Global Equity Strategy

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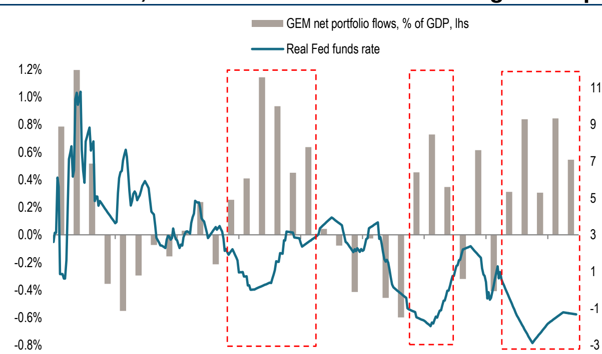
STRATEGY

Emerging markets: what is better and what is worse than in 1997?

This report compares the current bout of emerging market weakness with the Asian crisis in the mid-1990s:

- **What is the same?** In both cases, a global growth recovery is led by developed markets (US and Europe) against the backdrop of a stronger dollar, a falling yen and weaker commodity prices – all factors that hurt GEM. Furthermore, in both cases abnormally low real Fed Funds rates have led to large GEM portfolio inflows (4% of GDP in the early 1990s, compared to 3% of GDP now), pushing up leverage and turning current account surpluses into deficits. As US real rates start rising, portfolio flows reverse, leading to falling asset prices and currencies as well as weaker growth.
- **What is better?** GEM FX-denominated debt is lower (25% of GDP, cf. 40% in the 1990s), FX reserves are higher (30% of GDP, cf. 10% of GDP in the 1990s), current deficits are smaller (ex China, 2% of GDP in 1997, cf. a 1% peak in the current cycle), GEM GDP growth has already slowed by a third, to 5% (whereas prior to the Asia crisis, it was running at a 10-year high) and oil prices are unlikely to fall as much as they did in the 1990s.
- **What is worse?** Private sector leverage is higher (15% above trend cf. 5% in 1997, especially in China), labour markets are tighter, demographics are worse and emerging markets more exposed to a slowdown in China.
- **Conclusion:** While the macro drivers underlying the current turmoil are similar to those in the mid-1990s, GEM fundamentals look modestly better. Consequently, valuations should trough at higher levels than they did in the late 1990s (a 10-15% discount to global markets on a sector-adjusted P/B, compared to a 40% trough discount back then and parity now; see our report *GEM: when is it time to buy?*, also published today). The GEM slowdown is unlikely to lead us to alter our positive stance on equities – unless Chinese GDP growth falls below 5% or the RmB devalues by 10%+.

Figure 1: As in the 1990s, low US real rates have led to high GEM portfolio inflows



Source: Thomson Reuters, Credit Suisse research

Table of contents

Emerging markets: what is better and what is worse than in 1997?

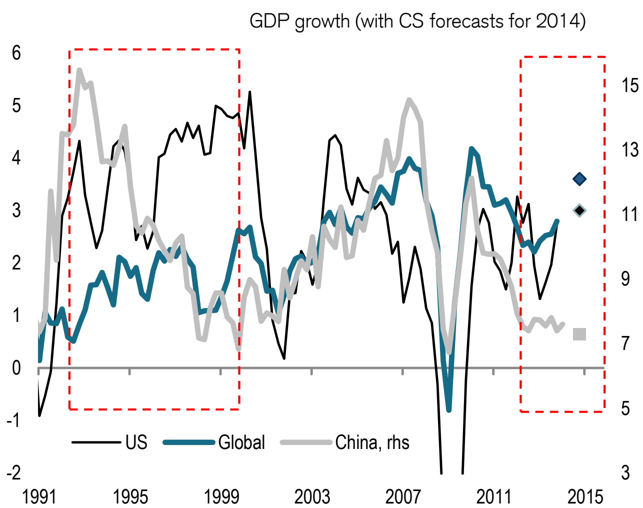
We think there are important structural similarities between the macro environment in the run-up to the Asian crisis and the current situation. However, there are also important ways in which emerging markets look less vulnerable this time around. We discuss these similarities and differences in detail below.

A similar global macro backdrop

We believe the current global recovery is in many aspects similar to that during the mid-1990s. In particular, the 1990s recovery featured:

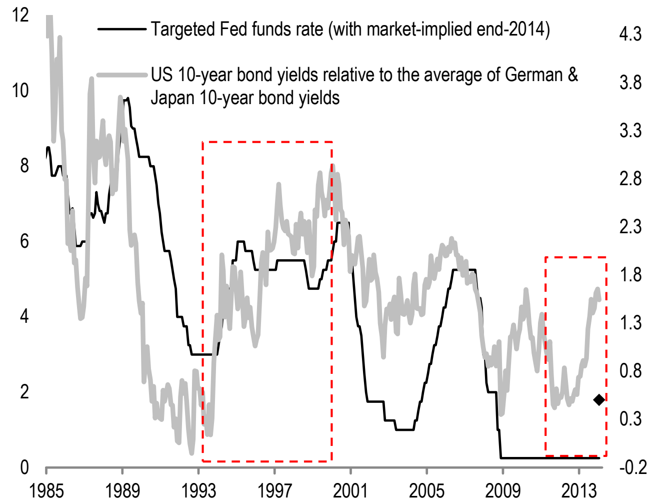
- **A US-driven global recovery** against a backdrop of a slowdown in Chinese growth (although a crucial difference is that China in 1994 was 5% of global GDP on PPP, compared with 15% now);

Figure 2: **In the mid-1990s – as now – the acceleration of global growth was driven by the US, while Chinese growth slowed**



Source: Thomson Reuters, Credit Suisse research

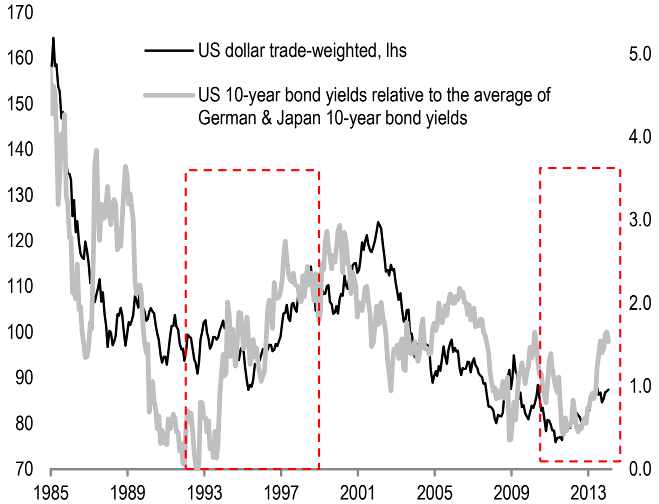
Figure 3: **In the mid-1990s – as now – US bond yields were rising relative to those of its trading partners, as the Fed entered a tightening cycle**



Source: Thomson Reuters, Credit Suisse research

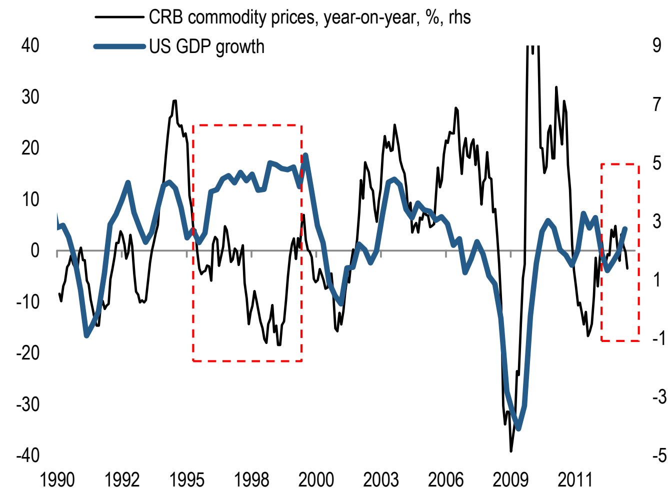
- **A Fed tightening cycle** at a time when European and Japanese interest rates remained subdued, leading to a rise in US bond yields relative to those of its trading partners – and, hence, **a strengthening of the dollar**.

