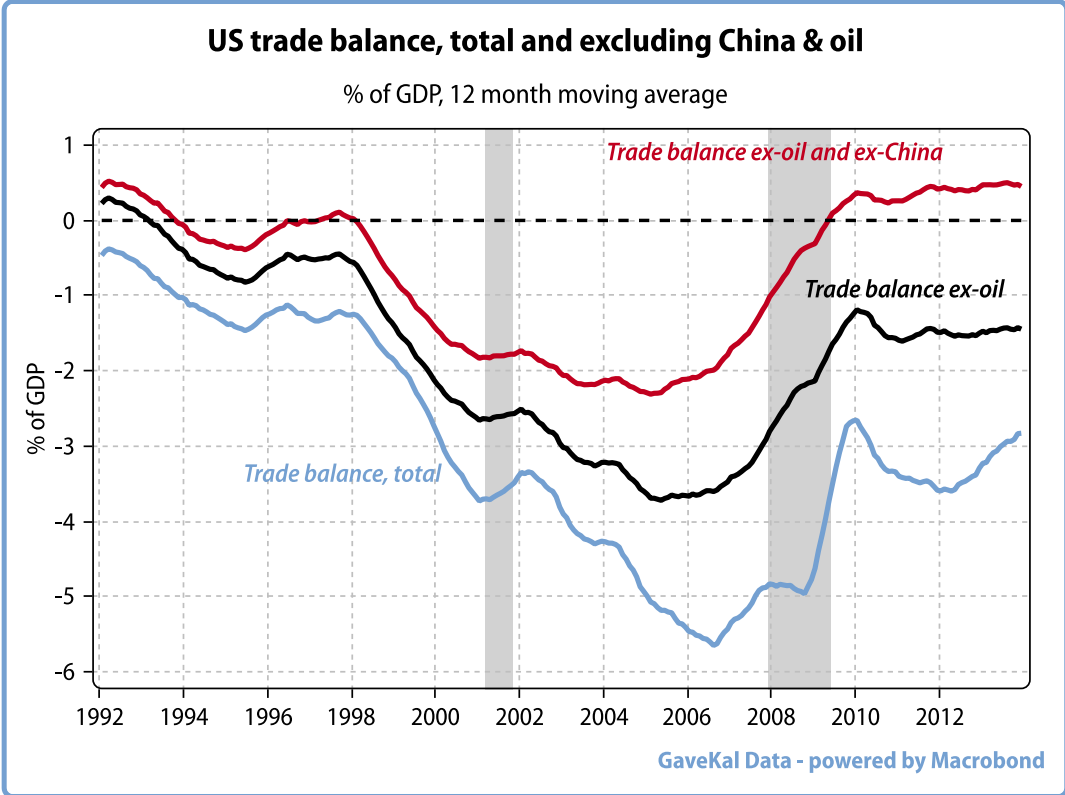

The emerging market challenge

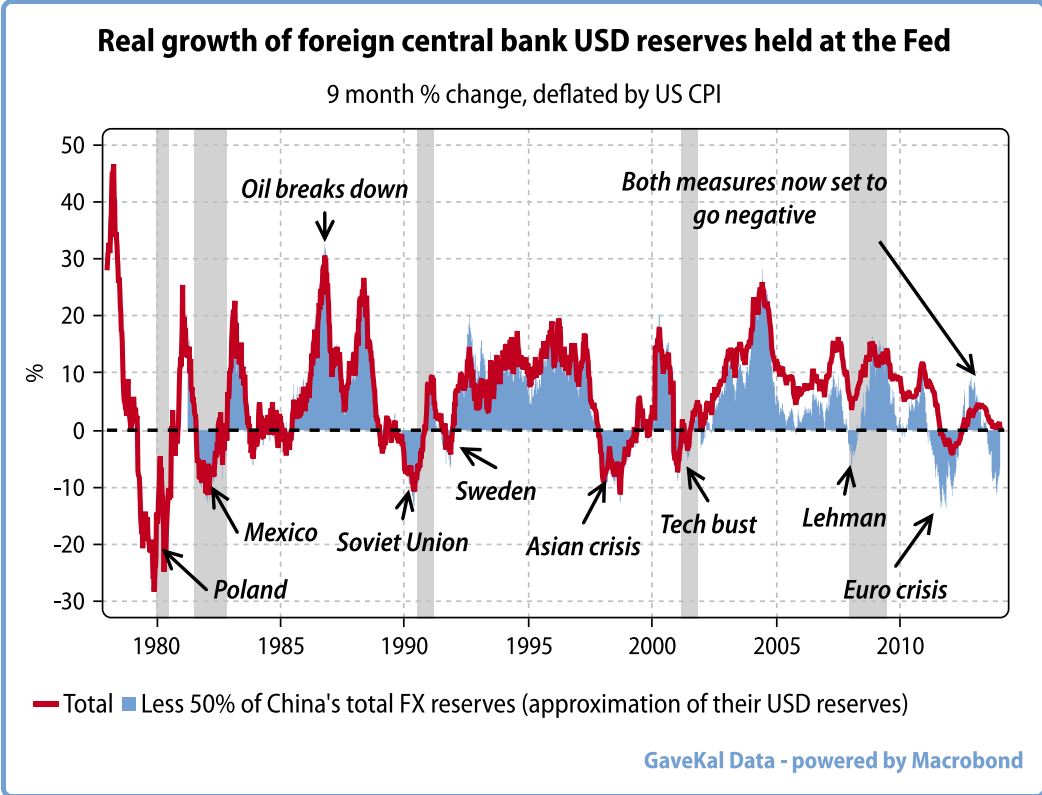
March 2014

A major change: the US is not exporting as many US\$ as it used to



One of the more important macro developments of the past few years has been the dramatic improvement in the US trade balance.

How much of this improvement is linked to cyclical factors (weaker US consumption), and how much to structural factors (shale gas revolution, manufacturing renaissance...)?



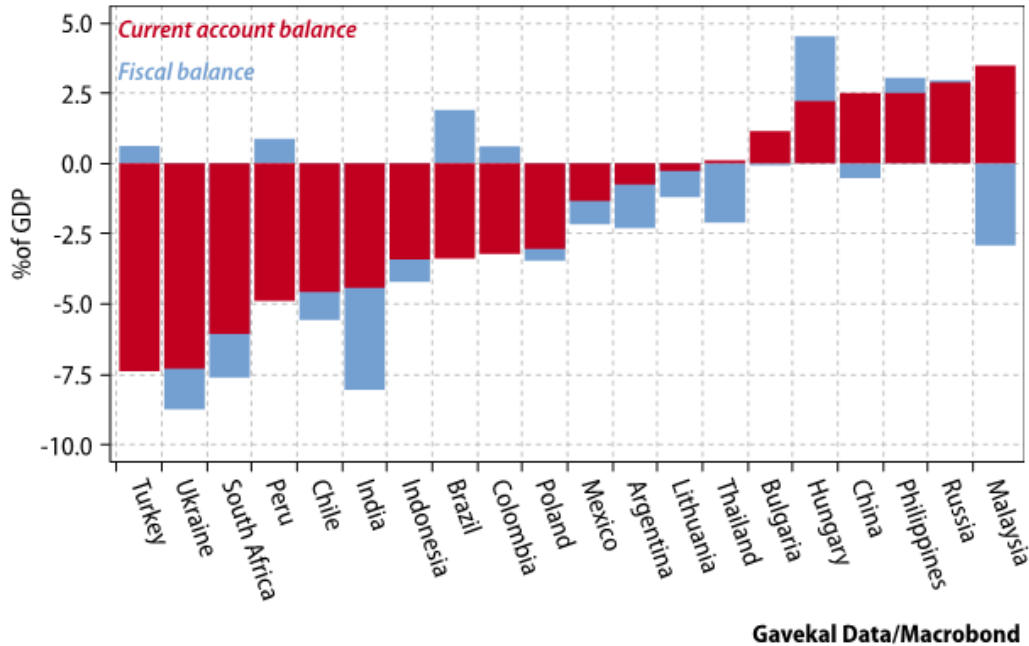
Either way, as the US exports ever fewer US\$, and as global trade continues to need US\$, central bank reserves starts to shrink.

And when central bank reserves start to shrink, bad things happen to good people. Usually, whoever carries too much debt, or which ever country is running large current account deficits, finds themselves squeezed.

This time around, it's the emerging markets in the line of fire

Twin balance (fiscal + current account) for EMs (2013 IMF forecast)

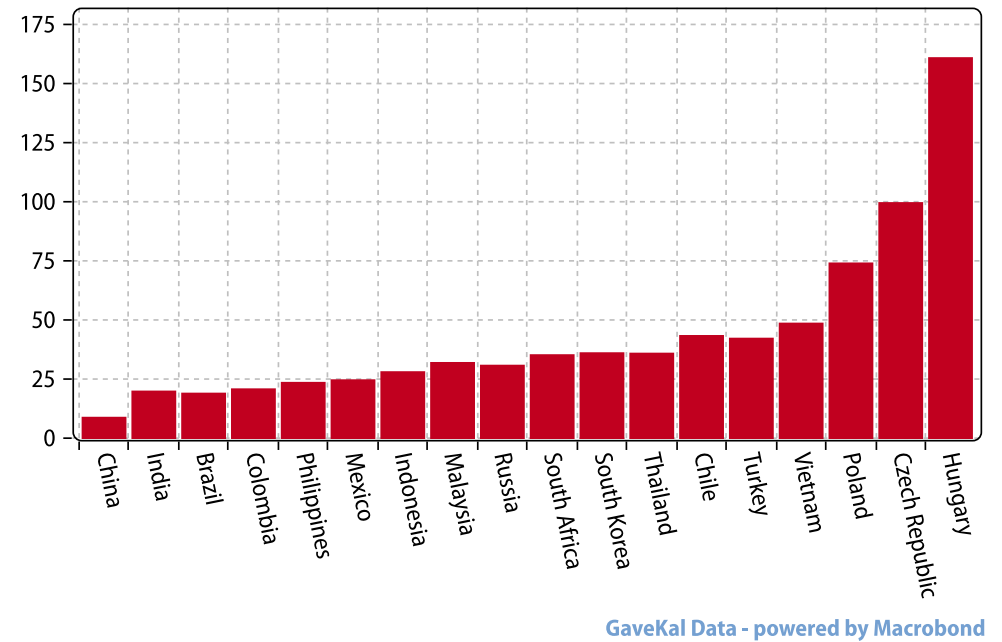
Fiscal balance = cyclically adjusted primary govt balance



In 2011-12, it was the PIIGS that got squeezed. This time around, it is clearly the emerging markets.

External debt ratio are (mostly) moderate







2012 (Except VN, CH & MX: 2011 using external debt stock as % of GNI)



There are two sets of potential victims: the countries with a large stock of foreign debt, or the countries running large current account deficits.

It seems that the markets have decided to focus on the countries running large deficits.

