Paragon Monthly

SEPTEMBER 2018

The Emerging Markets: Caught In The Crossfire

Source: www.grizzle.com

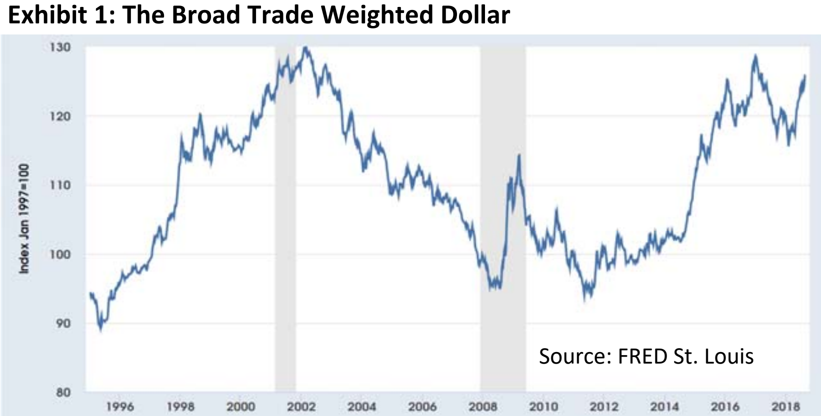
The main victim of the trade war between the U.S. and China is not the U.S. or China. The emerging market nations are caught in the war's crossfire. Their economies are heavily dependent on China's build-out of infrastructure. This is because China represents over 50% of incremental demand for commodities, which make up the bulk of many emerging nation exports and are a large swing factor in their income.

To add insult to injury, other confounding factors are roiling the world's capital markets and contributing to a cloud of uncertainty. The most important of these factors is the rising value of the U.S. dollar. See Exhibit 1 below. The rising dollar is due to the Fed's recent increase in interest rates as they head toward 'normal' or equilibrium, the acceleration in the U.S.'s GDP growth rate to 3-4%+, and because of growing global uncertainty. The dollar is a safe haven investment for some. But, by attracting capital from around the world, it is also decreasing global liquidity and raising costs for those with dollar denominated debt. Some investors are also worried about emerging nation debt.

As investors assess the situation, a primary worry is whether the combination of these forces are sufficient to create another Asian Contagion as in 1997-98 when a strong dollar also wreaked havoc on capital markets and economies across Asia. Exhibit 1 illustrates the rapid rise of the dollar from 1996-1998. The strong rise in the U.S. dollar since 2014 has many fearing a repeat of the Asian Contagion.

The 1997-98 financial crisis spread beyond Asia and affected our capital markets causing the demise of Long Term Capital Management (LTCM). This crisis required a special meeting organized by Alan Greenspan, the Chairman of the Federal Reserve, and a bail-out of LTCM. The crisis also caused a brief but traumatic decline in our stock market. Although conditions today in the emerging markets remind some of the Asian Contagion, we see similarities, but also significant differences.

Exhibit 1: The Broad Trade Weighted Dollar



Two Major Opposing Forces

The two primary forces influencing current volatility in markets are China's slowdown, combined with the U.S.'s strong GDP growth and rising dollar. Continuation of these two trends is not desirable for the health of global markets, and could eventually result in a decline in our stock prices. Fortunately, we are now seeing new signals that may be precursors of change.

This month we will describe in more detail how the two economic forces are interacting and identify how their clash is affecting the emerging nations. Then, we will identify signs that may be indicators of a change in current trends.