Figure 4: **In the mid-1990s – as now – a relative rise in US bond yields led to a strengthening of the dollar**



Source: Thomson Reuters, Credit Suisse research

Figure 5: **Then – as now – commodity prices are declining even as growth accelerates**



Source: Thomson Reuters, Credit Suisse research

- **Falling industrial commodity prices**, against the backdrop of a strengthening dollar and a US-driven recovery that is far less commodity-intensive than those during the Chinese-investment-driven cycles over the past 15 years. The year-on-year change in industrial commodity prices was negative for most of the period between early 1996 and 2000, just as it is now (although, as we point out on page 12, the outlook for the oil price is better now).

The upturn in global economic momentum in the mid-1990s was the only one over the past 20 years (before 2012) during which commodity prices fell.

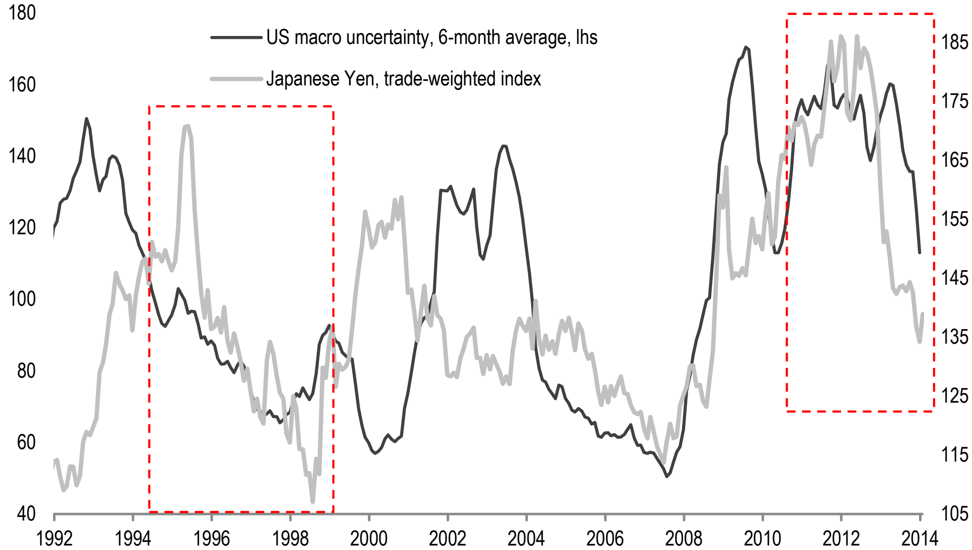
Figure 6: **Commodity prices fell during the upturn in global economic momentum between 1995 and 1997**

Period		Trough in EM relative to trough in PMI (months)	Peak in EM relative to peak in PMI (months)	Change in EM price relative (trough to peak in PMI)	Annualized change in EM price relative	Change in commodity prices (trough to peak in PMI)	Annualized change in commodity prices
Jun 95	May 97	5.5	-12.6	-10.9%	-5.7%	-0.6%	-0.3%
Nov 98	Nov 99	2.9	3.2	39.2%	39.2%	13.0%	13.0%
Oct 01	Jun 02	0.2	1.7	42.8%	64.2%	6.4%	9.6%
Mar 03	Jan 04	-2.5	3.3	54.3%	64.7%	8.6%	10.2%
May 05	Feb 06	-10.5	3.1	46.1%	60.9%	19.3%	25.6%
Dec 08	Aug 09	-1.1	2.8	58.3%	87.5%	10.5%	15.7%
Jul 12	Jul 13			6.8%	6.3%	-0.8%	-0.7%
Average/median		0	3	33.8%	45.3%	8.1%	10.4%
Avg. performance (1995 - today)					0.0%		4.2%

Source: Thomson Reuters, Credit Suisse research

- **A sharp depreciation of the Japanese yen:** between 1995 and October 1998, the yen trade-weighted index (TWI) dropped by almost 40%, partly as a consequence of a domestic banking crisis (accompanied by BoJ rate cuts) and partly as US macro-uncertainty continued to fall (with the yen tending to move inversely to macro uncertainty). Similarly, since mid-2012, the yen has fallen by 25% as a consequence of BoJ monetary easing and falling US macro uncertainty. Our FX strategists expect the yen to continue falling to ¥/$120 over the next 12 months, from the current ¥/$100.

Figure 7: In the mid-1990s – as now – the Japanese yen was depreciating against the backdrop of lower macro uncertainty



Source: Thomson Reuters, Credit Suisse research

All these features distinguish the recovery in the mid-1990s and the current episode from the global upswing between 2002 and 2007, when global growth was driven by China, the dollar was depreciating, commodities were outperforming the cycle and there was only modest yen depreciation (18% between 2004 and 2007, partly because the yen had already begun weakening in 2000, before the start of the global recovery).

GEM: those portfolio inflows, again

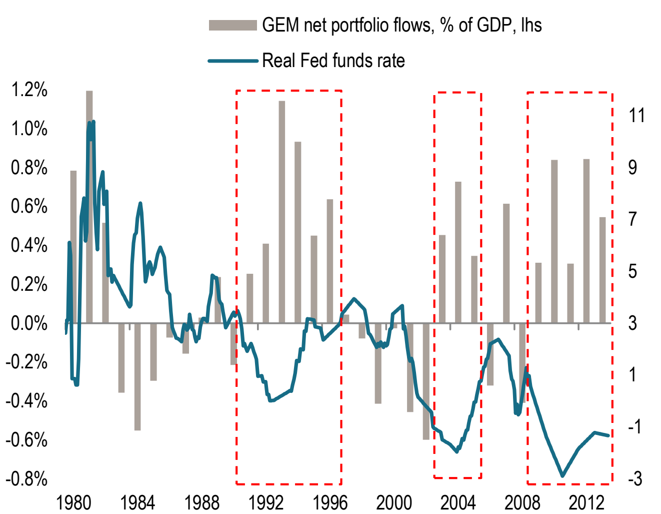
There are also a number of important similarities between the condition the emerging markets found themselves in the mid-1990s and their current predicament.