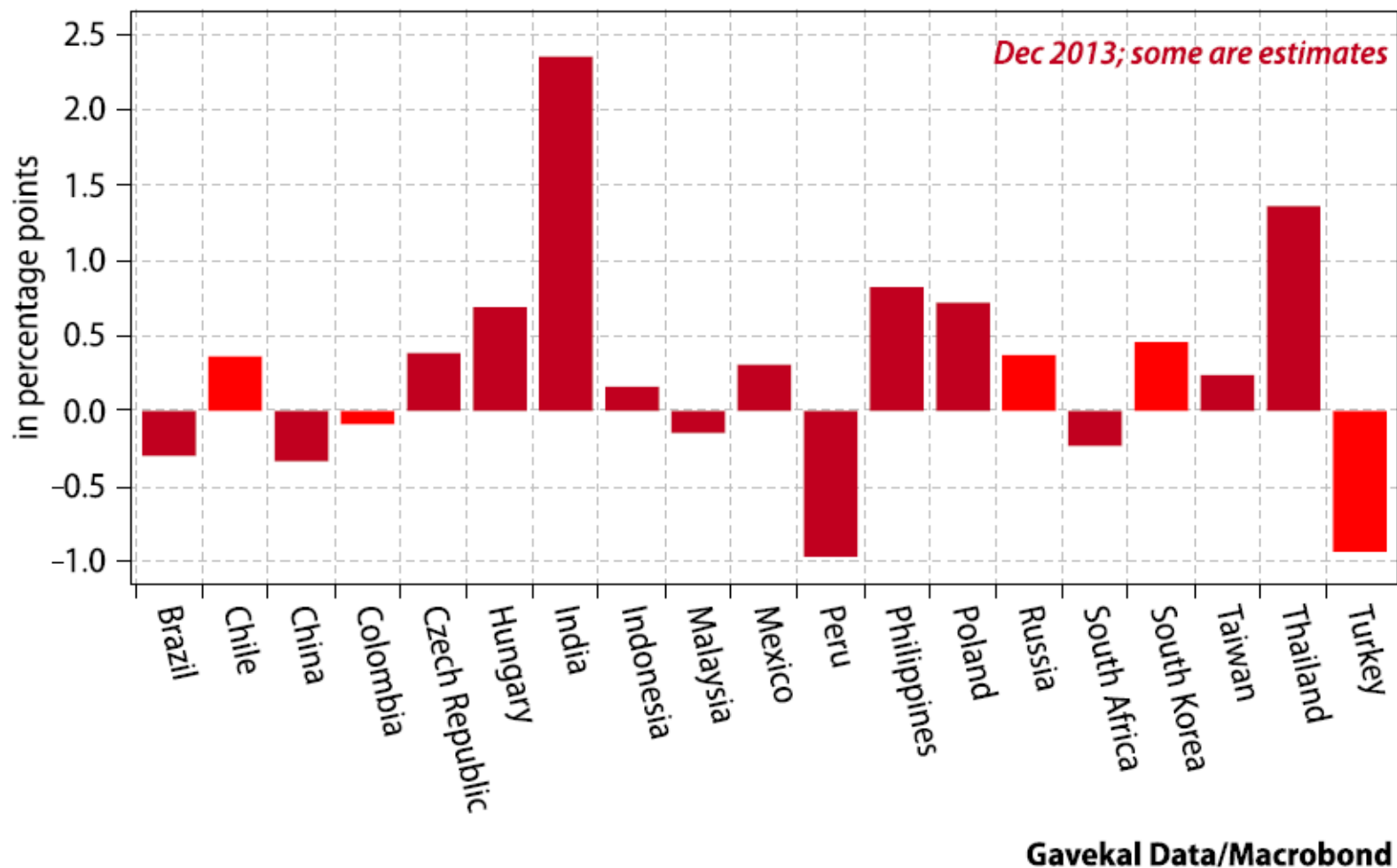
So who will the 'struggling' emerging markets adjust against?

US consumer steps up		Possible, thanks to rise in US asset prices. But a higher US\$ would help. For that to happen, we need ZIRP to end...
EU consumer steps up		Hard to imagine. While UK, Scandinavia, Switzerland and Germany are booming, rest of EU is busting
China levers up again		A simple no. The government is adamant that, unlike in 2008, China will not lever up to save the world.
China provides financing		A definite yes. Through swap lines, growth of dim sum markets, China intends to position RMB as EM trading currency
Japan provides financing		Very possibly. As Abenomics continues to devalue the Yen, Japanese savings could hunt for yield in EM bond markets?
EM consumer collapses		A bearish possibility for the world which would entail a collapse in global trade. On the plus side, it would also trigger lower oil...

Already, emerging markets are adjusting

Varied improvement in EM external deficits

Change in trade balance (% of GDP) over last 2 quarters



The currency devaluation over the past few months, while certainly painful for investors, have helped facilitate macro-economic adjustments through improvement in trade balances for most EM countries.

However, if one looks at the weakest links (and consequently those in most need of adjustment), the results are less encouraging.

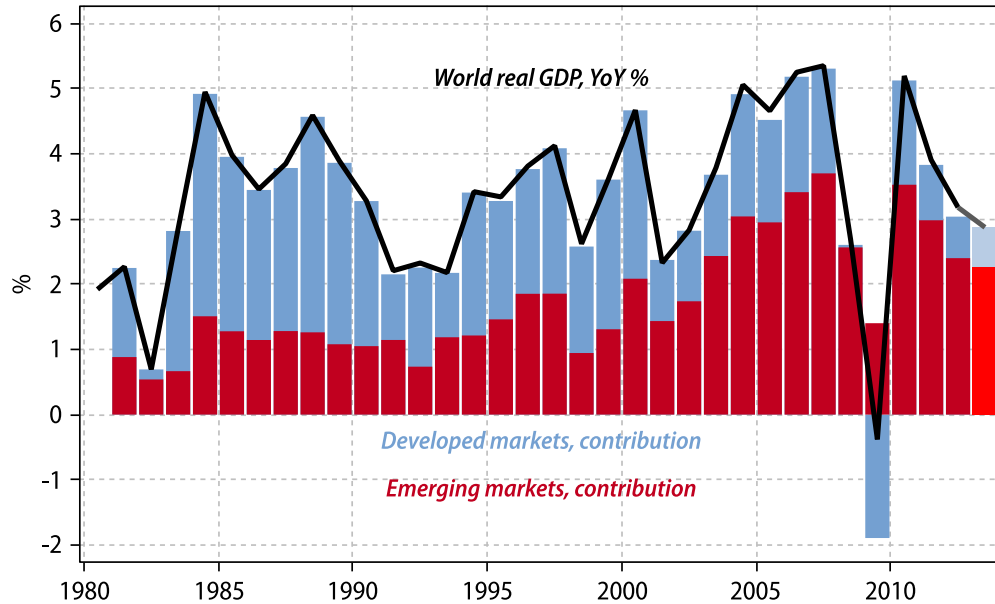
Only India and Poland have successfully achieved material improvements in external positions. The rest are still vulnerable.

The good news is that, despite very rocky EM financial markets, domestic demand has held up very decently.

But this adjustment raises a lot of questions

Emerging markets are the main contributors to global growth today

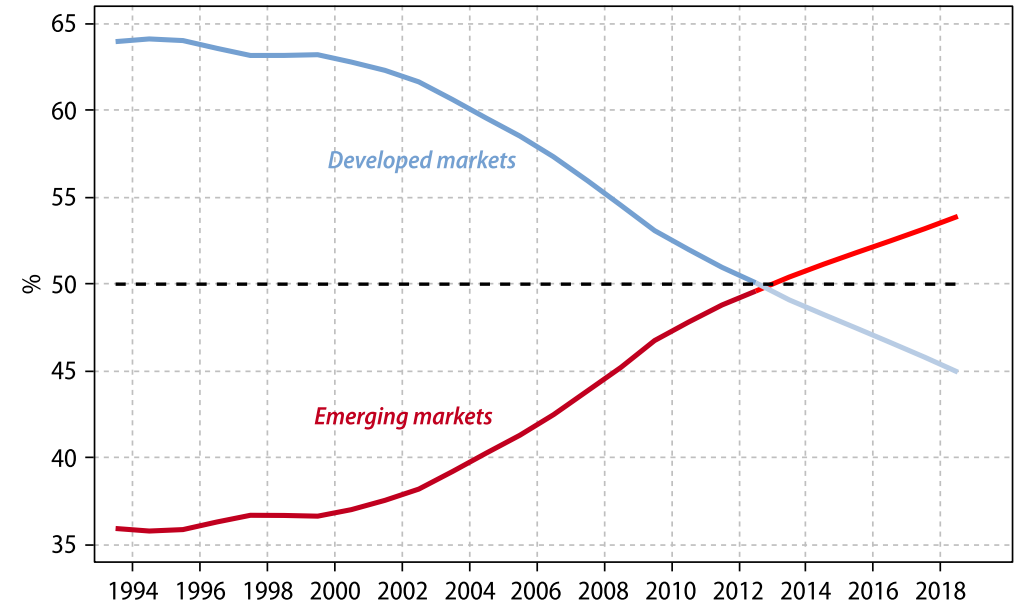
Real growth & contributions weighted by PPP; 2013 = IMF WEO estimate



Gavekal Data/Macrobond

Emerging markets now represent more than half of global GDP

IMF WEO estimates; share of world GDP on PPP basis



Gavekal Data/Macrobond

Emerging markets have become the primary contributor to global growth since the turn of the century (left chart). And now they represent the greatest share of global GDP (right chart).

In the 1980s and even 1990s, emerging markets represented a relatively small share of global GDP (right chart). Meanwhile, global growth rose and fell based on what was happening in developed markets. Since 2001, those roles have reversed.

Developed market growth has been lackluster to terrible. But emerging markets have largely picked up the slack—generally keeping global growth up above 3%.

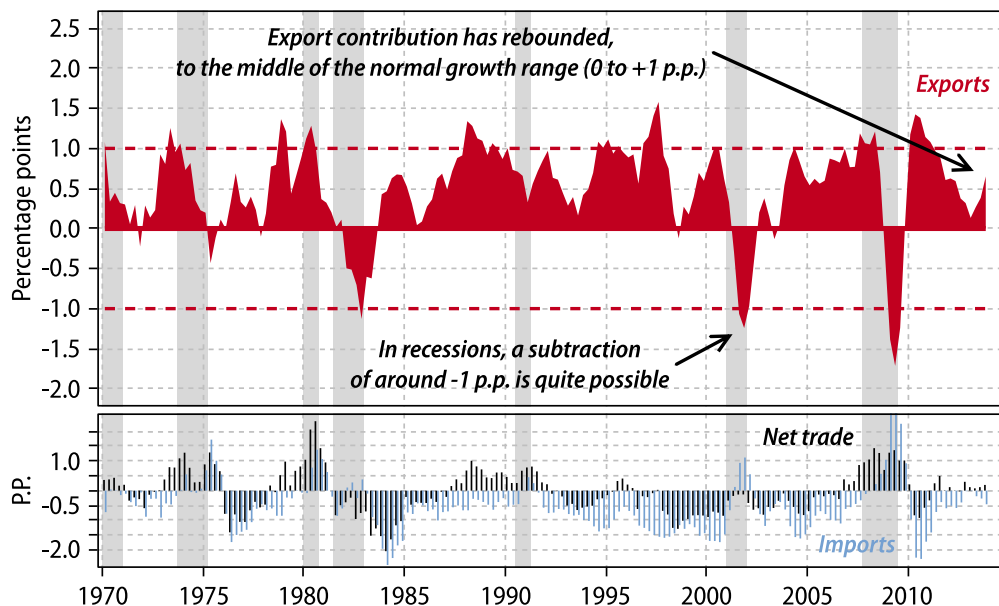
But now emerging market growth is slipping. What does this mean for the world? And what is the impact on the US?

We consider two areas: 1) US exports to emerging markets, and 2) US multinationals' operations in emerging markets.

Exports matter for the US, now more than ever

Exports are a 2 percentage point swing factor for US GDP

4Q moving average; percentage point contributions to real GDP



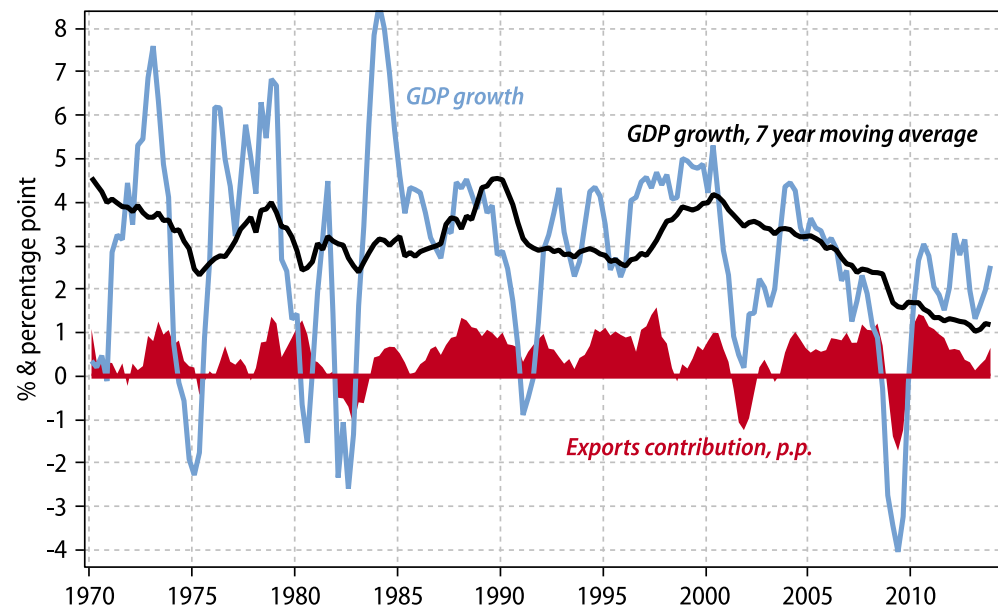
Gavekal Data/Macrobond

Outside of recessions, exports tend to contribute between 0 and +1 percentage point to US GDP growth. During recessions, it can subtract -1pp or more.

