JOHCM Funds

JOHCM Emerging Markets Opportunities Fund

EMERGING MARKETS SPOTLIGHT

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Followers of our strategy will be aware of our view that there have been three developing crises in emerging markets: the hit to economic activity, the stress in risky and leveraged assets, and the collapse in the oil price. Of these, it is the second that looks like the biggest challenge for many emerging countries right now.

For these economies, the economic shock from Covid-19 (for example, measured by the drawdown in foreign exchange reserves) has been both bigger and faster than the impact of the global financial crisis in 2008/9. As the crisis has developed, foreign bond and equity investors have been aggressive sellers of emerging assets in this subset of countries, while reduced trade volumes, lower commodities prices and a hard stop in tourism revenues have heavily reduced inflows of foreign exchange. Some of these countries were already seeing stresses back in 2019 as well.

Which countries have been hit this way? The first point to note is that this is not the case for the largest countries in the MSCI Emerging Markets Index: China, Korea and Taiwan, which have huge reserves that are barely changed. Nor is it the case for a number of other sizeable markets: Russia, India, Thailand and Malaysia. So, this isn't a systemic EM crisis.

But for Argentina, Brazil, Turkey, Saudi Arabia and Chile, the reserve drawdowns have been substantial, while South Africa and Mexico, facing large outflow pressures, have simply let their currencies slide (as, in fact, has Brazil despite also drawing down reserves). It should also be noted that outside of the emerging equity country universe, significant stresses and capital outflows have been seen in frontier markets like Lebanon, Nigeria and Ecuador. Some of the numbers here are big: year to date, foreign exchange reserves are down US$14bn in Brazil and US$98bn year to date in Saudi Arabia, while the Brazilian real, Mexican peso and South African rand are all down by more than 20% against the US dollar. It should also be noted that Chilean foreign exchange reserves are down US$3.7bn but that is 9.1% of the year's starting level, and also that, while Indonesian reserves recovered in April, the US$9.5bn decline seen in March is the largest monthly fall since the crisis of 2011.

To be clear, this isn't a repeat of the 1997 Asian crisis. In fact, what we are seeing is rather a direct result of the policy response to that crisis. Recognising that pegged exchange rates and dollar-denominated borrowing pose existential risk to economies and governments, emerging markets have, en masse, moved to fund sovereign debt in local currency, letting foreign investors take the exchange rate risk instead. However, these structures mean that period of aggressive risk-off sentiment in global markets will see substantial capital outflows, as foreign investors sell local bonds and switch the proceeds into US dollars. This comes alongside the inevitable co-synchronous equity outflows.

It is hard to overstate how concerned multilateral agencies like the IMF and Bank of International Settlements have been about this in recent years – a quick check of either entity's website should yield multiple documents on the topic. And now, with the US dollar strengthening and chains of lending and collateralisation breaking down, we have serious problems in some emerging and many frontier markets.

There isn't any easy solution to this for these countries. Where reserves are large, countries can just continue to draw them down at the risk of weaker debt fundamentals. Currencies can be allowed to weaken, with inflation seemingly not a threat anywhere. The easy source of US dollars is swap lines with the US Federal Reserve, but these are more for countries with systemically important banks, and will only be given to countries with close political relationships with the United States. Ultimately, the outflow stresses will continue until a return of investor confidence leads to inflows. Until then, we will remain cautious; we currently have zero-weight positions in Argentina, Brazil, Chile, Saudi Arabia and Indonesia, and have reduced our South Africa and Turkey weightings, where we also consider that we are defensively positioned.

Source: JOHCM/MSCI Barra/Bloomberg, as at April 30, 2020.

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