Portfolio inflows of 4% of GDP in the early 1990s, compared to 3% of GDP now

The most important of these is that – back then, as now – the cycle of portfolio flows into and out of the emerging markets tended to follow the US real interest rate cycle. When US real rates are low, investors are incentivised to look for the real yield pick-up offered by the emerging markets, leading to GEM portfolio inflows, while rising US real rates tend to lead to a reversal of these flows.

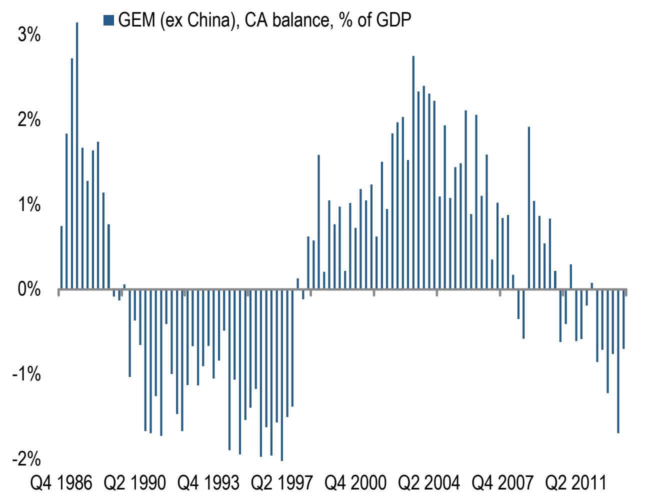
During the easing cycle around the US recession in the early 1990s, the real Fed funds rate dropped from around 5% in 1989 to around 0% in 1993, while the Bundesbank's policy rate fell from 8.75% in 1992, to 2.5% in 1996. This triggered cumulative portfolio inflows into the emerging markets of around 4% of GDP between 1991 and 1996, according to IMF data. These inflows boosted domestic leverage, consumption and inflation, making emerging markets less competitive and leading to *l*arge GEM current account deficits (especially given that the sharp weakening of the yen made Japan more competitive relative to other Asian exporters).

Figure 8: **The GEM portfolio flow cycle is driven by US real rates**



Source: Thomson Reuters, Credit Suisse research

Figure 9: **As in the 1990s, emerging markets are again running current account deficits**

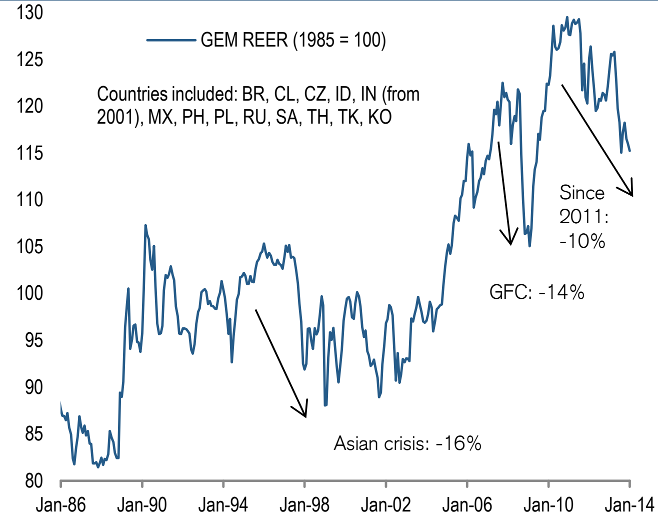


Source: Thomson Reuters, Credit Suisse research

Once US real rates started rising, capital inflows stopped and started reversing: between 1997 and 2002, net portfolio outflows out of the emerging markets were equivalent to 1.5% of GDP.

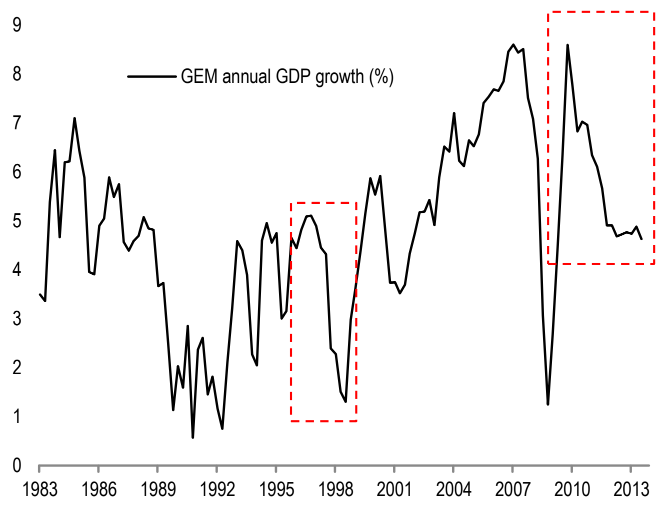
These outflows led to falling asset prices and an increasing difficulty to finance current account deficits. As a consequence, GEM currencies started falling (often through sharp one-off adjustments, as many GEM currencies were pegged against the dollar), making the abnormally high levels of debt denominated in foreign currencies harder to service. In many cases, policy makers hiked policy rates in the attempt to stabilise their currencies – or, worse still, imposed capital controls – as Malaysia did in August 1997 (which led to a severe loss of foreign confidence). The combination of capital outflows, and rising interest rates led to a sharp contraction of GEM GDP growth (from 5% in Q4 1996 to 1.5% in Q3 1998).

Figure 10: During the Asian crisis, the aggregate emerging market real effective exchange rate fell 16%



Source: CS Fixed Income Strategy, Thomson Reuters, Credit Suisse research

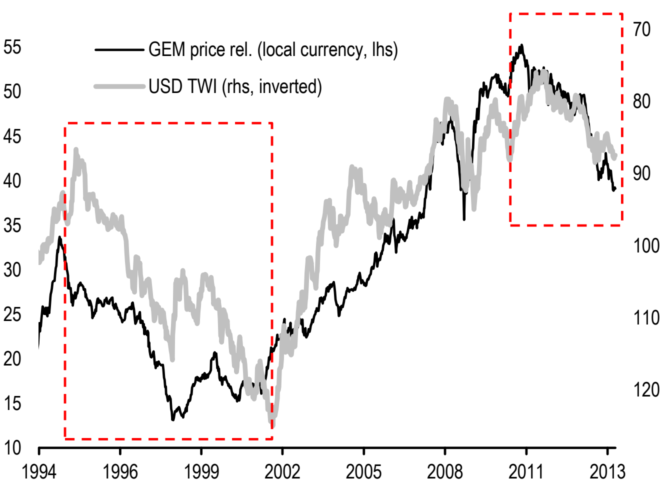
Figure 11: GEM GDP fell from 5% in Q4 1996 to 1.5% in Q3 1998



Source: Thomson Reuters, Credit Suisse research

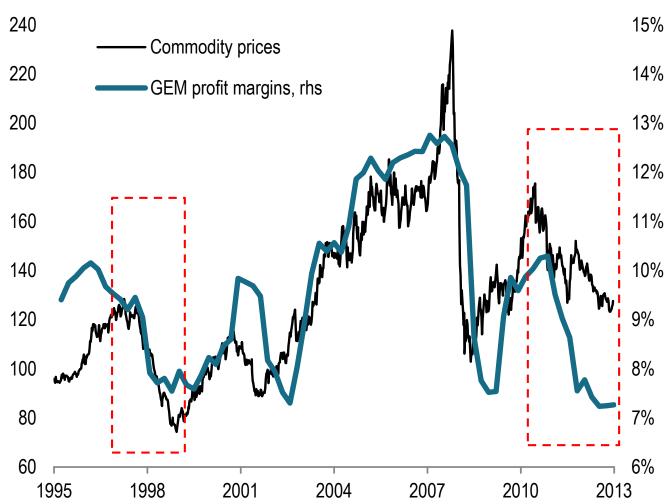
Lastly, in the mid-1990s, emerging market equities underperformed in line with a strengthening of the dollar (owing to the portfolio flow effect and the impact of a stronger dollar on commodity prices), while GEM margins contracted as commodity prices fell.

