September 2017

FOR PROFESSIONAL INVESTORS ONLY

J O Hambro Capital Management Group

Emerging Markets Spotlight

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"The new configuration of [current-account] imbalances poses distinct global risks, particularly over the medium term." - *IMF 2017 External Sector Report*

As international investors in emerging markets, our focus is on US dollar returns, not local currency ones. This means that an assessment of the outlook for the currency is an important factor to consider (in fact, it is one of the five main drivers of our investment process).

There are a number of ways to assess the over/under valuation of a currency relative to its long-term prospects. One is to use purchasing-power parity (PPP), which assumes that currency fair-values should reflect price differences between countries; the Economist's Big Mac index is a simple and well-known example of this approach. Another approach, and one which we lean to, is to try to assess how a country's current-account balance is moving relative to the strength of its economy and the relative prices of its imports and exports. Known as the external balance approach, we think it is of significant use, and is why we pay so much attention to current-account balances (as regular readers will be aware).

Of particular interest to us this month has been the IMF's 2017 External Sector Report, released at the end of July, which contains IMF staff views on 29 leading economies, including 13 emerging markets. The IMF's Consultative Group on Exchange Rates have developed sophisticated models that analyse the factors that contribute to a country's equilibrium current-account balance, from which they can then assess currency valuations.

One of the main conclusions in the report is that the problematic current-account deficits in many emerging markets (particularly Brazil, Indonesia, South Africa and Turkey) have eased, largely on tighter fiscal and credit policies. Also gone, is the excessively large current-account surplus in China with correspondingly looser fiscal and credit policies. These serve to reduce the overall level of risk in emerging markets as an asset class.

Indeed, where the report sees concerning imbalances, it is in the sustained pattern of surpluses and deficits in the developed world. The report notes that fiscal consolidation supported the widening or persistence of excess surpluses in some key advanced economies (such as Germany and Japan; the Netherlands, Singapore and Sweden are similarly mentioned elsewhere), but did little to reduce excess deficits in other advanced economies (Australia, Canada, the UK, the US). The global risks from conflicts around trade and protectionism originate in the developed world.

That is not to say that there is not the potential for large currency moves in some emerging markets. Our analysis agrees with the IMF's views that the Korean won, Thai baht and Malaysian ringgit remain significantly undervalued and also that the South African rand is overvalued. The signals are more ambiguous on currencies nearer fair value, including the Chinese renminbi and the Indian rupee.

There is one significant risk which is perhaps underplayed in the report and overlooked elsewhere. Our analysis comes to the same conclusion, that the Saudi riyal is substantially overvalued and in need of a significant devaluation. As the currency is currently pegged to the US dollar, any such devaluation could be difficult both for Saudi citizens and for the nation's financial system. Saudi Arabia is an otherwise interesting frontier market, but our long experience of emerging market investing makes us very wary of overvalued, pegged currencies.

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