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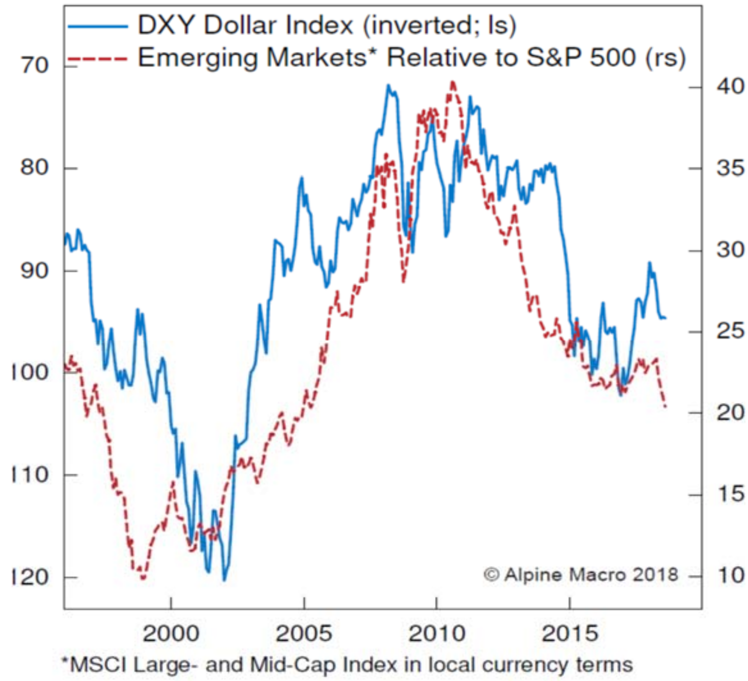
Why The Rising Dollar Is Negative For EM Countries
Exhibit 2 illustrates a close inverse relationship between the dollar and the emerging markets' (EM) relative stock price performance. As the dollar goes up (inverted in the graph), emerging market stocks go down (relative to the S&P 500 stocks). There are at least two fundamental reasons for this.

1) Most commodities are priced in dollars. As the dollar's exchange rate increases, commodities become more expensive and at some point, demand falls. Since commodities are an important source of income for many, if not most, emerging nations, the price of the commodity affects their economic growth rate.
2) Emerging nations are also negatively affected by a rising dollar because they issued a significant amount of dollar denominated debt. Exhibit 3 illustrates this. When we look at the second panel in Exhibit 3, we note that falling commodity prices make it much harder to service debt when the income from those commodities is a large swing factor in their ability to service debt.
3) An additional factor exacerbating some EM countries' financial condition has been the decision (post the 1997-98 financial crisis) to let their currencies freely "float" versus the dollar. The former regime required that they "peg" their currency to the dollar. This decision put the economic and financial management of their country back on themselves rather than be subject to U.S financial and economic cycles. However, in those countries where there has been recent financial mismanagement, (such as Argentina, Brazil, Turkey, Columbia, and Indonesia), the result has been a severe depreciation of their currency relative to the dollar. This unfortunately results in increasing costs for importing goods or paying off dollar denominated debt. But it administers the necessary message to get their house in order, even though that is easier said than done.

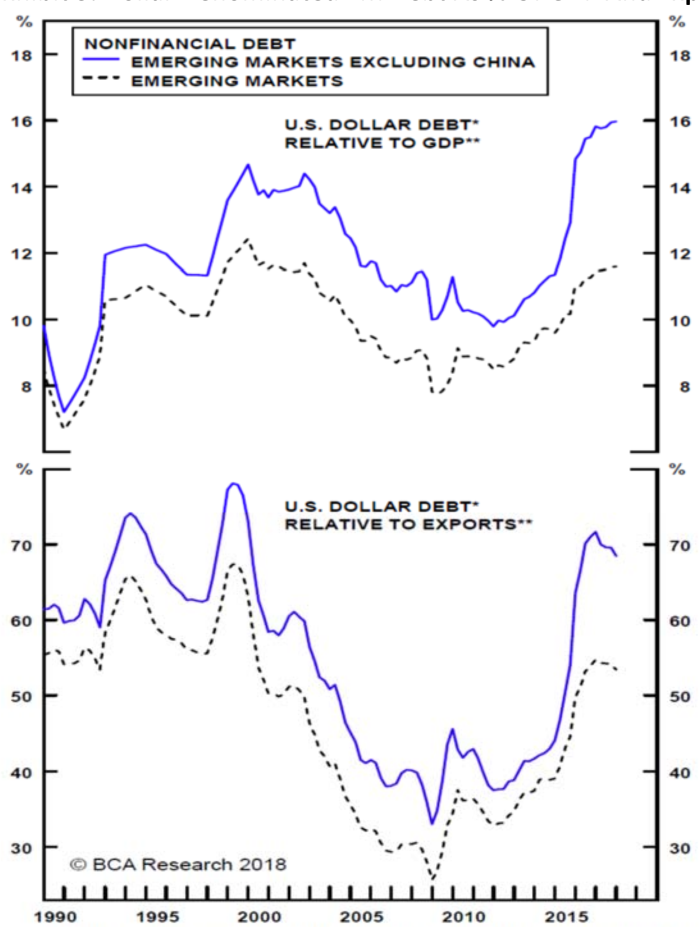
The EM Countries With Weak Finances Are Few
Fortunately, as shown in Exhibit 4, there are not that many emerging market countries that are financially weak and those that are, do not represent a large economic block. Highlighted in red in Exhibit 4 we see Turkey. There, foreign debt servicing obligations as a percent of exports are 140%, a heavy burden. Combined with high internal inflation, and a private external debt load that is 40% of GDP, the Turkish Lira has understandably fallen 26% since August 1st. The shock and weight of this may also result in political regime change.