Figure 12: As in the mid-1990s, emerging market equities fell in line with the strengthening of the dollar…



Source: Thomson Reuters, Credit Suisse research

Figure 13: … and GEM corporate margins contracted against the backdrop of falling commodity prices



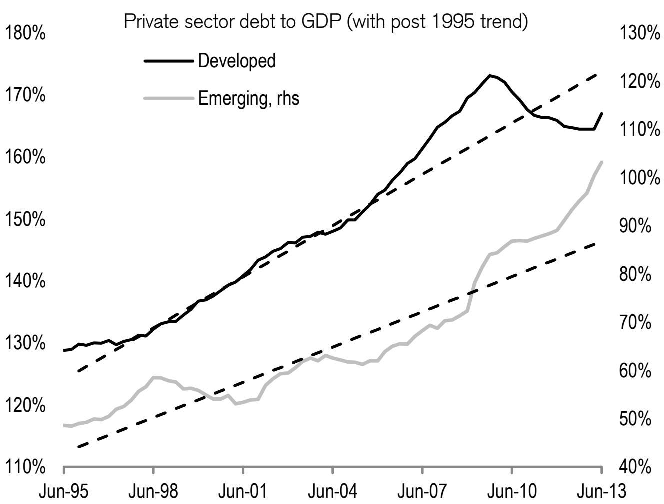
Source: Thomson Reuters, Credit Suisse research

In the current cycle – as in the mid-1990s – Fed easing has led to significant portfolio inflows (2.8% of GDP since 2009).

As in the earlier cycle, these inflows have pushed up GEM currencies (the aggregate GEM real effective exchange rate – REER – rose 23% between 2009 and 2011 – Figure 10) and domestic leverage: the aggregate GEM private sector debt to GDP is now 15 percentage points above its 20-year trend (see Figure 14 below). However, if China is excluded, this measure – which the BIS identifies as the best leading indicator for a financial crisis when it moves above 10 percentage points – stands at only 6 percentage points (see the Appendix).

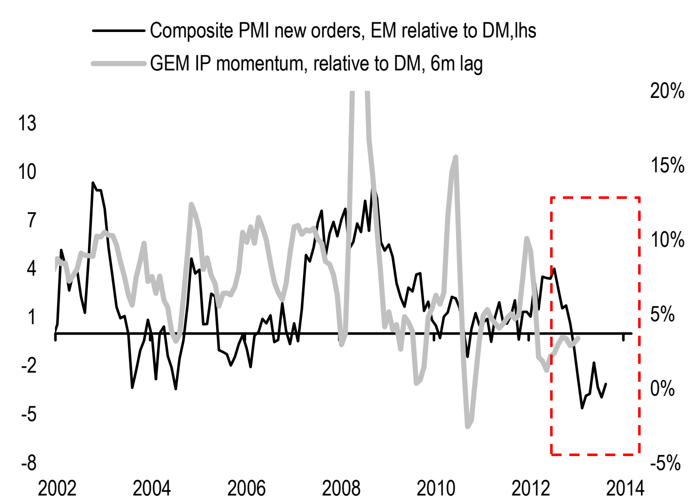
As during the earlier episode, this has led aggregate current accounts to fall into deficit (excluding China, emerging markets CA balances moved from a surplus of 2% of GDP in 2006 to a deficit of 1% of GDP in 2013 – Figure 9).

Figure 14: Emerging market private sector debt to GDP is now 15 percentage points above trend, while it was just 6 percentage points above trend in 1997



Source: BIS, Thomson Reuters, Credit Suisse research

Figure 15: Emerging market growth momentum has weakened relative to that in the developed world



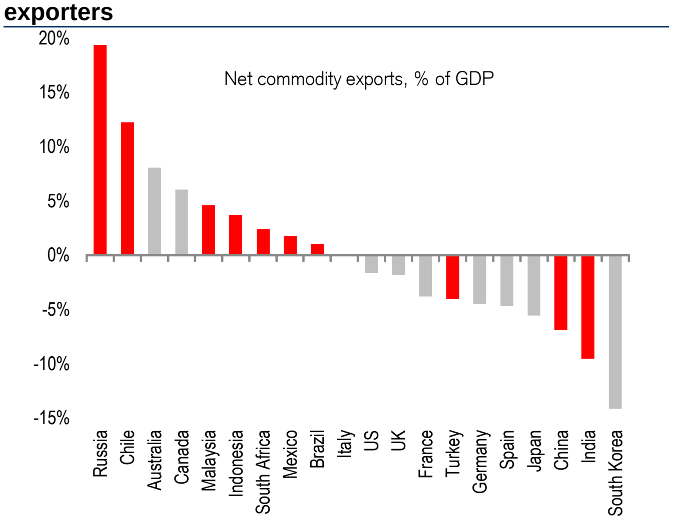
Source: Thomson Reuters, Credit Suisse research

As in the 1990s, growth momentum in the emerging markets is slowing, as a function of weak commodity prices, high leverage and capital outflows. As policy makers react to currency weakness (GEM REER have fallen by 10% so far since the middle of 2011) and the resulting increase in inflation by rising interest rates, domestic growth momentum is set to be weakened further.

Figure 16: Emerging market policy makers have started raising interest rates

Source: Thomson Reuters, Credit Suisse research

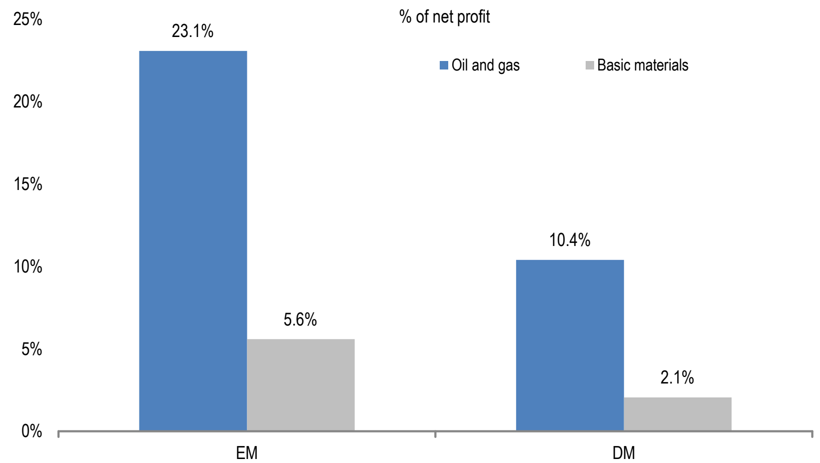
Figure 17: Most emerging markets are commodity exporters



Source: World Bank, Thomson Reuters, Credit Suisse research

Lastly, emerging market equities continue to move inversely with the dollar (underperforming as the dollar strengthens – Figure 12) – and margins are once again hit by falling commodity prices (which matter for emerging markets, given that most of these are commodity exporters and around 30% of corporate earnings come from the resource complex).

