# Viewpoints

For institutional investors only

## Turning the Corner – Emerging Market Currencies Take A Knock

The outlook for higher interest rates this year in the U.S. has supported a stronger U.S. dollar. At the same time, across the emerging markets there has been a broad range of FX performance with some sharp sell-offs. Over the second quarter to date, currency impact has lowered the +0.71% local currency return of the MSCI Emerging Markets Index to -2.10% in USD. We believe this volatility reflects a change in investment opportunity as rates rise - early steps of the market turning the corner from a low rate/risk-on environment towards a more sanguine view of risk pricing, as the bond market draws investors back from equities. We do not believe there has been an abrupt change in fundamental risk across the major emerging markets.

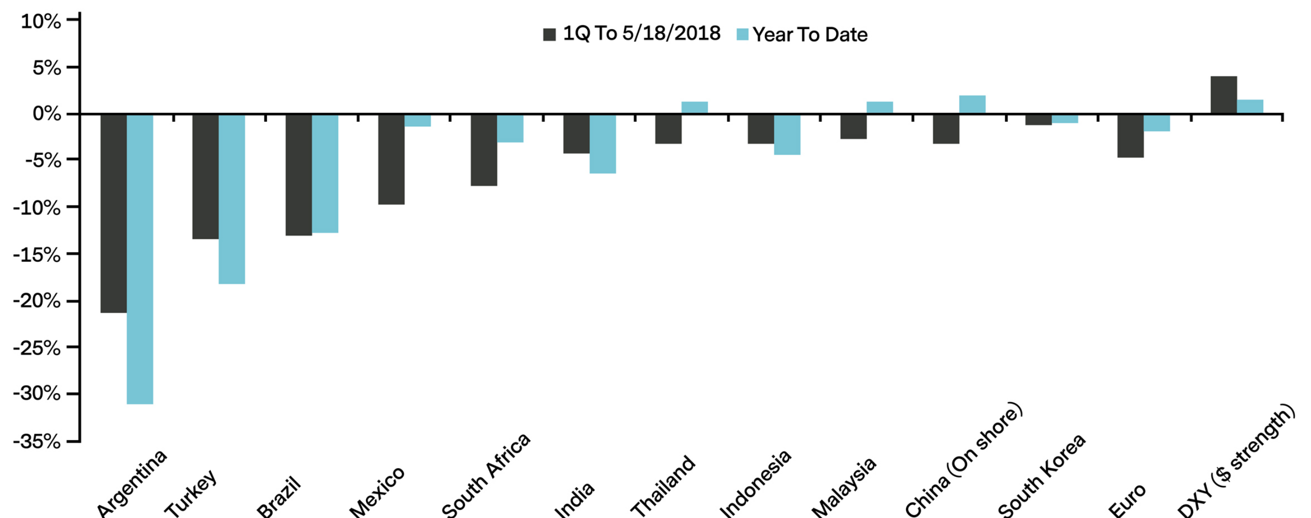
The last time we saw a major sell-off in EM currencies was the taper tantrum of 2013, when the markets first flinched on the prospect of higher rates. The 'Fragile Five' (Turkey, Brazil, India, South Africa and Indonesia) emerging market currencies sold-off as investors focused on these countries' double deficits of current account (net international business flows) and fiscal (government budget) deficits. Despite the volatility and sell down, there were no fundamental blow ups in 2013. While this illustrated a level of economic robustness that had not been tested for a few years, it also acted as a wake-up call. Central banks and governments across the emerging markets took note, and since then deficits from a number of countries have narrowed.

**When assessing risk today, we see areas of relative weakness that stand out, including:**

- Weak budget management. Low cost debt provides room for fiscal attitudes that might not sit well in tighter market conditions – e.g., Turkey or South Africa under Zuma (things may start to look better under Ramaphosa).
- Debt has risen sharply across a number of lower income countries, in part due to China financed infrastructure.
- Exposure to foreign denominated public debt
- Likely rising current account deficits for energy importers such as India

Recent currency weakness has focused on countries

**Exchange Rate Moves vs. US Dollar (2018 YTD)**




Source: Bloomberg

return of +1.42%. In the second quarter through 18 May, FX has detracted -2.81% from returns turning a 0.71% gain in local currency to a USD loss of -2.10%. Only two countries in the benchmark have positive FX impact quarter to date, and approximately half the negative impact has come from Brazil (Real vs USD -12.9%), South Africa (-7.5%) and India (-4.3%).

The Vontobel Emerging Markets strategy has been impacted by approximately -3.33% from currency in the second quarter through May 18. The greater impact reflects the overweight to Brazil, India and Mexico held by the strategy relative to the benchmark.

**Outlook**
One of the issues a falling currency can create is domestic inflation. For hard currency returns, it is important that earnings growth is generated in real terms, i.e. excluding any lift from inflation, which in turn calls for genuine pricing power. We find pricing power reflected in rising nominal ROEs through times of inflation. This is important when investing in the emerging markets. We believe our holdings are well-positioned to continue to deliver growth in real terms should inflation snap upwards.

Regarding Brazil, we see its economy recovering gradually, but steadily from a deep recession. We recognize there are challenges for the economy, as is the case for any developing market. Pension reform, which is critical, has been on hold due to one political crisis after another, and the upcoming election. Pension reform is of great importance to the longer term functioning of the government, as the tax payers, who are already highly taxed relative to GDP, cannot afford the current set up as the pension aged population rapidly accumulates. However, Brazilian institutions are strong and its business communities are rational and forward-looking. Without trying to predict who will be president after the October election, we feel confident that reform will be high on the agenda of the next government. In addition, Brazil is a major commodity exporter and rising prices for oil and a less abrupt recovery in iron ore will contribute to both government income and demand for the currency.

In our view, India also remains in a solid condition with the quickest growth across the emerging markets and a government that is dramatically opening bottlenecks in the economy while remaining popular. India tends to run a current account deficit, in part due to its unusual accounting method that includes gold imports in the trade balance (imported gold bullion rose from 648 tonnes in 2016 to 996 in 2017), but also due to its need to import energy. We remain comfortable with the demand outlook for our holdings in India.

Mexico: even with NAFTA still being renegotiated, the country continues to draw investments. Together with reserves and portfolio flows, we see little problem in the country covering its twin deficits and supported by the recovery in oil prices. The Mexican central bank anticipates the trade and current account balances for 2018 will come in around 1.1% and 2.1% respectively, which we regard as comfortably manageable. Still, an important variable to watch for in Mexico is energy production, where output has fallen steeply due to lack of investment. This has led to Mexico running an energy deficit within its import/export balance – exporting crude, where production is falling, but importing gas and gasoline. This led to the government passing the first significant energy sector reforms for decades in 2014, and where the benefits will take time to work through. We continue to believe Mexico provides a stable economic platform for secular growth companies to operate and grow.

We are bottom up investors, but always have to be aware of the macro environment in which our companies operate. With conviction in the potential of companies we hold, or would like to hold, opportunities can rise if the market does get spooked and sell down. Throwing the baby out with the bathwater, as ETFs can do, sometimes provides buying opportunities for mispriced growth.

Over the twenty plus years we have been investing in the emerging markets, we have navigated through many cycles and shocks. We remain committed to our quality growth investment approach, and believe the long term prospects for the companies we are invested in remain healthy as vehicles to deliver absolute returns for our investors in US dollar terms through the economic cycle.

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