That makes exports a significant component of GDP—a 2 percentage point swing factor. Exports matter.

With less domestic growth, exports have become evermore important

4Q moving average; percentage point contributions to real GDP

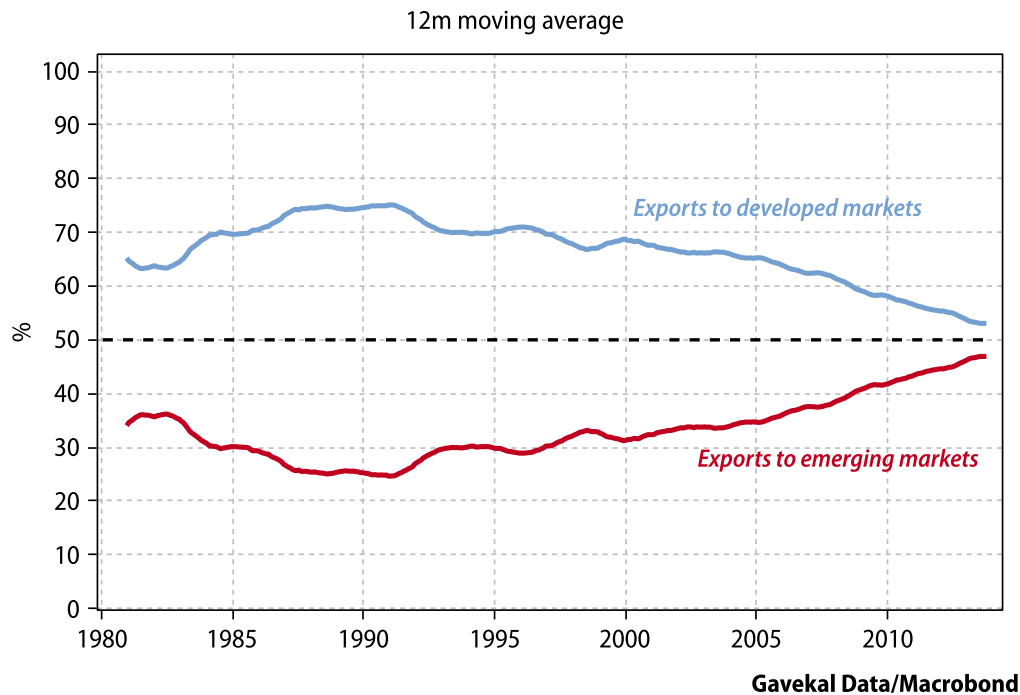


Gavekal Data/Macrobond

And exports matter even more now, with less growth coming from the domestic components. Domestic growth has slowed since the turn of the century, and not entirely because of the cyclical drag of the great recession. With the population having aged, and with the female participation surge having run its course, the US now has to get used to structurally lower growth rates—with the norm probably being closer to 2-2.5%, as apposed to the 3-3.5% norm late last century (see [New Century, New Structural Growth Rates](#)).

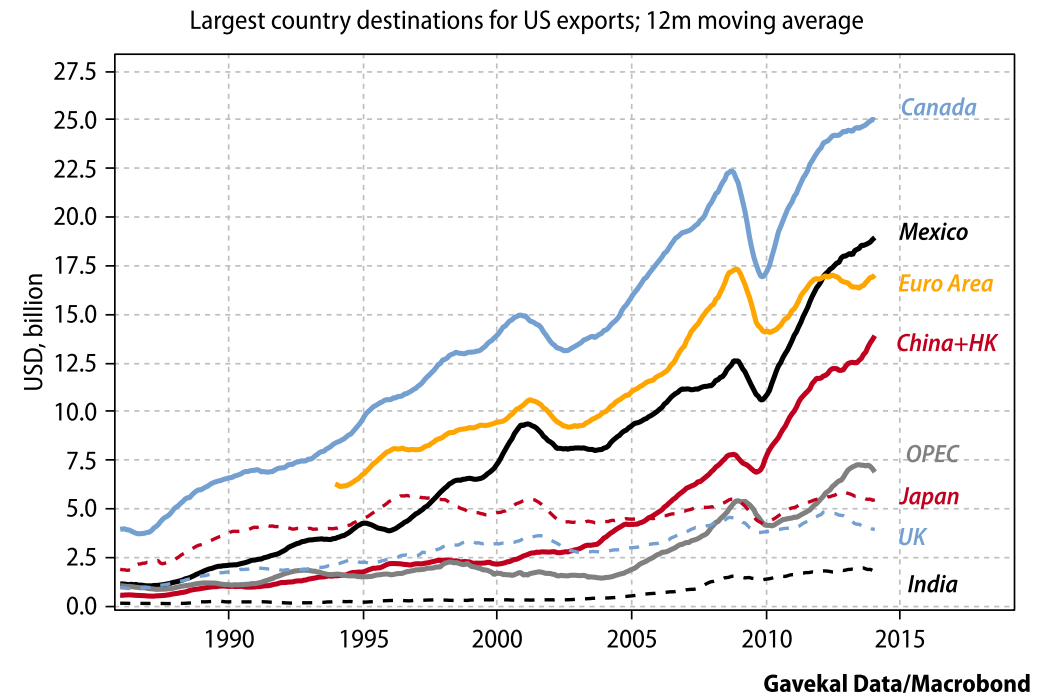
Half of US exports go to emerging markets (much to China & Mexico)

Nearly half of US exports now go to (or at least thru) emerging markets



About half of US exports now go to emerging markets. To be sure, some of this is re-exported, more of it provides capital goods for emerging markets to use to produce consumer goods that are shipped back to the US or other developed markets. So, we cannot conclude from the chart above that half of end demand stems from emerging markets.

A lot of US exports go to (or at least thru) Mexico and China

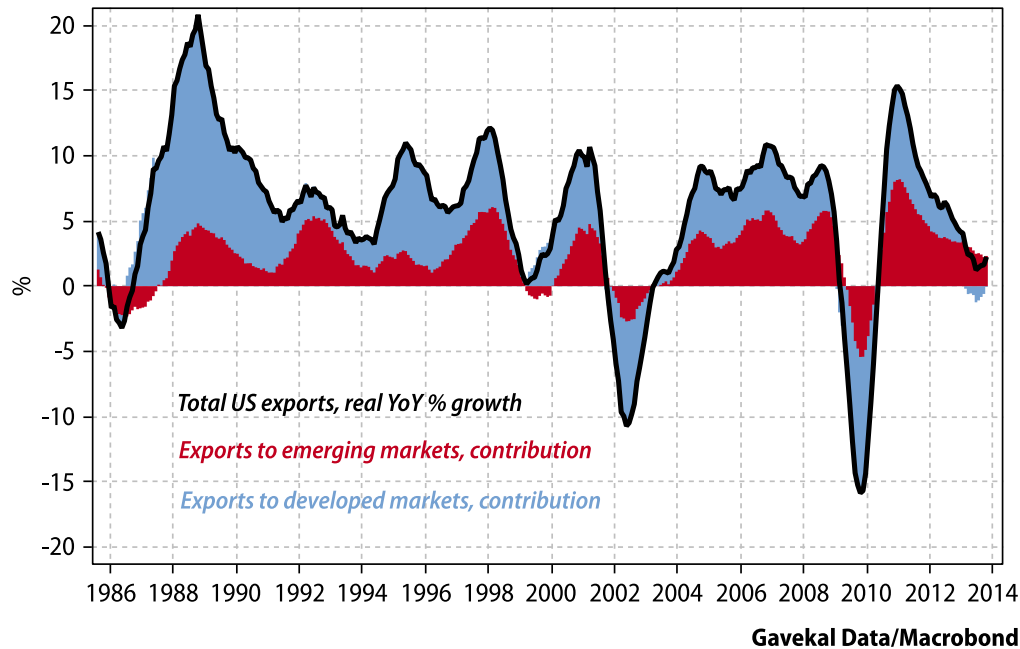


However, when we recall from earlier slides that more than half of world GDP, and well over half of world GDP growth, is now found in emerging markets—it is not a stretch to say that more than half of global demand growth is now found in emerging markets.

DM demand growth has been non-existent; while EM demand is slowing

EMs are a key contributor to US export growth (the only one last year)

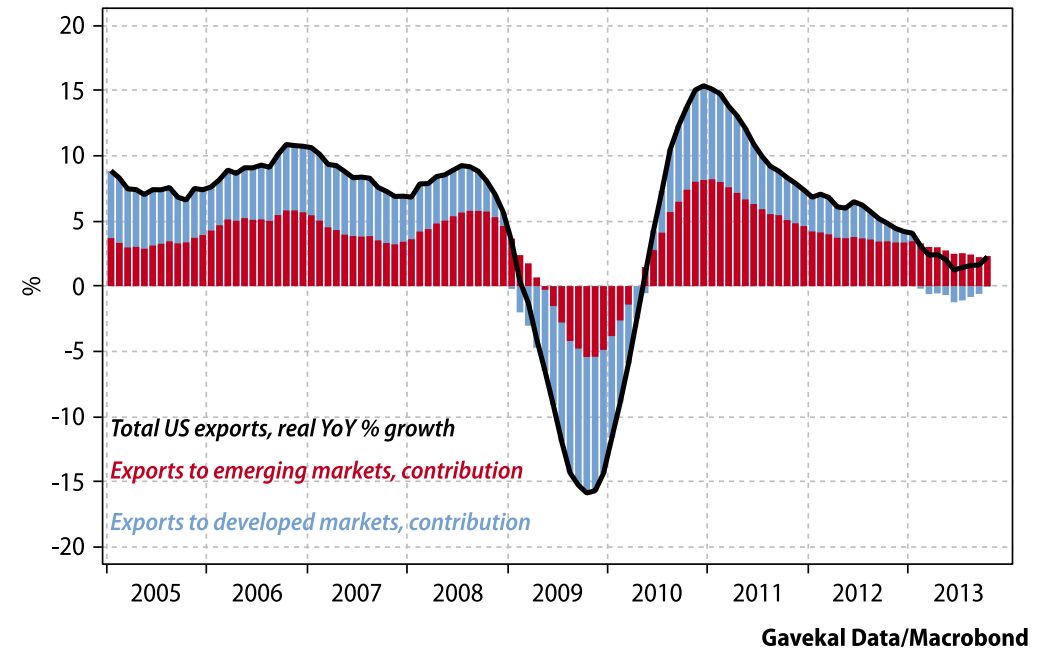
12m moving average; contributions estimated assuming similar export price inflation rates



EM demand growth for US exports has slowed recently. DM demand even contracted last year, but it now looks to have stabilized. This is largely a reflection of the double dip in Europe followed by the more recent stabilization. What is clear is that both EM and DM demand now matters greatly for US export growth.

EM demand is slowing; will DM demand growth return?

3m moving average; contributions estimated assuming similar export price inflation rates



In conclusion, US export growth can add or subtract as much as 1p.p. to US growth—with structural growth now running close to 2%, that's a sizeable contribution. Meanwhile, emerging markets receive about half of US exports and have recently contributed more growth than developed markets. So, if we get a continued decline in EM growth, this will have a material negative impact on US GDP growth—unless developed markets (namely Europe and Canada) can pick up all the slack (doubtful).

How much of this bad news is already discounted?

FIGURE 3

The Price/book ratio for EM stocks is now below 1.5x, levels seen during periods of crisis



Source: Barclays Research, MSCI, DataStream

One important point: not every EM has been a dog with fleas

Different EM currency devaluation trends



Gavekal Data/Macrobond

As we have often highlighted, emerging markets should no longer be viewed as a unified bloc.

The reality is that there are plenty of strong economies in the emerging markets that have actually weathered the storm just fine.

However the receding global liquidity continues to expose the weak-links of the emerging universe, which are usually characterized by vulnerable external positions and irresponsible fiscal policies.