Figure 18: **Around a third of GEM earnings come from the resource complex**



Source: Thomson Reuters, Credit Suisse research

What is better this time around?

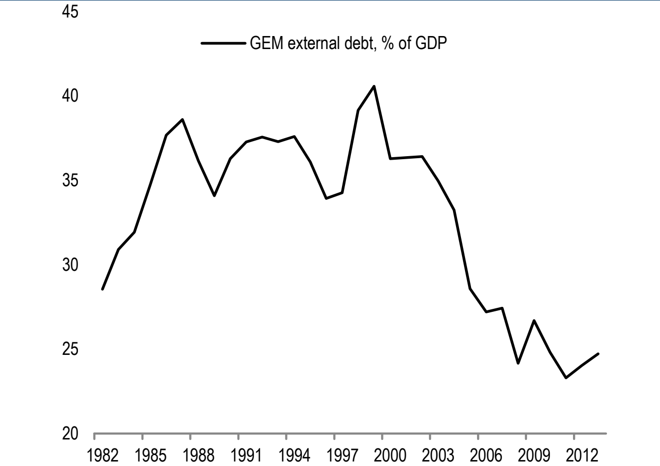
While there are structural similarities between the situation for emerging markets in the mid-1990s and now, there are also important aspects that are better in the current episode:

- **Lower levels of FX-denominated debt**

As many emerging markets had their currencies pegged to the dollar before the Asian crisis, their residents had an incentive to borrow in US dollars at lower interest rates than those available for loans in their local currency. As a consequence, external (i.e. FX-denominated) debt in the emerging markets was high, at around 40% of GDP. This meant that once the pegs were broken and currencies started depreciating, the local currency value of these debts rose, impairing debt sustainability.

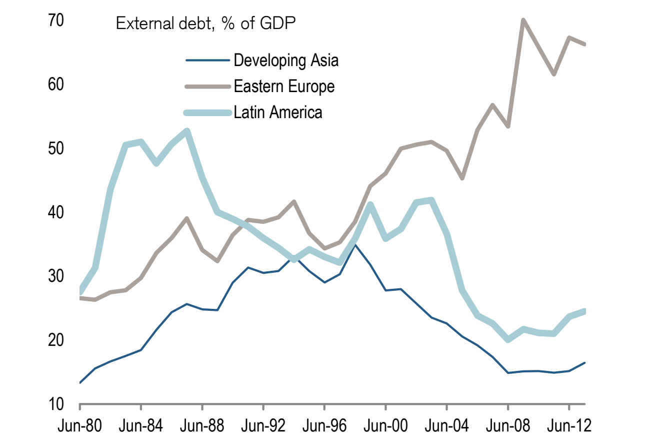
In the run-up to the current episode, on the other hand, many borrowers were able to borrow in their own currencies. As a consequence, FX-denominated debt now stands at 25% of GDP, close to a 30-year low. This means that the vicious circle between currency weakness and debt sustainability is not as pronounced this time around .

Figure 19: GEM FX-denominated debt as a proportion of GDP is close to a 30-year low…



Source: Thomson Reuters, Credit Suisse research

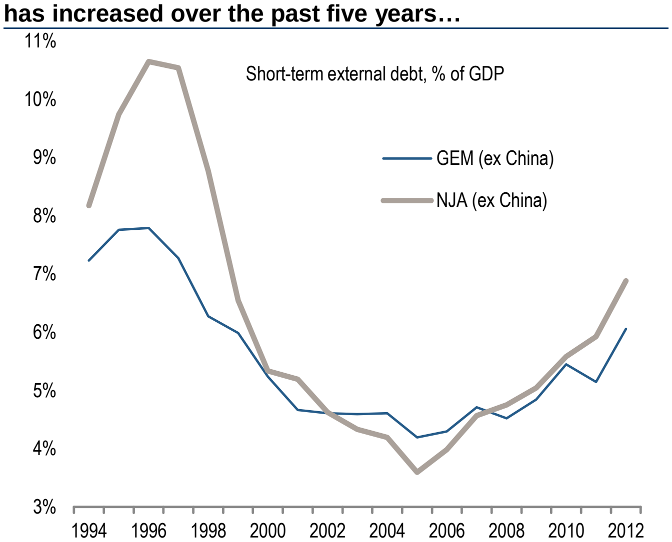
Figure 20: …yet, they are high in Eastern Europe



Source: Thomson Reuters, Credit Suisse research

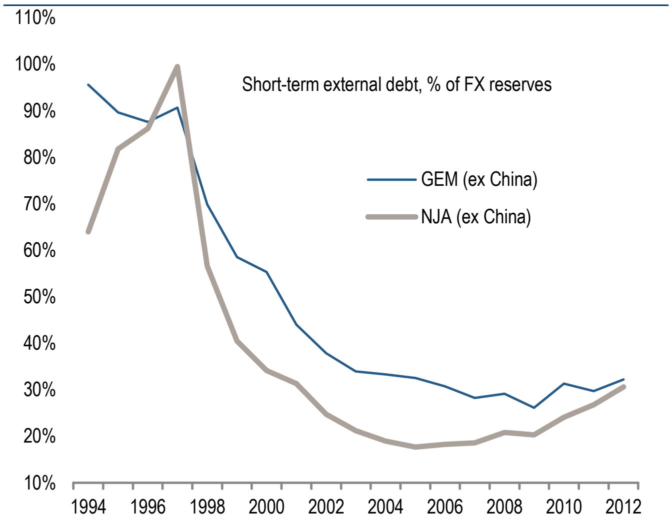
There are, however, two qualifications to this point. First, external debt to GDP in Eastern Europe is now significantly higher than it was during the mid-1990s (66% now, compared to 41% then). Second, aggregate short-term external GEM debt to GDP ratios been rising over the past eight years – and, at 6% of GDP, now stands at the highest level since 1999 (in 1996, they peaked at 8% of GDP). That said, in Non-Japan Asia, the epicentre of the 1990s crisis, short-term external debt continues to be significantly below the mid-1990s peak levels (at 7% of GDP, compared to 11% of GDP back then). Furthermore, GEM short-term external debt relative to FX reserves continues to be low (see next point).