Exhibit 2: The Inverse Relationship Between The Dollar And The Emerging Markets' Stock Performance



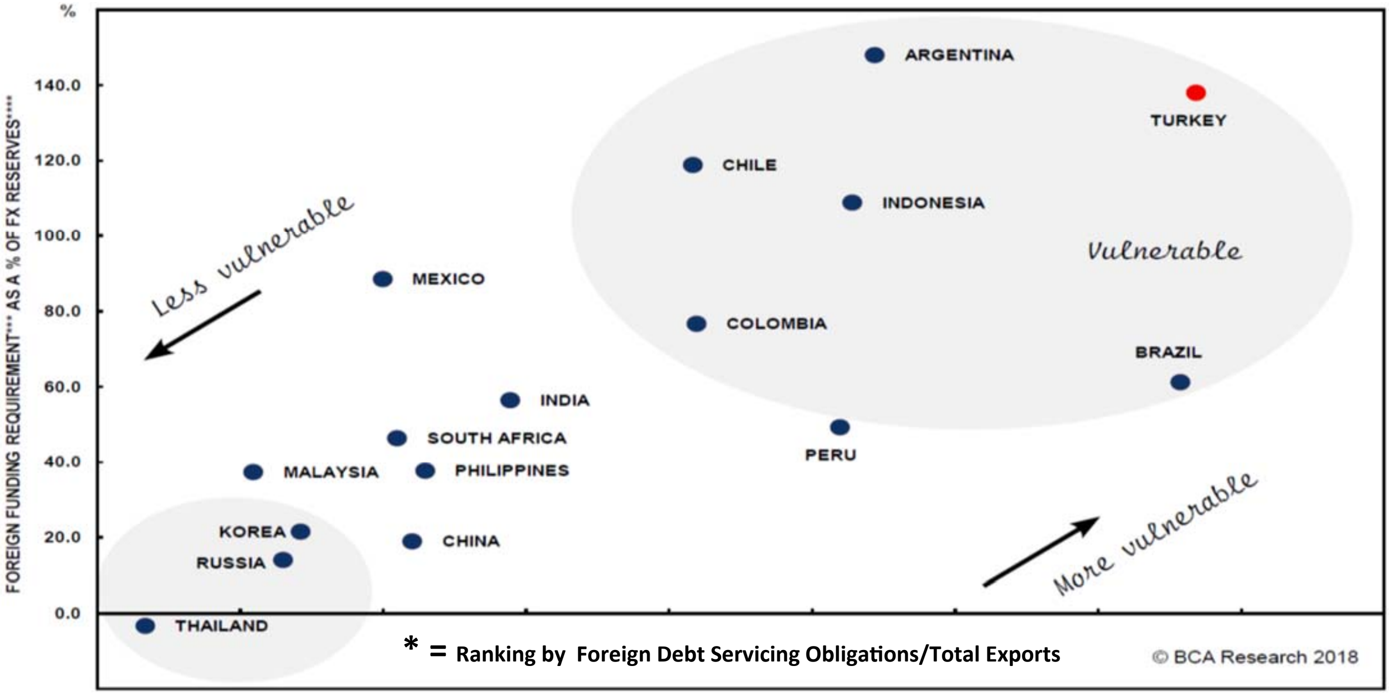
*MSCI Large- and Mid-Cap Index in local currency terms

Exhibit 3: Dollar Denominated EM Debt As % Of GDP And Exports



* SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS (BIS) AND WORLD BANK. BIS DATA FROM 2000. BACK ESTIMATES FOR THE 1990-2000 PERIOD ARE BCA CALCULATIONS BASED ON EXTERNAL DEBT DATA FROM THE WORLD BANK'S INTERNATIONAL DEBT STATISTICS.
** SOURCE: IMF.