In Asia, there are still some good EM stories

India, Equity Indices, MSCI, Mid & Large Cap, Total Return, USD



Indonesia, Equity Indices, MSCI, Mid & Large Cap, Total Return, USD



Taiwan, Equity Indices, MSCI, IMI (Large, Mid & Small Cap), Total Return, USD



Philippines, Equity Indices, MSCI, IMI (Large, Mid & Small Cap), Total Return, USD



2- Beyond the EM shock, the China slowdown

China is still digesting the 2009-10 credit boom

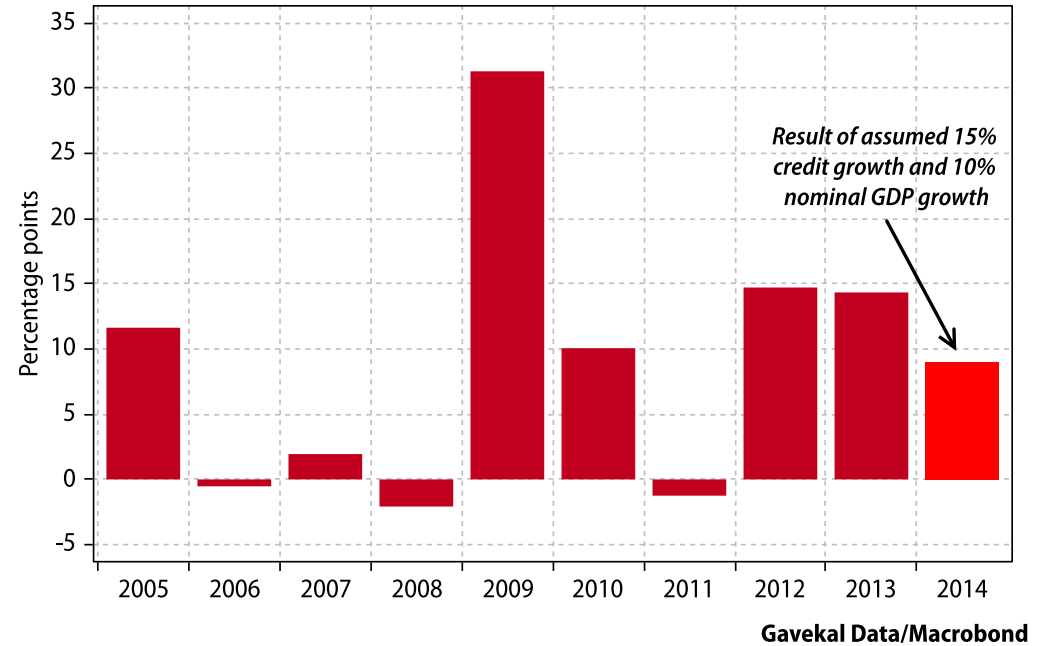
China's credit expansion has cooled substantially since mid-2013

Growth in stock of outstanding credit, by type



China is slowing growth in leverage rather than reducing leverage

Change in China's credit-to-GDP ratio, annual



China's torrid pace of credit growth has been steadily slowing since May 2013, as authorities try to contain the worst excess in the shadow finance system. This sharp slowdown has raised worries that China's allegedly debt-dependent growth will collapse, and that overstrained borrowers will become an increasing burden on the financial system, perhaps triggering a crisis. While growth is clearly going to cool in 2014, we think these worries are overblown.

The pace of credit growth is still quite fast: 17% against 10% nominal GDP growth. And while we do expect credit growth to slow further in 2014, it will do so more moderately—perhaps to 15-16%. This reflects the administration's conviction that debt can be dealt with gradually over time, and that growth also needs to be supported. Indeed, an aggressive deleveraging policy could be counterproductive: if growth falls sharply, credit ratios would rise rather than fall. So 2014 is more likely to see a slowdown in leverage rather than a true credit crunch.

Growth is off to a weak start

Growth readings have softened since end-2013



Given the substantial slowdown in credit already in place in 2013, a lagged impact on growth in 2014 is a given, even if policy does not get much tighter from here. Industrial sector readings and other surveys started cooling off at the end of 2013, and have been largely weak in early 2014.

China's exports are starting off the year much worse than expected

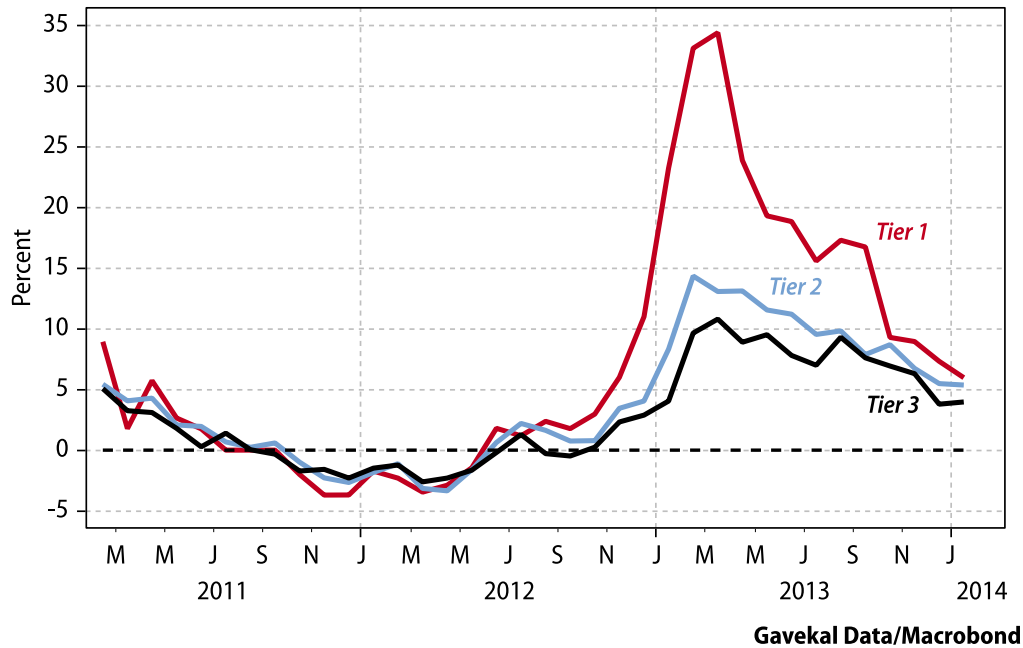


The slowdown is not purely domestic: export growth has been disappointing, particularly relative to what usually reliable leading indicators had signaled. Shorter-term issues like the reduction in export over-invoicing and weak growth in the US during the harsh winter are likely a factor. More worrying for China are structural issues related to slower growth in outsourcing, like the fact that US imports are not rising as rapidly in this recovery as in previous ones.

Real estate is cooling, but a big price shock is unlikely

Prices gains corrected in big Chinese cities and stabilized in smaller ones

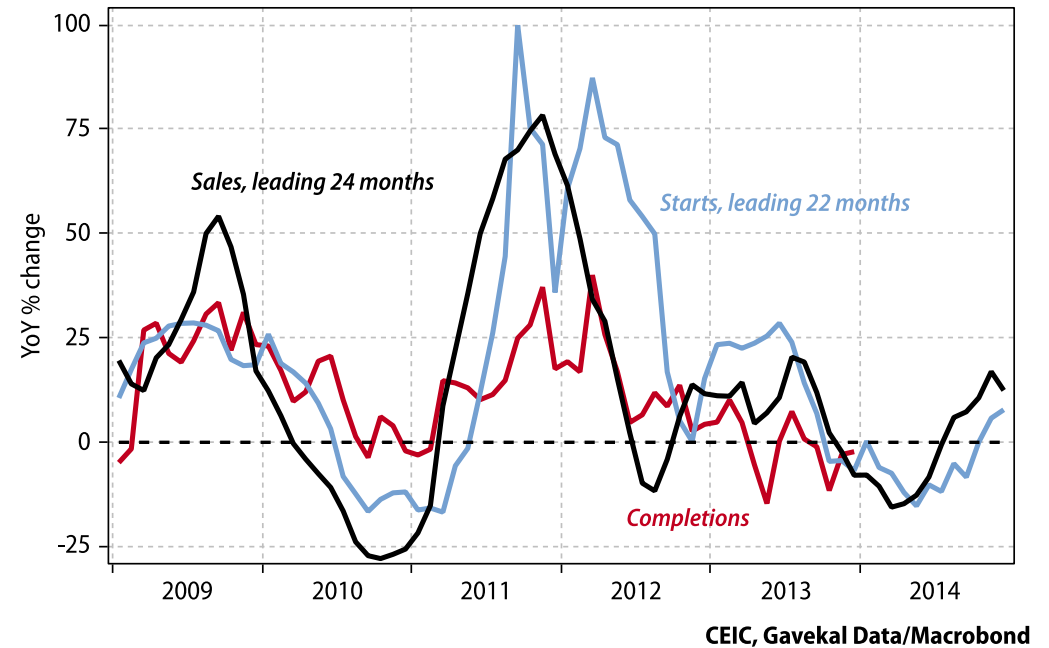
Average annualized MoM change in 70 cities' price index for new housing, by city tier



The momentum of real estate prices has clearly cooled, but this is largely a result of the correction in the excessive and speculative price surge in big tier-one cities (Beijing, Shanghai, etc) early in 2013. The big cities continue to have strong fundamentals and price growth, but there is an overhang of inventories in many smaller cities that will weigh on prices.

Housing completions will contract in 2014, supporting prices

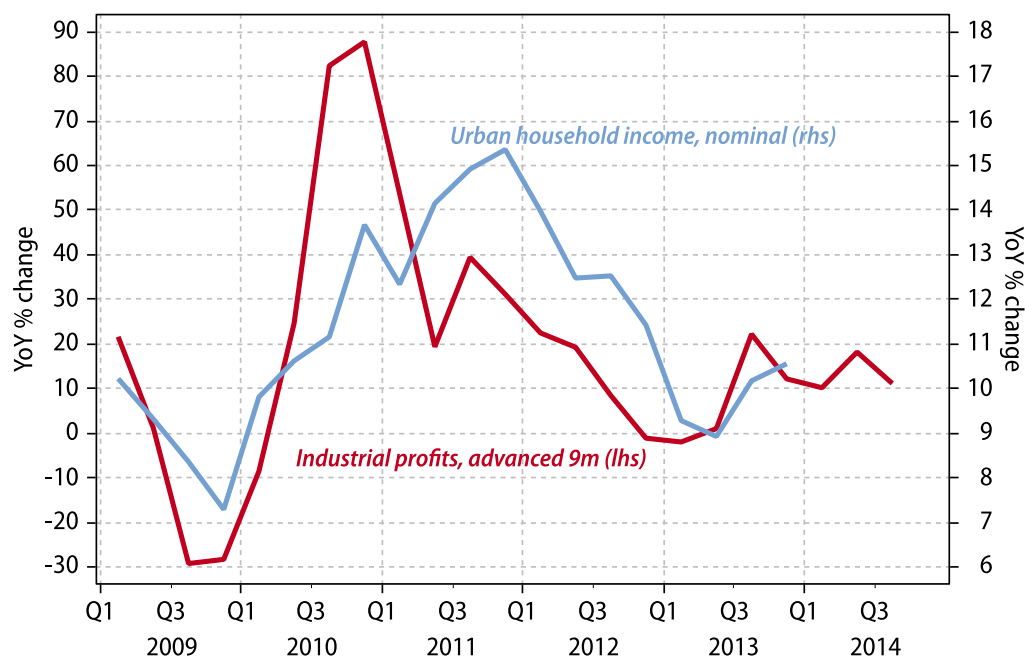
Area of floor space sold, started and completed, 3mma



Supply and demand fundamentals still give some support to housing prices, and government policy has moved away from the crackdowns on housing demand that led to previous price corrections. The supply of newly completed housing will contract this year, a result of weak construction starts in the past, which will help keep markets in balance even with sales growth slowing.

Still, momentum of consumption and investment is decent

China's profit cycle points to decent wage growth in 2014



CEIC, Gavekal Data/Macrobond

The two big components of domestic growth both look to have decent if not spectacular momentum. Household consumption was surprisingly weak in 2013, the effect of sluggish wage growth—itsself the result of the corporate profits crunch of 2012 that left employers feeling ungenerous with raises. The recovery in profitability in late 2013 should make employers more generous this year, and therefore give households more wherewithal to spend.