Figure 21: GEM's short-term external debt to GDP ratio has increased over the past five years…



Source: World Bank, Credit Suisse research

Figure 22: …yet, GEM short-term external debt relative to FX reserves remains low

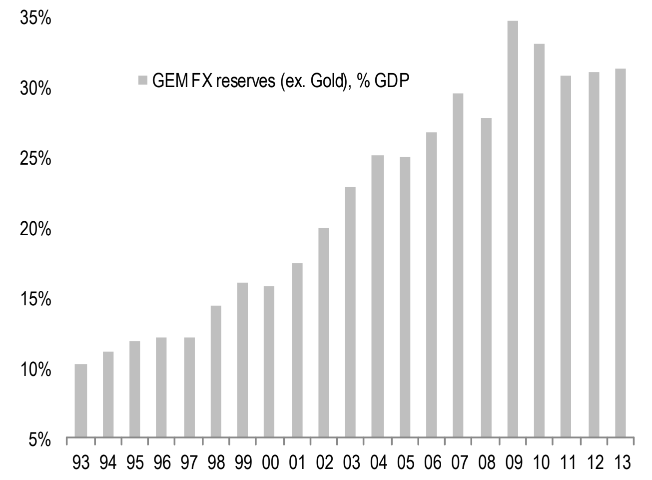


Source: World Bank, Credit Suisse research

- **FX reserves are higher**

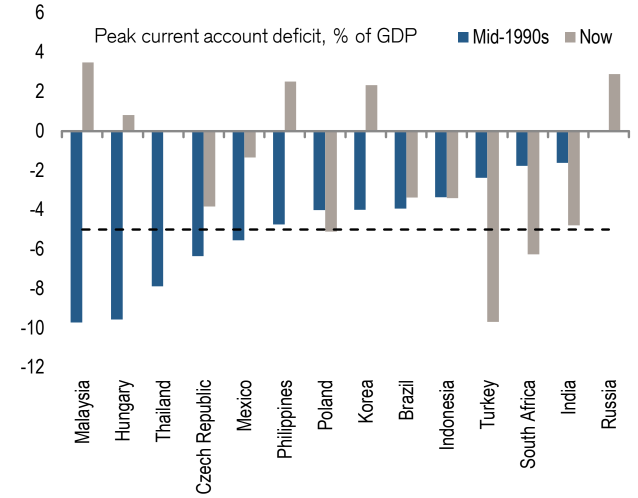
In the run-up to the Asian crisis, FX reserves of emerging markets as a proportion of GDP were only 10% of GDP, meaning that GEM economies had few resources to protect their currencies. Now, on the other hand, FX reserves stand at 30% of GDP, at least a 20-year high.

Figure 23: **GEM FX reserves stand at a 20-year high**



Source: Thomson Reuters, Credit Suisse research

Figure 24: **Fewer emerging market economies running excessive current account deficits in the current cycle than was the case in the mid-1990s**



Source: Thomson Reuters, Credit Suisse research

- **Less excessive current account deficits**

In 1997, aggregate emerging market current account deficits (excluding China) peaked at 2% of GDP, compared with a peak GEM CA deficit of 1% in the current cycle (Figure 9). Similarly, in the mid-1997s, current account deficits for Malaysia, Hungary, Thailand, the Czech Republic and Mexico all peaked above 5% of GDP, while in the current cycle only Turkey, South Africa and Poland reached CA deficits of this magnitude.

- **Fed policy is set to be less aggressive in the current cycle**

After starting to raise rates in February 1994, the Fed raised policy rates by 300bps over the following year (from 3% to 6%). This sharp monetary tightening immediately led to the 1994 Tequila Crisis in Mexico – and, with some delay, to the Asian crisis. This time round, the Fed tightening cycle is set to be significantly more gentle, given that in the mid-1990s central bankers' dominant concern was inflation, while now it is deflation. As a consequence, monetary policy is likely to be more dovish. Furthermore, GEM now accounts for slightly more than half of global GDP on a PPP-basis, compared to a third in the mid-1990s – and thus any economic damage that Fed policy inflicts on GEM will have a bigger impact on US GDP and, hence, on US monetary policy.

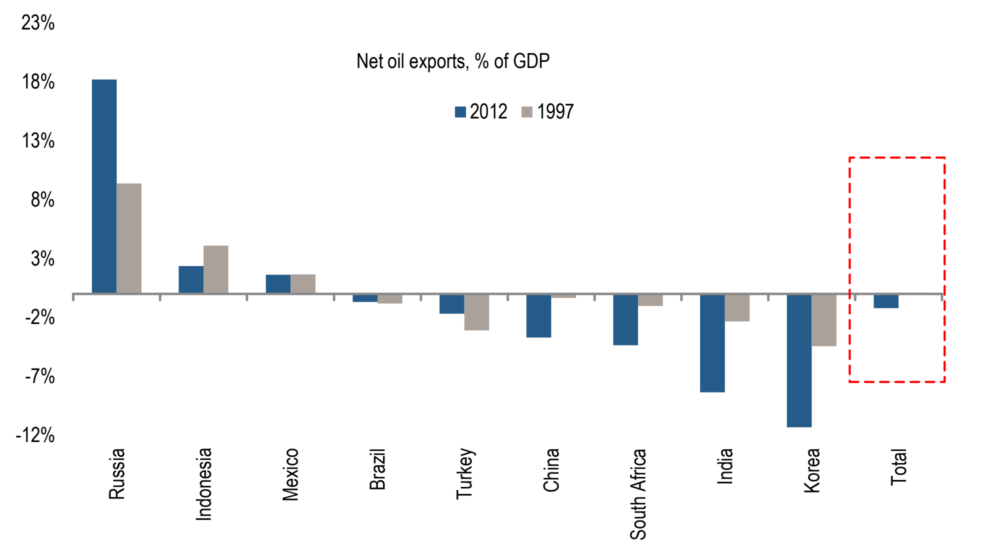
- **GEM growth has already slowed significantly**

On the cusp of the Asian crisis, GEM GDP growth was running at a 10-year high. Now, on the other hand, GEM GDP has already slowed to a three-year low of around 5% (down from around 8% in early 2010), as highlighted in Figure 11 (admittedly, though, in absolute terms, the growth rates are at comparable levels) suggesting less downside risk to growth.

■ The oil price appears to be less of a problem

The large emerging market economies were net exporters of oil to the tune of 1% of GDP in aggregate. Consequently, they suffered as oil prices declined 60% between 1996 and 1998. While Russia, Indonesia and Mexico are still net oil exporters today, the large emerging markets in aggregate now have flat net oil exports (i.e. in aggregate they are neither net oil exporters nor net oil importers). Furthermore, while the oil price is down around 15% from its peak of around $125/bbl in early 2012, we think a downturn similar to that of the mid-1990s is unlikely, given that the high cost production (i.e. US oil fracking and sub-salt Brazil) would start to be uneconomic with the oil price below $80/bbl.

Figure 25: The large emerging market economies are no longer net oil exporters



Source: Thomson Reuters, Credit Suisse research

What is worse this time around?

