Flash Comment #122

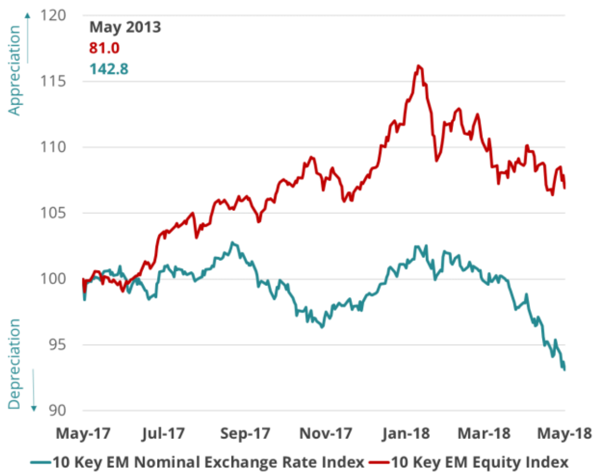
May 18, 2018

EM financial turbulences: is a crisis looming?

Financial markets and a number of exchange rates in emerging economies have declined both substantially and rapidly over the past weeks. Though such development are consistent with both our aggregate risk measures, specific country vulnerabilities and global financial uncertainties, our tools and analysis suggest that a broad-based and sustained period of difficulties in EM is not yet in front of us. Supporting fundamentals and our assumptions of renewed USD weakness environment should provide significant support over the next few quarters. Our global view of worldwide cyclical reversal during 2019 clearly suggests nonetheless that next year will be more difficult, after a second part of 2018 characterized by persistently high volatility.

With a modest time-lag on mature financial markets, Emerging Markets' financial assets have gone through a period of significant decline over the past weeks, with substantial outflows of capital in most assets classes and rapid currency depreciation. This has raised worries and questions about an imminent collapse or broad-based reversal for EM.

10 Key EM Exchange Rate and Equity Index
Base 100 May 2017

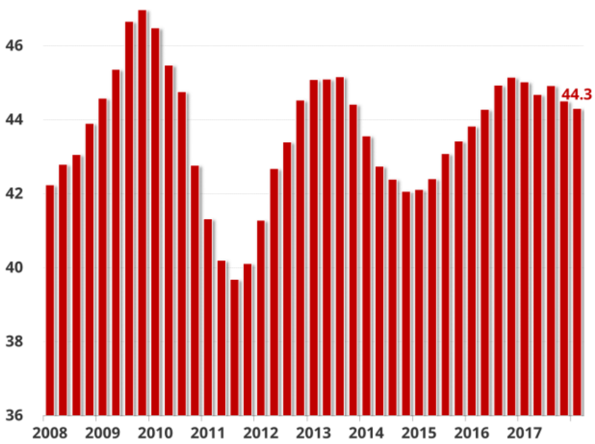


Source: TAC ECONOMICS, Datastream

Not really coming out of the blue

Our tools have provided very useful insights into the current turbulences, at least through three different approaches: (1) We highlighted the excessive increase in asset valuations in EM during the past 12 months, with our combinations of risk / valuation deteriorating sharply; as soon as mature markets reverted brutally in February-March, differentials between EM and mature markets was becoming unsustainable; (2) Our broad-based Economic & Financial Risk Rating for all 100 countries now covered in our RiskMonitor tool has deteriorated steadily after the end of 2015 and reached more alarming levels in 2016Q2 and Q3: when adding the traditional 2-year time -lead of our risk ratings, it pointed to an increasing risk materialization during 2018 and extending into 2019;

Average Economic & Financial Risk Rating across the 100 countries included in RiskMonitor
From 0 (lowest risk) to 100 (highest risk)



Source: TAC ECONOMICS

(3) EM turbulences coincided with significant movements in mature economies, including the "repricing" of US inflationary pressures, monetary tightening and bond yields and the associated appreciation of the USD, coming back below EUR/USD 1.20 in mid-May.

This combination provides a solid explanation of past problems. We also note that countries most affected (Argentina, Brazil, Turkey, ...) are also those for which we had either a WatchList Indication of very high vulnerability (Brazil, Turkey), hard-to-achieve Fx borrowing requirements (Argentina, Turkey) or political problems and uncertainties (Turkey, Brazil).

Where do we go from here?

Until the end of 2018 and early 2019, positive fundamentals (persistent momentum of economic growth, contained external deficits, large Fx reserves) associated to our assumptions of renewed weakness for the USD and supportive commodity prices should be enough to prevent any kind of global, contagious and lasting deterioration in both currencies and asset markets.

Later in 2019, stars will become much more negatively aligned: a cyclical reversal in the US coupled with significant declines in mature markets would be almost coincident with a Chinese slowdown, and create conditions for a global economic slowdown and reversal in commodity prices. Then, the vulnerability issues for EM, and notably the excess corporate leverage both in domestic and foreign currencies, would become unbearable and lead to more acute difficulties.

Both for the end of this year and for 2019, we believe that differentiation will remain the most critical element in investment and operational strategies, with much higher financial volatility in the short run and a broader-based range of difficulties next year. The next quarters should therefore be considered as a transitory period and used to prepare for what could be much more nasty in 2019.