Private-sector investment is holding up while state-led projects fade

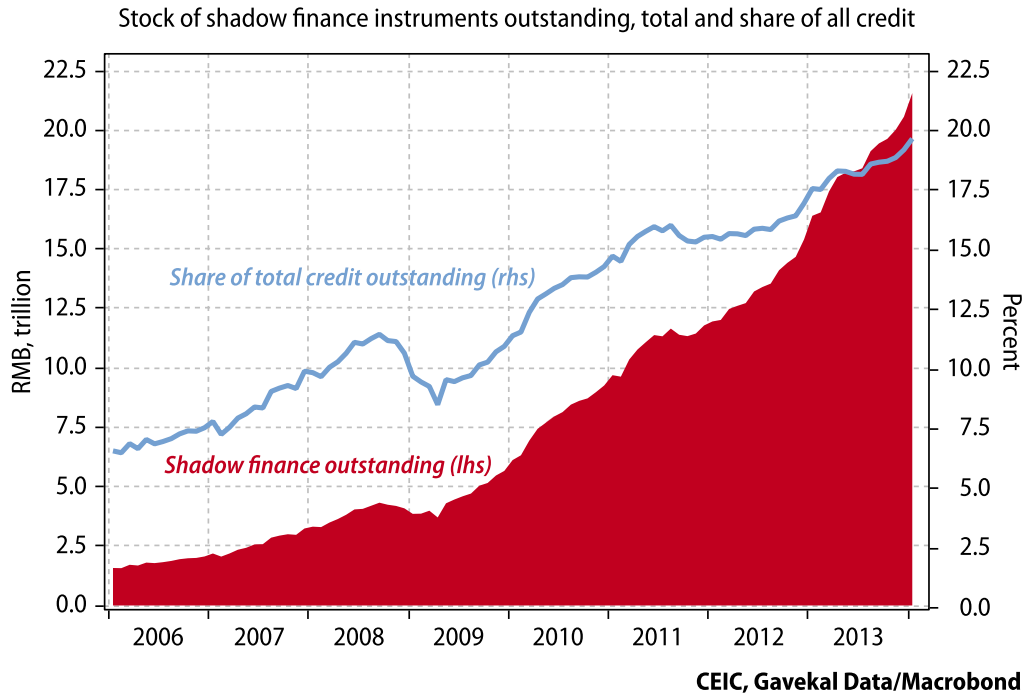


CEIC, Gavekal Data/Macrobond

For investment, the big question has been how well private-sector investment would hold up when the government starts pulling back on infrastructure spending by state enterprises. So far the answer has been surprisingly well, and the government is busy with numerous measures to cut the red tape that impedes business investment and open up previously restricted areas to private firms.

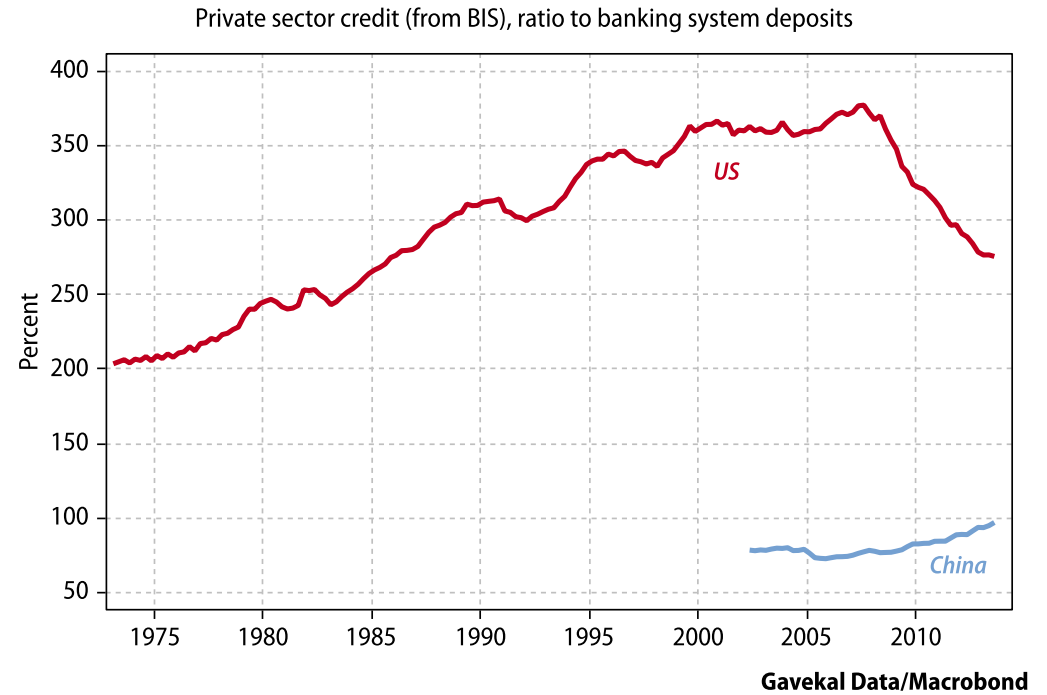
How vulnerable is China's financial system?

China's shadow finance has grown rapidly



While foreign investors' confidence in China's banking system is low, this has not triggered the problems it might in other EM because of a closed capital account, lack of reliance on external funding and state backing of the system. China's "shadow" finance has grown rapidly, and is larger than in many other EMs, but is still small relative to the enormous shadow systems in the US and Europe.

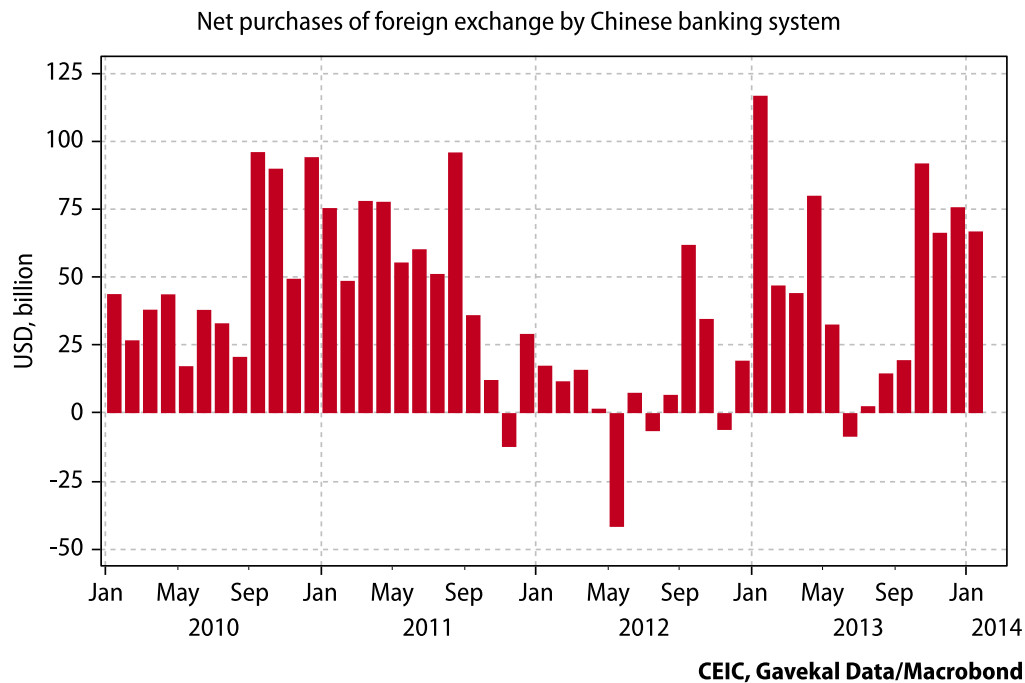
The difference between the funding of US and Chinese credit



Despite the growth in less-regulated credit, total credit in China remains fully funded by domestic deposits, a sharp contrast to the pre-crisis US. Lending practices for shadow finance are not substantially different than for regular loans and do not involve true securitization. The explosion in debt over the last few years has clearly put strains on China's financial system, but there are few obvious triggers for a financial crisis.

Interestingly, strength of capital inflows has worried the central bank

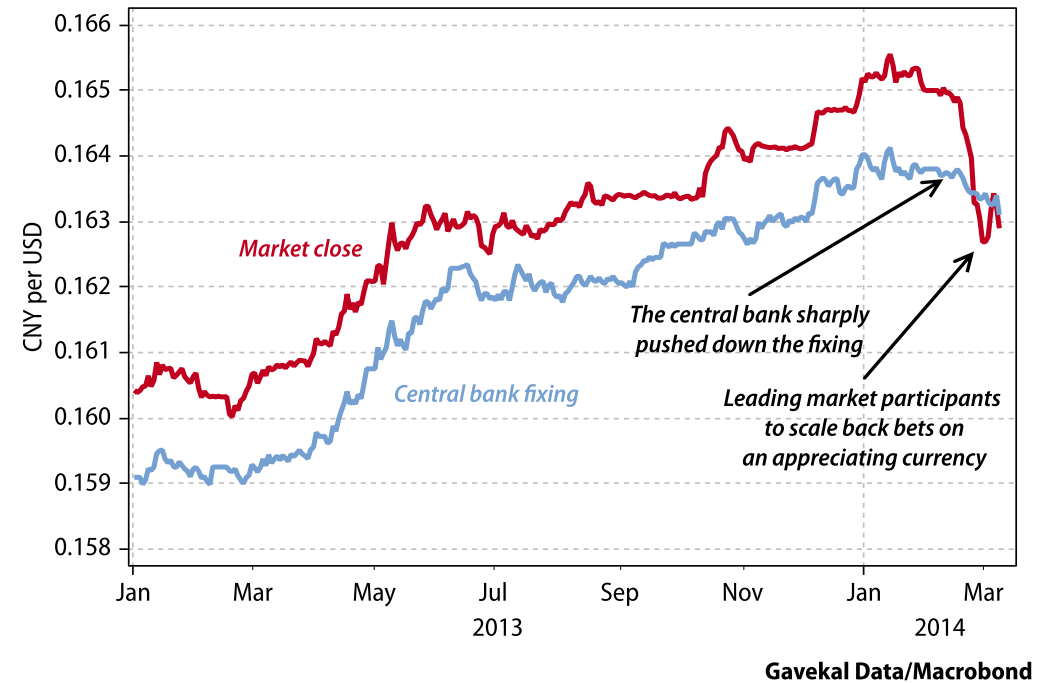
Capital inflows have been strong despite signs of slowing growth



But rather than fleeing the country in anticipation of a growth collapse, capital has actually continued pouring into China—perhaps because it is seen as a relative safe haven given the political and economic turmoil in other EMs.

These capital flows apparently triggered a dramatic change of course from the central bank, which engineered an -1.4% decline in the renminbi in February.

The central bank pushed back against CNY appreciation expectations

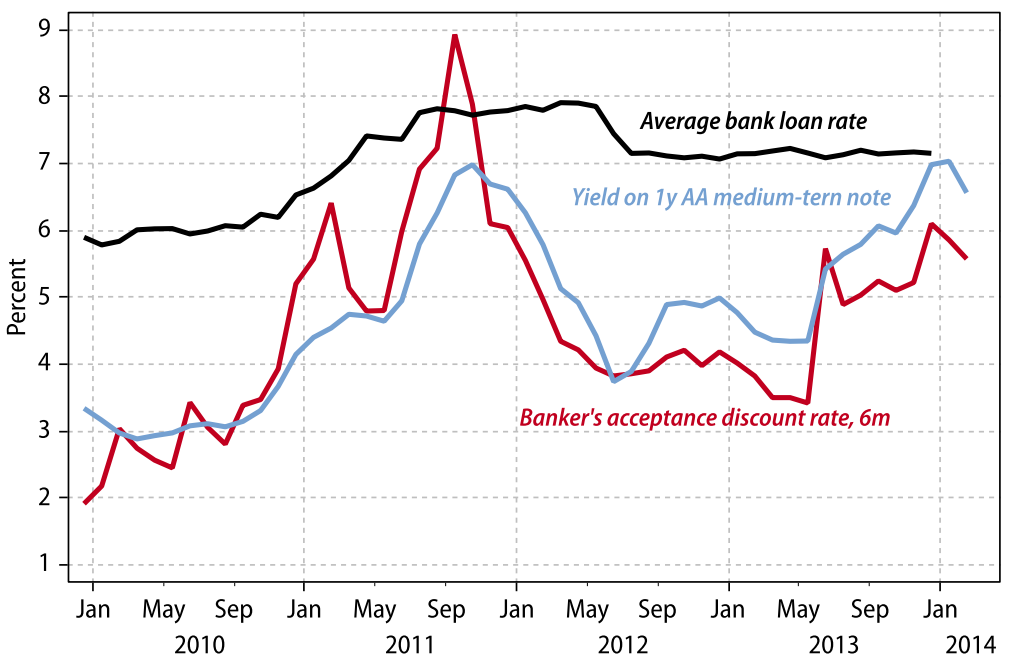


This helped shake out expectations of entrenched currency gains. But this is not a prelude to extended currency depreciation, simply because

- 1) Boosting low-value added exports has never been the top priority of China's currency policy, and
- 2) Entrenching expectations of depreciation would be very damaging, encouraging capital flight among other problems.