There are also some features about the macro backdrop that look worse for emerging markets than they did in the mid-1990s:

- **High private sector leverage**

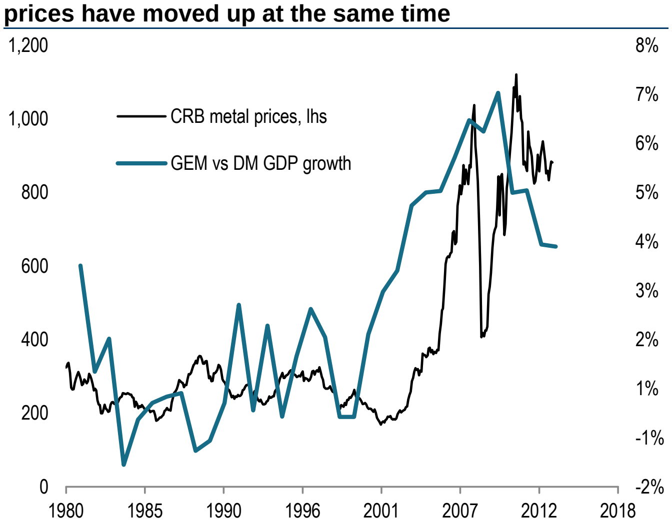
As highlighted in Figure 14, private sector debt to GDP in the emerging markets is now significantly higher than it was in the mid-1990s – and, crucially, significantly more above its long-run trend than was the case back then: 15 percentage points, compared with 5 percentage points. Admittedly, with our data only starting in 1995, this comparison is not entirely reliable, given that we effectively measure the GEM debt level not with reference to a preceding trend, but one based on later data points. Yet, given that the data we have point to extraordinarily high private sector debt levels (104% of GDP, compared to 54% of GDP in 1997), the negative impact from private sector deleveraging could be more significant during the present cycle than it was in the mid-1990s.

- **More downside potential for industrial commodity prices**

The rise in industrial commodity prices between 1986 and 1995, at around 70%, was small compared to that between 2001 and 2011, when they almost tripled. As a consequence, there is a risk that commodity prices fall by more than they did between 1995 and 2001 (35%).

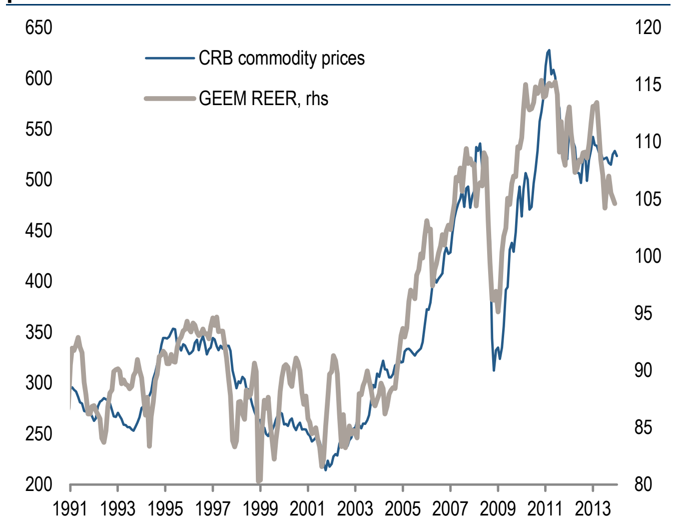
Uncomfortably for the emerging markets, the EM-DM growth differential and emerging market REERs have followed commodity prices over the past decade – and both are still unusually high. Even after the recent relative slowdown, gap between EM and DM GDP growth – which has risen in line with metal prices after 2001 – is still around 4 percentage points, compared to an average of 0.7 percentage points between 1980 and 2000. Similarly, there has been a close correlation between commodity prices and the aggregate emerging market REER, leading the latter to rise by 40% between 2002 and 2011 (compared with a 25% increase between 1989 and 1997). This suggests that both the GEM growth premium and GEM currencies have further downside if commodity prices continue falling.

Figure 26: **The GEM GDP growth premium and commodity prices have moved up at the same time**



Source: Thomson Reuters, Credit Suisse research

Figure 27: **GEM currencies appreciated as commodity prices rose**



Source: Thomson Reuters, Credit Suisse research

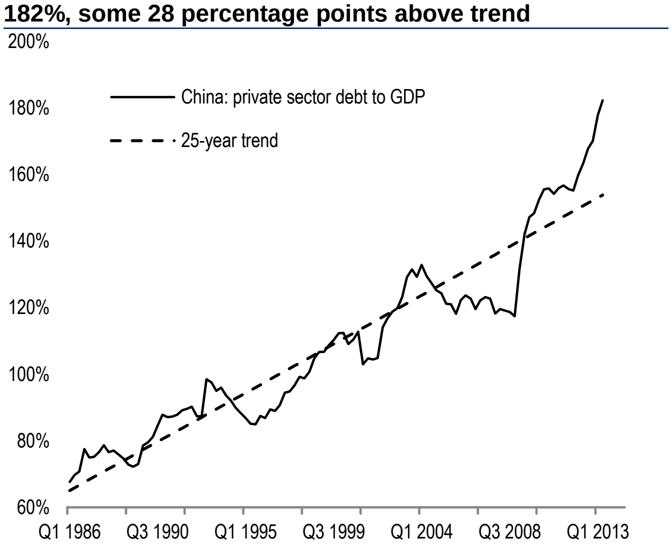
Higher exposure to a slowing China

In the early 1990s, the Chinese economy slowed sharply, with GDP growth dropping from 15% in Q4 1992 to 7% in Q2 1998. Following the rebound from the global recession in 2008/09, Chinese GDP growth peaked at 12% in Q1 2010 – and has since slowed to around 7.5%.

However, while the slowdown in Chinese growth so far has been less sharp than that during the 1990s, we see two risks: First, as we argue in the accompanying report (*GEM: when is it time to buy?* 12 Feb), it is likely that Chinese growth slows further over the next few years, given the bubbles in credit (the third biggest credit bubble on our database, with private sector debt to GDP 28 percentage points above trend), investment (with investment to GDP at 48%, the highest ever recorded) and housing (with real estate being 19% of GDP, mortgage rates being five-fold the rental yield) – as well as reduced scope for a fiscal response (government debt to GDP on official data stands at 58% of GDP – and aggregate leverage at 230% of GDP). However, one important similarity with the late 1990s is that China has net foreign assets and can thus afford to print.

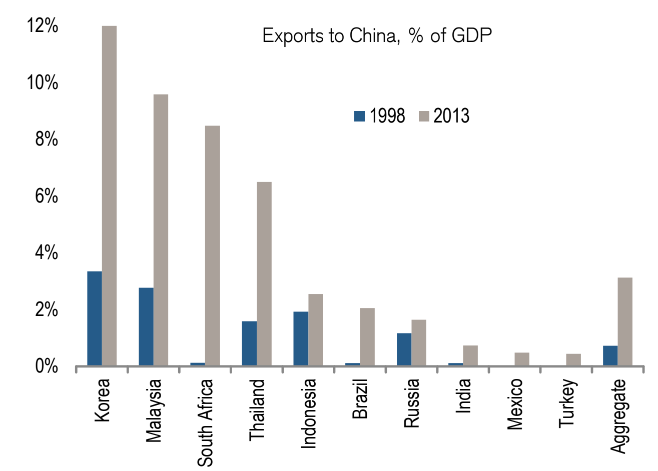
Second, emerging markets are now far more dependent on China than they were in the 1990s: other big emerging markets' exports to China are equivalent to 3.1% of GDP now, compared to 0.7% of GDP in 1998.