Exhibit 4: The EM Countries Most At Risk *

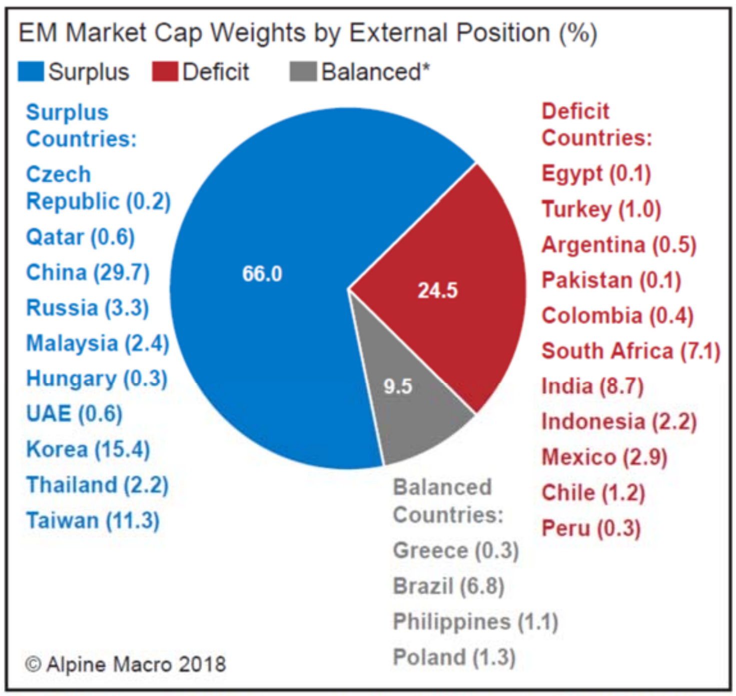


An additional point for investors can be made by examining Exhibit 5. This exhibit illustrates that the bulk of the countries represented in the Morgan Stanley EM Index are in relatively good shape (blue portion of the graph). The graph is constructed by color coding those countries who are running a surplus in their current account (blue) and a deficit (red). The weight of each country in the MSCI EM Index is shown in parenthesis. Surplus countries (66%) far outnumber the deficit countries (24.5%). But, when you take India out of those countries categorized as weaker because of their running external trade deficits, the number of weak EM countries is reduced to 15.8%. It is fair to remove India from this categorization because although India is running a deficit, it is one of the fastest growing EM countries and its finances are strong. Therefore, the underperformance of EM stocks relative to the S&P 500 stock Index illustrated in Exhibit 2, is probably not a result of EM countries exhibiting poorer internal finances. It is much more likely due to another factor. We trace that back to the slowdown in China.

2018 Will Not Repeat The 1997-98 Experience

The conclusion we draw from these graphs is that conditions around the world for emerging market stocks and nations are not the same as they were in 1997-98. On average, the EM nations are in better shape than before, and most are not subject to the fierce forces that enveloped them in the past. However, there is still the China factor to take into consideration.

Exhibit 5: Relative Market Weights Of EM By Country



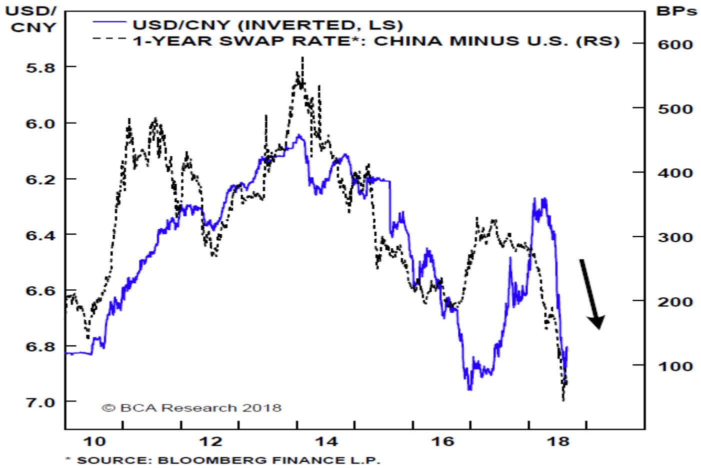
Note: Numbers in brackets represent country weights in MSCI EM Index
*Current account balance within +/-1% of GDP

We maintain that China needs to stimulate its economy. Not surprisingly, that is exactly what China is now doing!