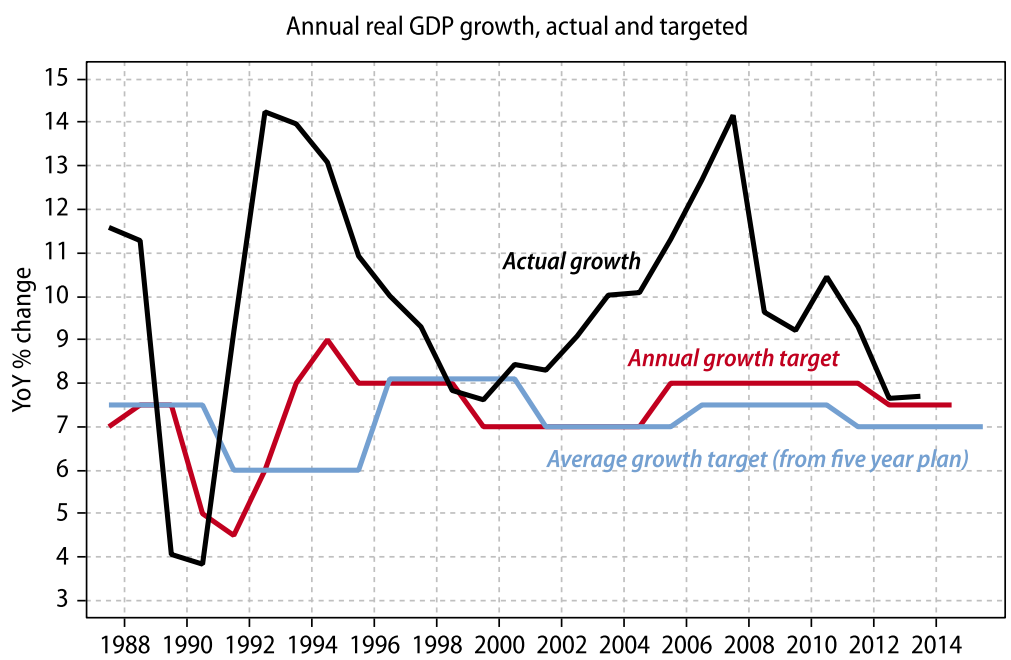
Policy is not excessively hawkish, and has been turning more dovish

Higher funding costs mostly hit shadow finance, not bank loans



CEIC, Gavekal Data/Macrobond

China is keeping growth targets steady to maintain confidence



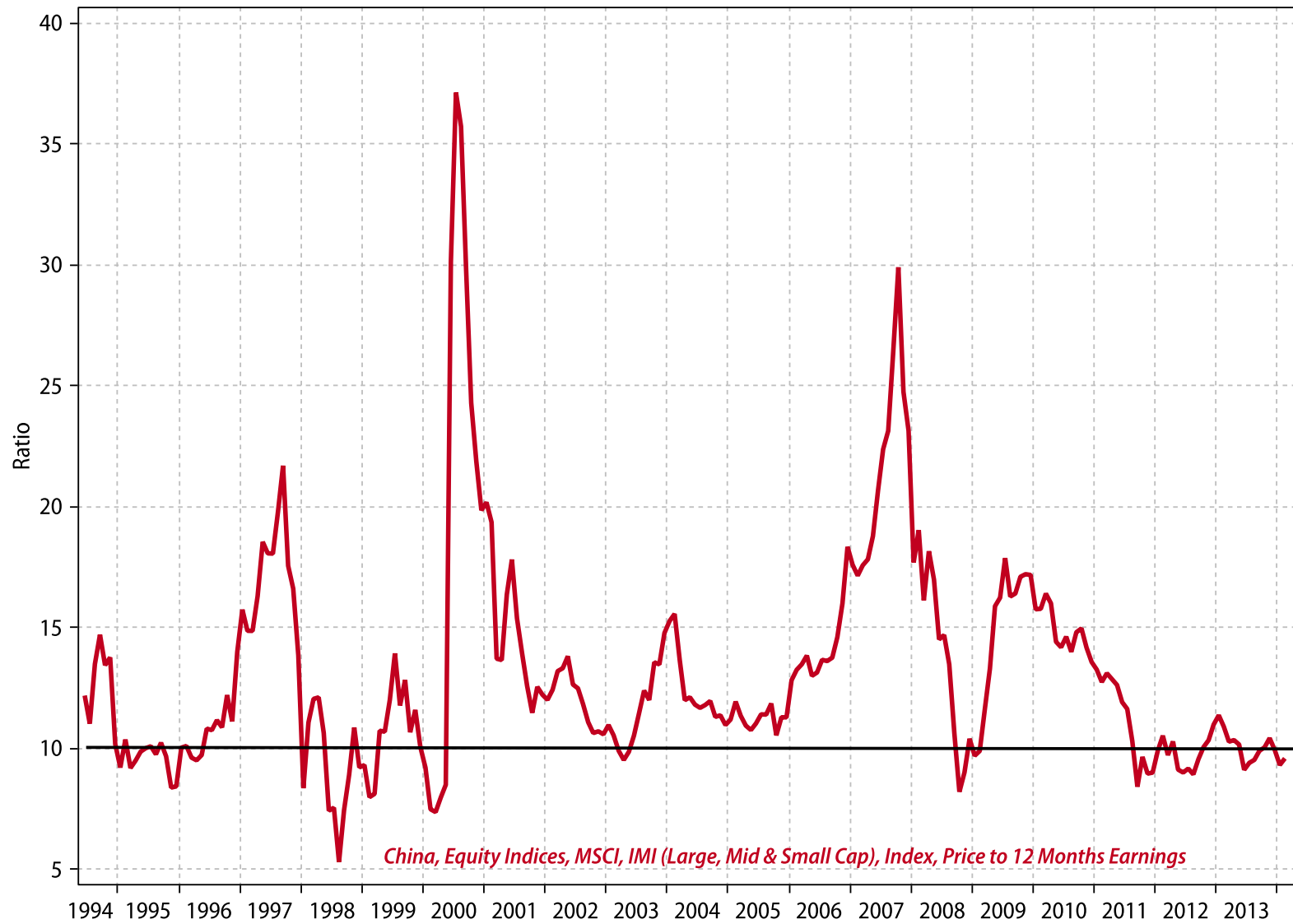
Gavekal Data/Macrobond

While 2013's repeated squeezes on the interbank market grabbed lots of headlines, the impact on the real economy has been more moderate. This is as intended: the central bank's main concern is financial system stability rather than rising inflation or overheated growth. Borrowing costs for official bank loans have remained essentially unchanged for months; market-driven funding for short-term debt have come up more substantially, but are already easing.

Policy signals at the start of 2014 have favored growth more than austerity: January credit flows were surprisingly strong, interbank interest rates have come down sharply from their recent peaks, and the official GDP growth target was kept unchanged at 7.5%. While many criticized the target as unrealistic for 2014, on past experience the target can actually have a big effect on domestic growth expectations.

How much of this bad news is already discounted?

Buying China below 10x PE has worked every time except past 3 years

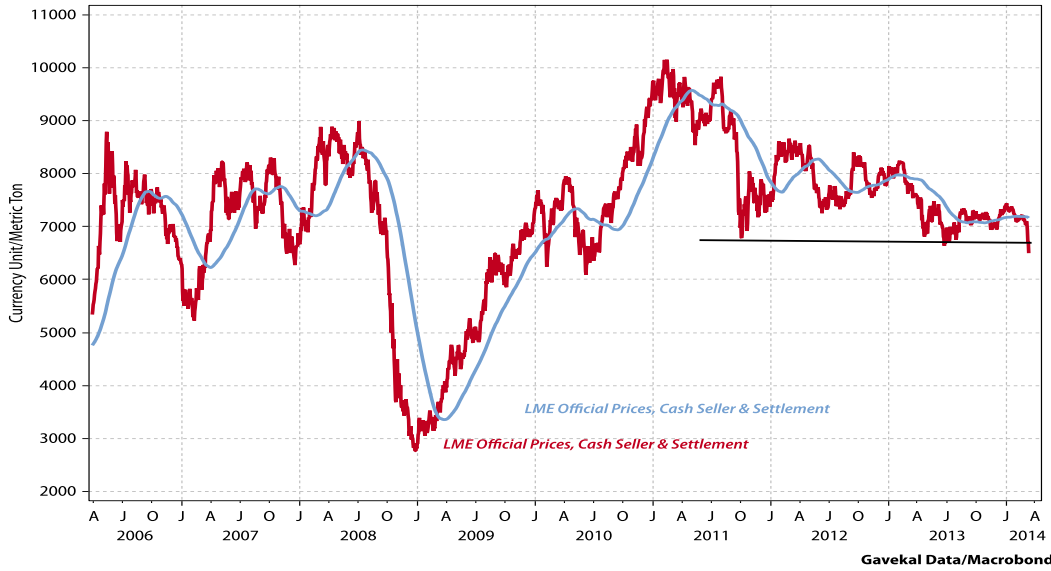


Gavekal Data/Macrobond

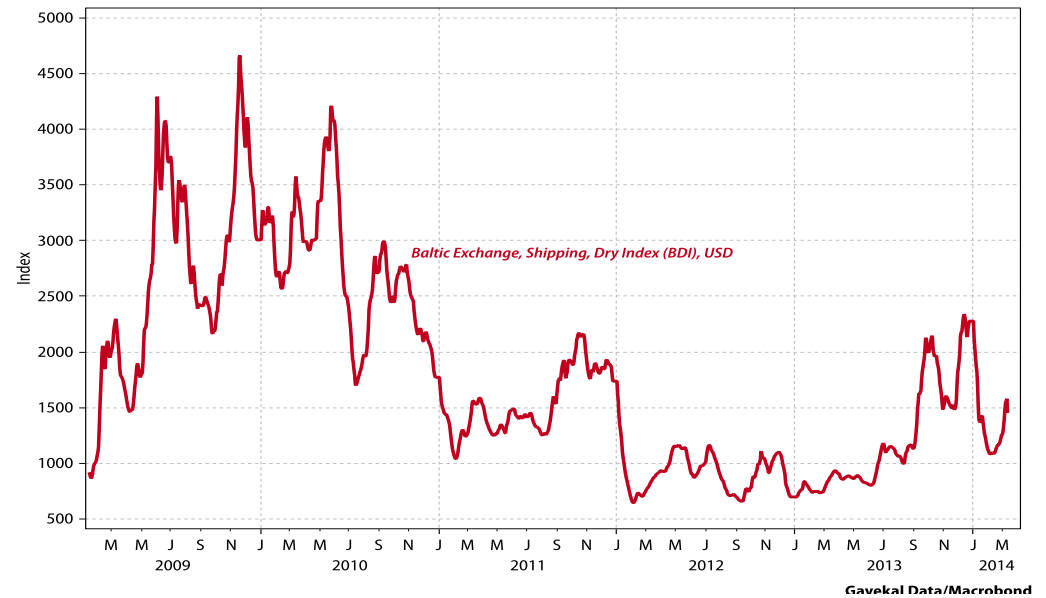
3- Should we fear another deflationary shock?

Does the EM + China slowdown represent a deflationary shock?