Figure 28: **China's private sector debt to GDP stands at 182%, some 28 percentage points above trend**



Source: Thomson Reuters, Credit Suisse research

Figure 29: **Emerging market export exposure to China has quadrupled since 1998**



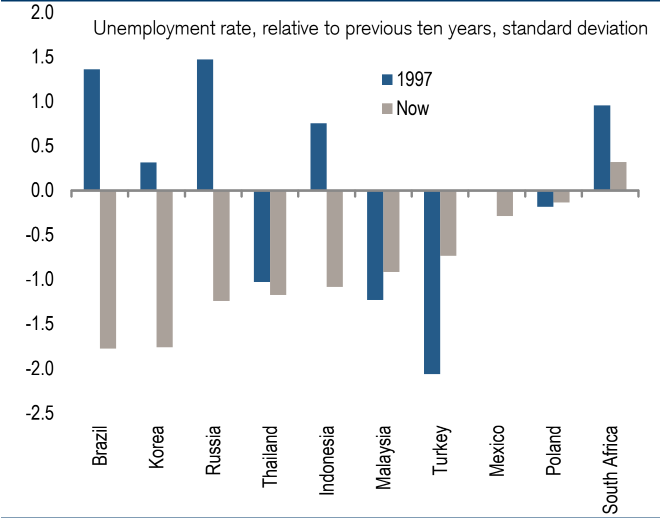
Source: Thomson Reuters, Credit Suisse research

Less spare capacity means a reduced ability to benefit from the global recovery

Most emerging markets are already operating above potential, suggesting that they are less well positioned than many developed markets (which have significant spare capacity) to benefit from a pick-up in global growth (which, when output is above potential, is more likely to translate into inflationary pressures and lower margins, rather than higher output).

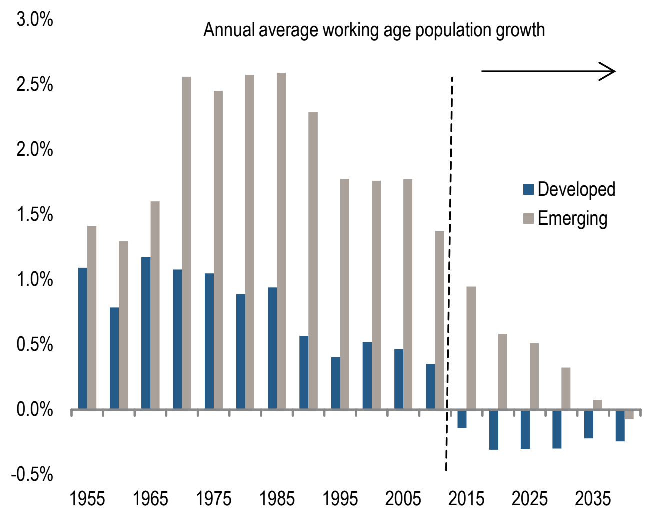
One way to gauge spare capacity is to look at unemployment rates, which are below the long-run average in many of the emerging markets, suggesting already tight labour markets (e.g., unemployment in Brazil is 4.3%, compared with a 10-year average of 8.0%).

Figure 30: **GEM labour markets are tighter than they were in the run-up to the Asian crisis**



Source: Thomson Reuters, Bloomberg, Credit Suisse research

Figure 31: **Average annual working age population growth in the emerging markets has fallen from c2% in the 1990s to c1% now**



Source: UN, Credit Suisse research

Other data highlight that India (where 100m rural families are now being guaranteed 100 days of work a year), China (where surveys show a shortage of skilled workers) and Indonesia (where unemployment is 6.3% against a 10-year average of 8.2%) all suffer from a shortage of unskilled labour.

- **Lower working age population growth**

The problem of tighter GEM labour markets is in part due to worsening demographics: while the GEM working age population was growing at around 2% in the 1990s, this growth rate has now fallen to around 1%, reducing the underlying growth rate of the economy.

Conclusion

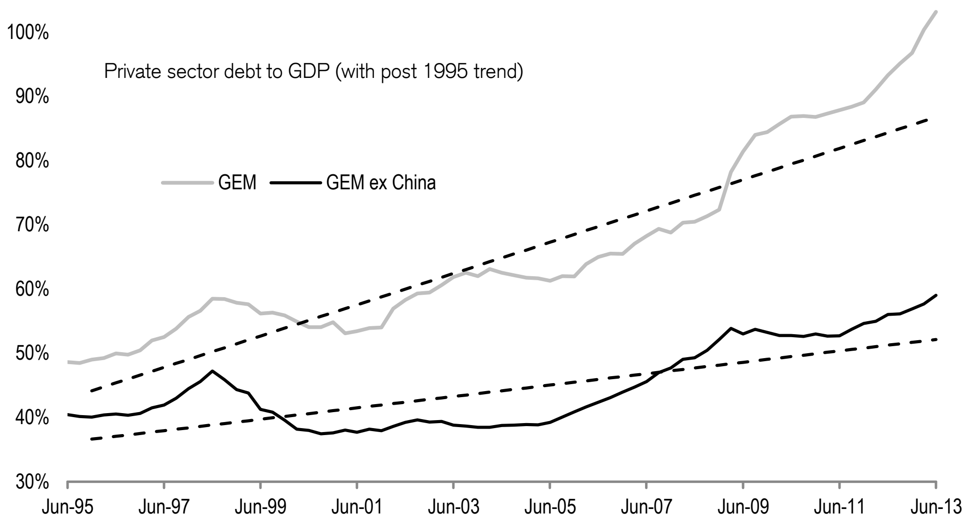
We expect that clients may not have not fully appreciated how many similarities there are with the 1990s period. On balance, however, we believe the fundamentals for emerging markets are better now than they were in the run-up to the Asian crisis. Consequently, we believe that valuations and currencies should be able to trough at higher levels than they did during the 1990s. Currently, equity and currency valuations are only back to historical average levels (looking at the sector-adjusted GEM price-to-book relative to global markets or GEM currencies' deviation from PPP against the dollar).

In our view, this means that it is too late to go underweight but too early to be overweight. We believe that if the sector-adjusted P/B relative got to a 10-15% discount (compared to a 40% discount at the trough of the Asia crisis and parity now) or GEM currencies' discount to PPP fell some 10% below their long-run average, it will be time to buy (see our report *GEM: when is it time to buy?*, 12 Feb, for more detail).

We note that GEM consumption growth has already slowed to a 10-year low of 6% and that only Turkey has the toxic combination of high net external debt and a large current account deficit. Consequently, we think the current GEM growth slowdown is unlikely to derail the global recovery – unless Chinese GDP growth falls below 5% or the RmB devalues by 10%+ (for more details on this point, see our report *Equities: Hold your nerve*, 5 February 2014).

Appendix

Figure 32: Excluding China, GEM private sector debt to GDP is some six percentage points above trend



Source: Thomson Reuters, BIS, Credit Suisse research

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