China Has Begun To Stimulate Its Economy

Evidence of stimulus in China has been hard to discern or interpret. However, this year's annual Chinese leadership retreat in Beidaihe, on August 11th held special interest as glob-

Exhibit 6: The RMB Falls As Interest Rates Fall

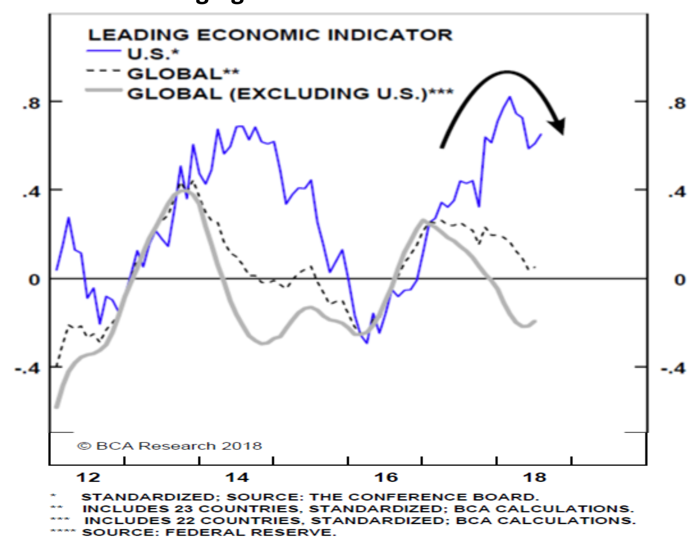


al observers have tried to determine its outcome. As we understand it, several new ideas and programs have emerged.

1) The leadership recognizes that growth is slowing and vows to improve growth.
2) Words to the effect of "we will do whatever it takes" are being mentioned.
3) Large individual tax cuts are scheduled for October 1st with more tax cuts to come in January 2019.
4) Although the leadership discussed further depreciation of the currency, the official statement is that the current 6.8 Yuan/Dollar ratio is sufficient to stimulate export growth and to offset the Trump tariffs. See the decline in the currency in Exhibit 6 (blue line inverted) and the narrowing of relative interest rates (the swap rate-dotted line).
5) Chinese leaders are readying their economy for a long trade war, which means they will have to take other measures to stimulate the economy.
6) Beijing has begun to actively court new partners such as South Korea, Japan and the EU, as the U.S. relationship deteriorates.
7) Initiatives to begin yet another set of infrastructure programs have been announced and new lending for special projects are currently being discussed.
8) Housing starts and sales in China have been picking up this year as the government lowers interest rates. Housing starts are now up more than 20% year over year.

The U.S. Economy's Growth Rate Is Peaking
Exhibit 7 illustrates that the Leading Economic Indicators in the U.S. have begun to roll over. After registering 4.1% GDP growth in the second quarter, estimates for the 3rd and 4th quarters are 3.1% and 3.0%. 2019's GDP number could slow a bit farther as the tax stimulus of 2018 fades. In the meantime, global economic activity could be about to pick up modestly. See the grey line in Exhibit 7. A relative improvement in global growth prospects would take pressure off the U.S. dollar and its strength would diminish.

Exhibit 7: Changing Economic Growth Rates



We Are Watching Global Metals Prices
Improving growth in China will show up in rising metals prices. We are watching copper, steel, and other industrial metals prices for clues. EM earnings are highly correlated with metals prices. There is current evidence in Emerging Market Industrial sector price indexes that metal prices are stabilizing and may begin to rise toward the end of the year. These stocks are now rising relative to the overall EM stock index.

Investing is most difficult when major economic forces are working in opposite directions. Such has been the case this year. We have described a possible path toward economic stability for the emerging nations. We may see some resolution by the end of this year, but expect volatility until we do.

Stay tuned for further developments.

MARKET STATS

S&P 500	2902
DOW JONES	25965
10 YR T-BOND	2.86%

As of 08/31/2018
Source: Bloomberg