Copper breaks down



Baltic Dry index under pressure



China, Iron Ore, Average Imported Iron Ore CIF Price, CNY

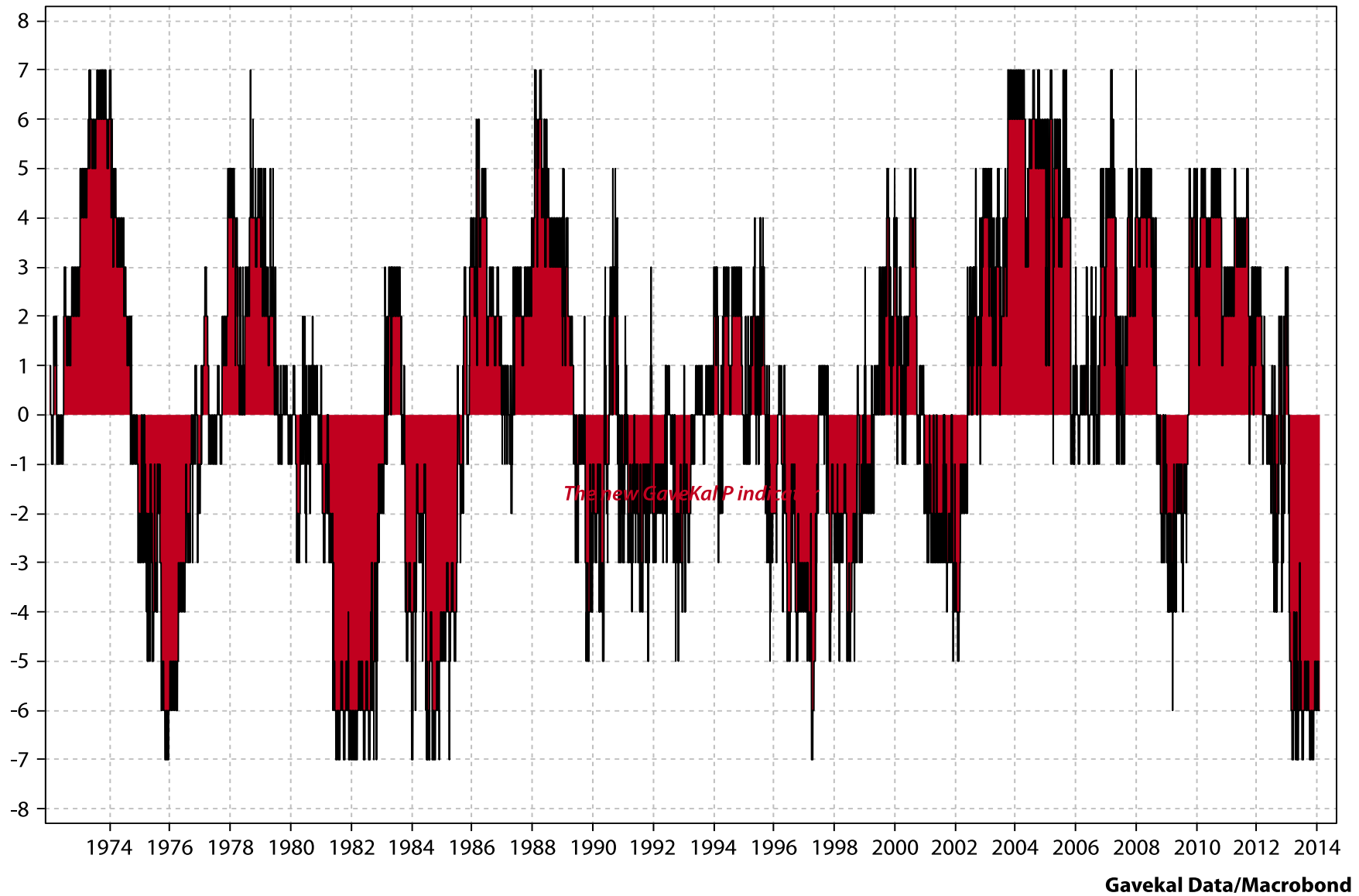


Crude Oil, WTI, Global Spot, Close, USD



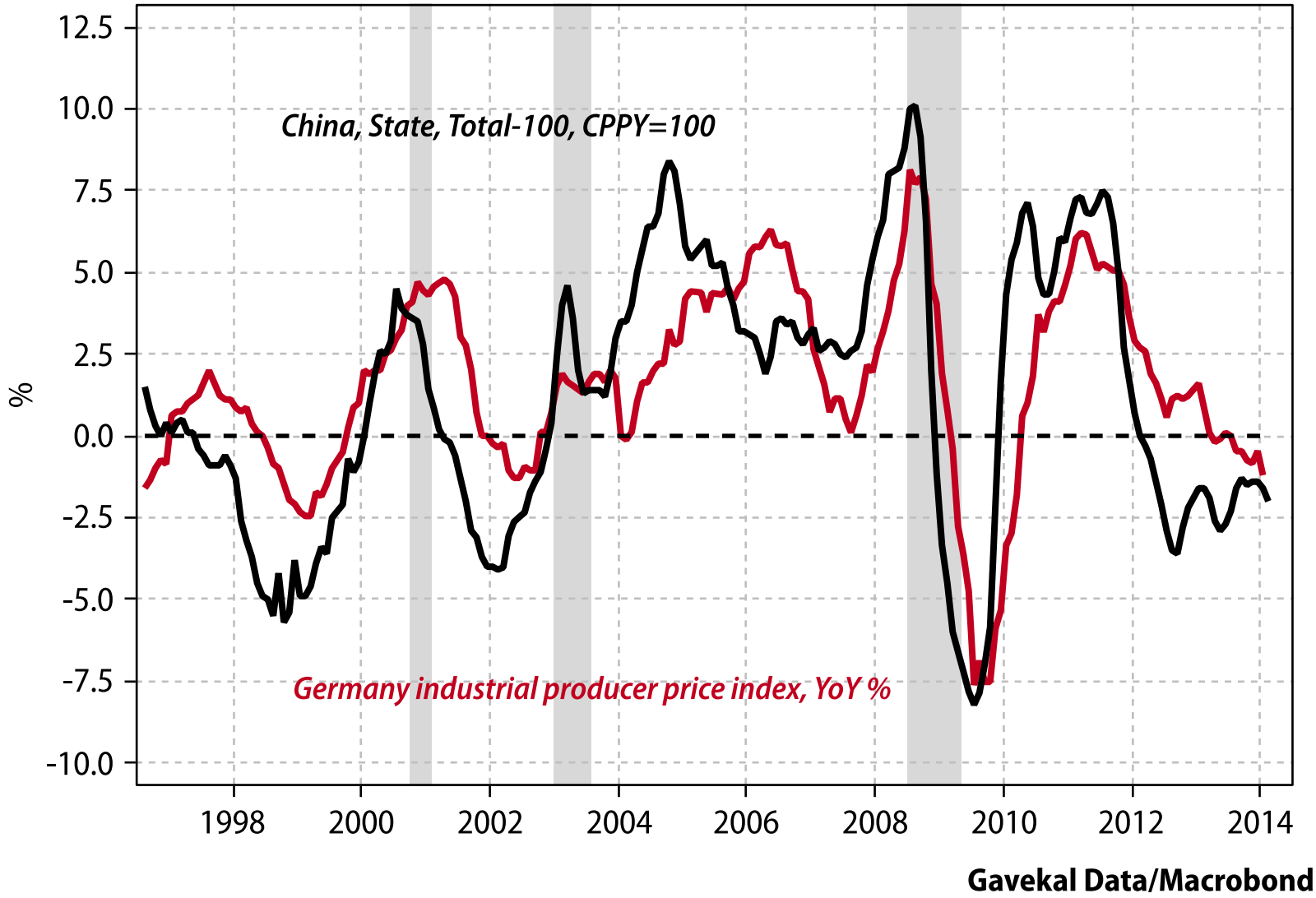
Already, global inflation is very weak

The new GaveKal P indicator



Falling PPI in industrial powers at this stage in the cycle is surprising

China and Germany PPI, YoY % Change



The inflation-deflation debate

Deflationary

Cyclical

- Weak US money growth
- Weak EMU money growth
- Weak EM money growth
- Negative loan growth in Euroland
- Weak loan growth in EM
- Weak global trade
- Falling industrial commodities
- Weak Yen
- Weak RMB
- Weak EM currencies
- Weak EM demand
- Japan restarting nukes

Structural

- Robotics/Automation
- Industrialization of emerging markets
- Higher value-added of Chinese exports
- Ageing labor force in Western world
- Shale gas revolution
- Zombie companies stay alive
- Companies buy back stocks rather than invest

Inflationary

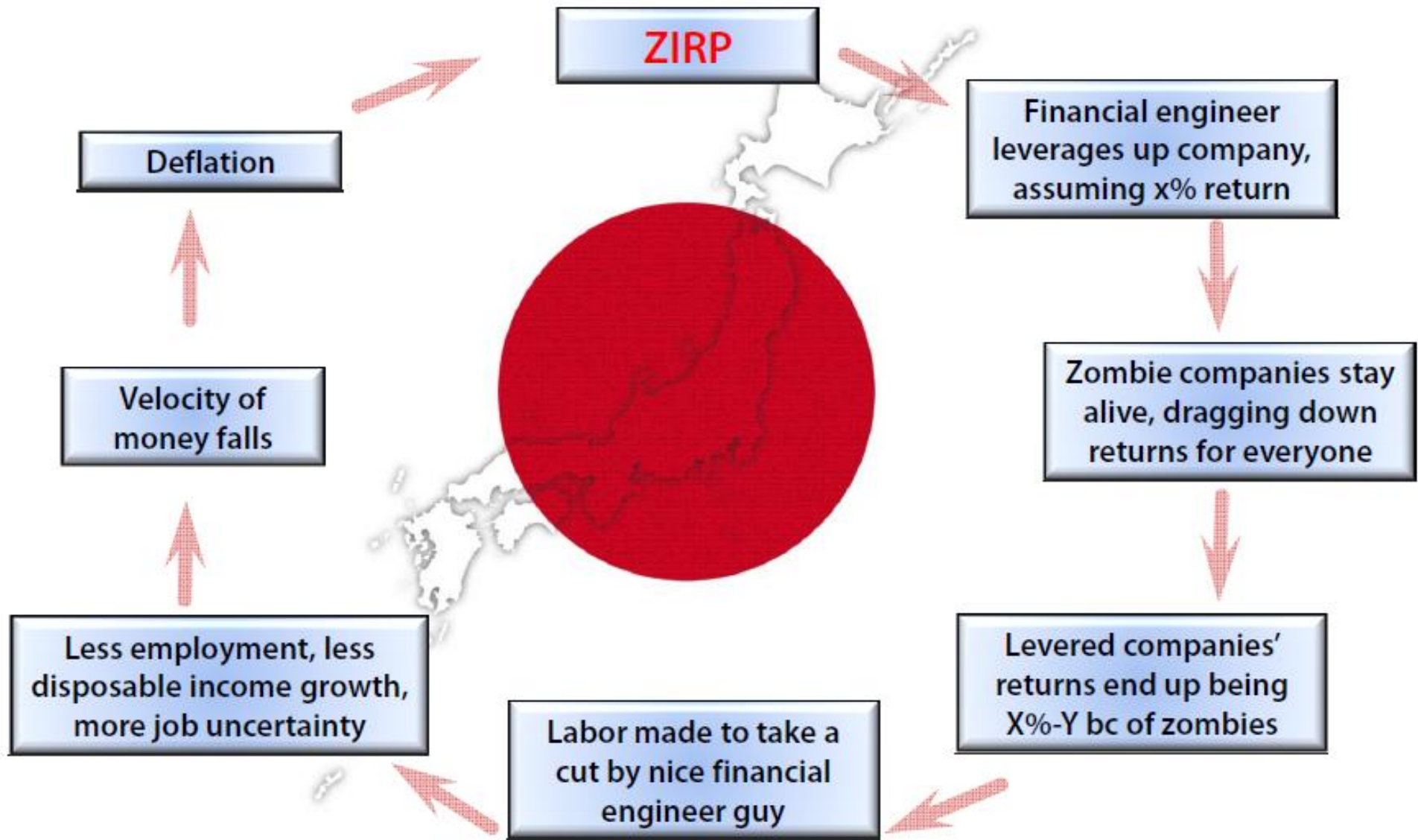
Cyclical

- Higher agricultural prices (California drought)
- Pick-up in US loan growth
- US labor costs moving higher
- Japanese wages moving higher
- Chinese wages moving higher
- Japanese capital bidding up assets everywhere
- Global growth on the mend?

