flexible currencies helping many emerging economies, we still believe well-managed corporations will deliver good performance in 2018.

July 15, 2018

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[5] J.P. Morgan, EM Corporate Weekly Monitor, July 2, 2018

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