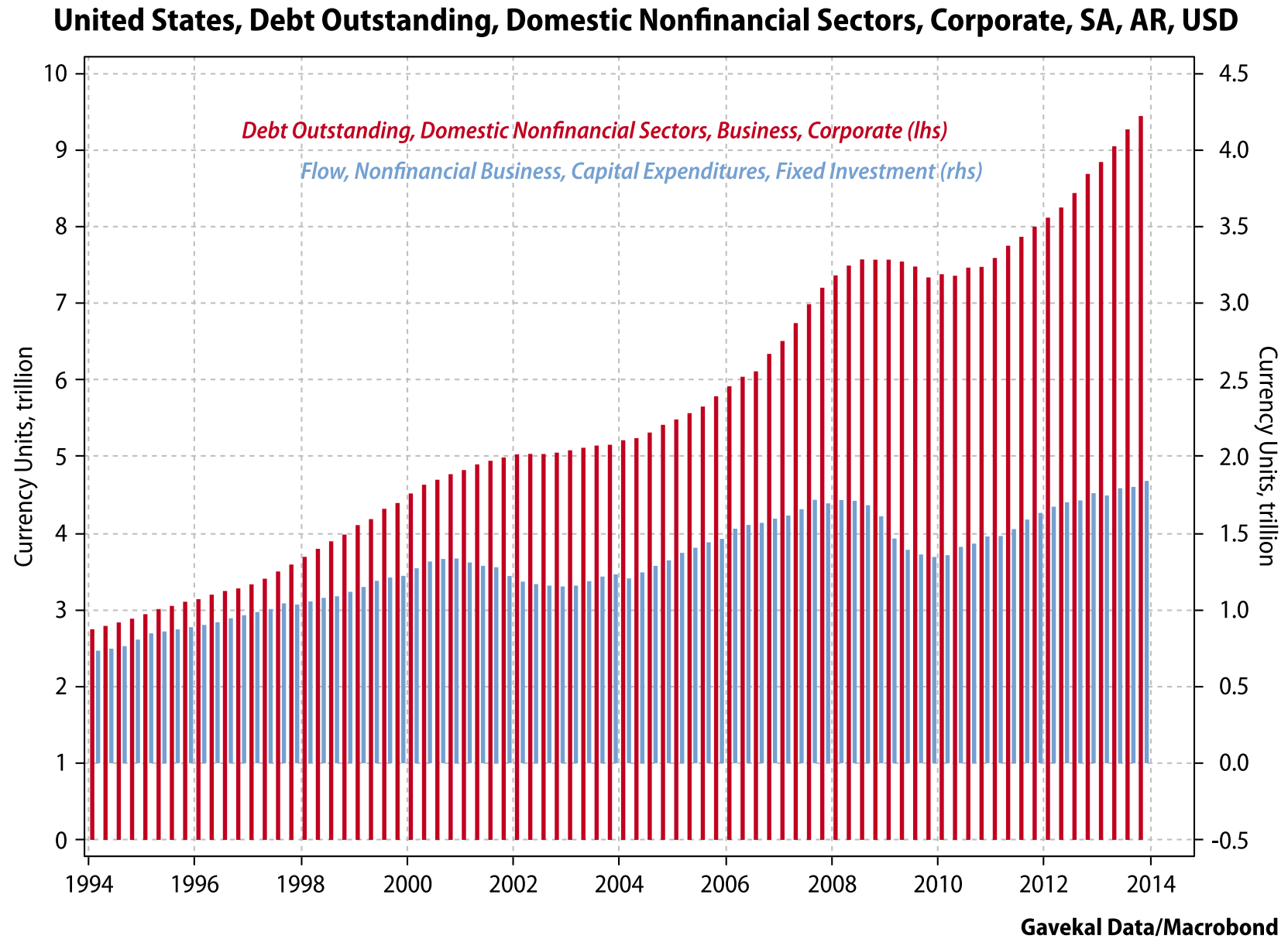
Structural

- Uber-dovishness of central banks

Is ZIRP inflationary? Or deflationary?



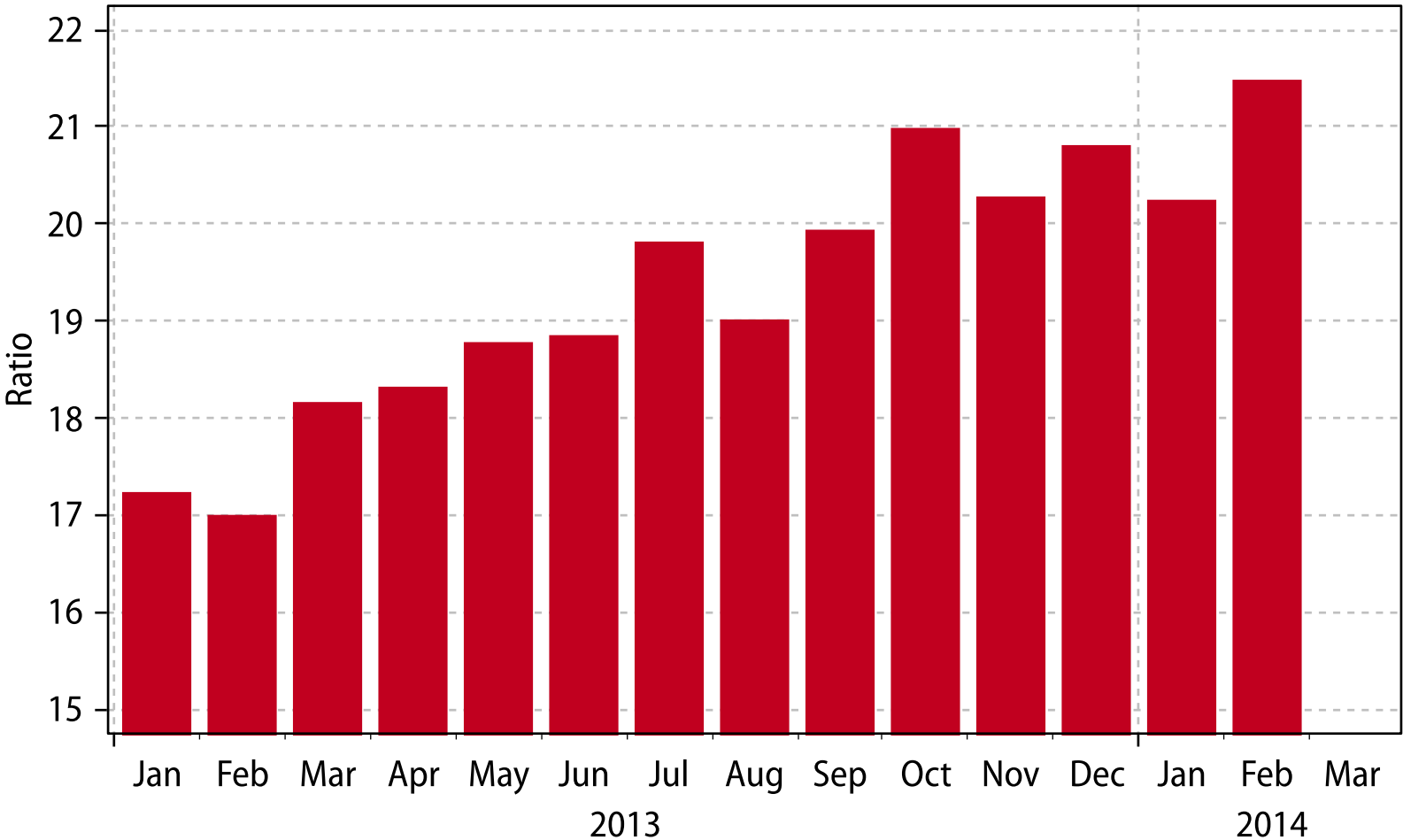
We have witnessed a big increase in debt... without any increase in capex



Has the debt increase financed productive investments? Or higher valuations?

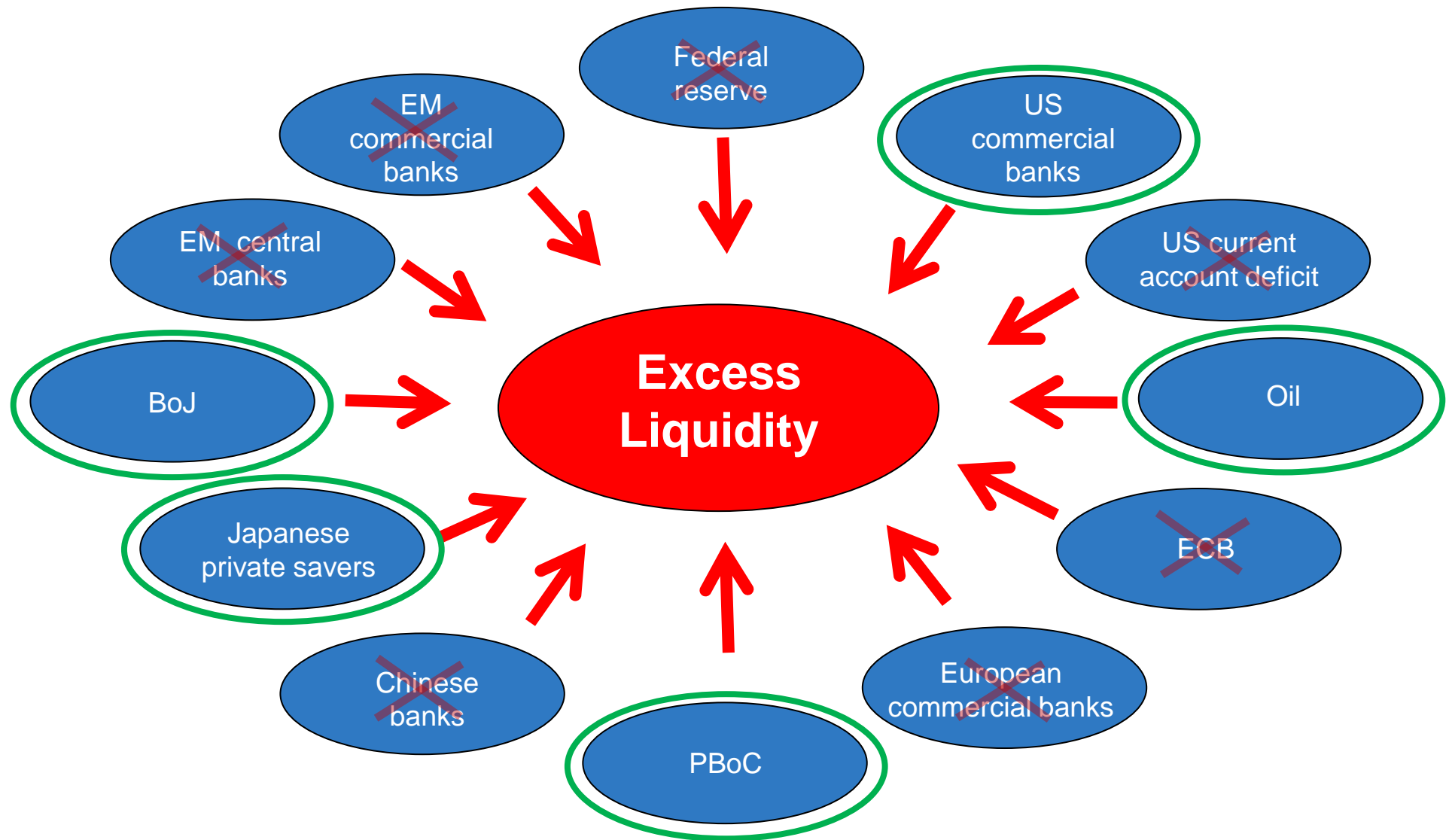
Powerful P/Es

MSCI US mid & large cap equally weighted index P/E ratio



Gavekal Data/Macrobond

Where will the excess liquidity come from to push markets higher?



4- Structuring a portfolio in this environment

Investment conclusions

- **The global deflationary risk is still present.** As such, maintaining some fixed income, or high dividend yielding stocks, in portfolios, if only as a hedge, makes sense.
- **Another key risk for portfolios is a squeeze higher on the US\$.** Right now, with ZIRP, QE and Janet Yellen, this risk may seem remote. But given the improvements in the US trade picture, the pick-up of US growth, and the continued ability of the US to attract the marginal US\$ of investments.
- **Chinese growth is slowing, but the economy is not imploding.** Dips in the RMB are to be bought and the distressed valuations of Chinese equities (China is the only major market to have registered negative returns over the past five years) offer terrific opportunities for the patient investor.
- **The emerging market slowdown is very real** – and will be a drag on global growth. Still, within the emerging market sphere, Asia looks relatively the best. So if/when fund outflows out of EM abate, Asia should be able to find its footing.
- **There are a number of interesting investment stories unfolding in Asia:** India's elections should lead to renewed investor interest. The birth of domestic consumer classes in the Philippines and Indonesia are encouraging developments, etc...
- **Japan is a key uncertainty.** Second quarter should be disappointing, only to bounce back in the second half of the year. Will the market look through? Or get spooked? Whatever happens, one thing we can count on is for the BoJ to keep printing aggressively.

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