Weekly Market Commentary

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Emerging Markets and the Fed — What's Attractive and What to Avoid

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Highlights

Nowhere have the effects of the Fed's message on tapering been felt more acutely than in the world's emerging markets. However, there are attractive countries and regions among emerging markets that may fare well through this transition to less global liquidity.

While the Federal Reserve (Fed) could surprise investors this week, the Fed has been careful to communicate its intentions to the markets ahead of this week's meeting. Most market participants expect the Fed to announce a tapering in the monthly pace of its bond-buying program coupled with more guidance on when, in the distant future, it may raise rates. (See the *Weekly Economic Commentary: Trust* from 9/9/13 for details).

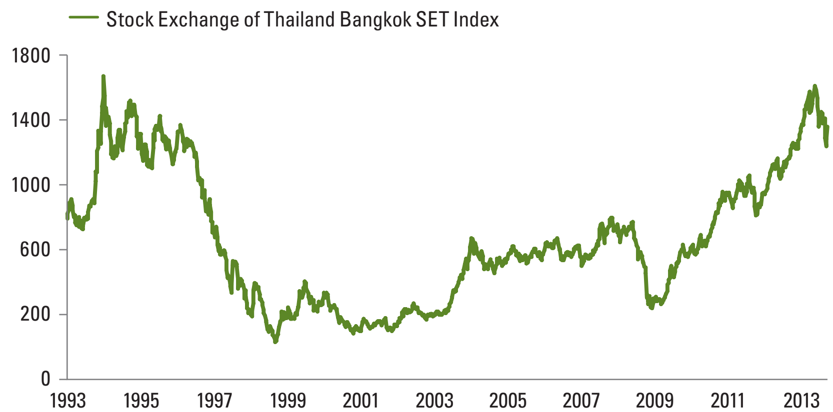
Nowhere have the effects of the Fed's message on tapering been felt more acutely than in the world's emerging markets (EM). The Fed's taper talk has put emerging markets under pressure. The MSCI Emerging Market Equity Index is down 4% for the year compared with a 20% gain for U.S. stocks based on the S&P 500. Much of that decline came following the Fed's May 22 communication on its intention to taper, with EM stocks falling about 15% over the following month. In addition, most EM currencies are depreciating as investors are pulling their money. The values of the currencies of Brazil, India, and Indonesia have fallen by about 10% over the past three months, echoing the start of the currency crises in Mexico in 1994 and Asia in 1997, which were devastating to emerging markets investors.

Echoes of a Crisis

Similar to the environment that preceded the July start of the 1997 Asian financial crisis, U.S. economic growth has prompted the Federal Reserve to reduce monetary stimulus. The Fed's tapering draws a comparison to the Fed rate hike of March 1997. In addition, the Japanese government has recently decided to raise the consumption tax from 5% to 8%, echoing a similar move they made in April 1997, when the tax was raised from 3% to the current 5%. These events have created headwinds for emerging market countries and acted as a weight on the relative performance of emerging market stocks versus U.S. stocks.

In the face of relatively sluggish global demand in recent years, many emerging market countries have relied on the extraordinary liquidity provided by the world's central banks to grow their economies, at the cost of running current account deficits as they increasingly borrow to import more than the export. But living on borrowed money has turned into living on borrowed time. Emerging economies have come under increasing pressure. As global credit conditions tighten and developed market bond yields rise, funding for widening current-account deficits becomes scarcer. Emerging market

1 Echoes of Late 1990s Asian Financial Crisis Appear Ominous for Thailand's Stock Market



Source: LPL Financial, Bloomberg data 09/15/13

The Stock Exchange of Thailand Bangkok SET Index is an unmanaged index, which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. Index performance is not indicative of any particular investment. Past performance is no guarantee of future results.

currencies are depreciating as investors find more attractive yields in more financially stable markets, as global liquidity is starting to be drained. In response, countries like India, Turkey, Indonesia, and others have seen their currencies and stock prices pummeled.

Avoiding Another Crisis

However, unlike in 1997, smaller deficits, larger foreign currency reserves, debt denominated in local currencies, and flexible exchange rates are positives likely to help avoid another emerging market crisis.

- **Smaller deficits** – Compared to 1997, most emerging market economies are running only moderate deficits and the currency declines that have already taken place may be sufficient to shrink the deficits to sustainable levels.
- **Larger reserves** – Focusing on Asia, where foreign currency reserves to cover imports have historically been skimpy, it is worth noting that many Asian emerging market countries now have doubled their foreign currency reserves relative to imports compared to 1997. These added reserves can help to protect a country from an outflow of funds.
- **Local currency debt** – Most importantly, in 1997, the money borrowed by these governments was denominated in foreign currencies. Emerging market central banks spent much of their foreign currency reserves to support their currency. Ultimately, the currencies broke the peg and devalued companies and banks were unable to pay back the debt, resulting in defaults that had global consequences. This time, much of the debt is denominated in local currency, so the government can preserve foreign currency reserves for paying for imports and payments on foreign currency denominated debt.

- **Flexible currencies –** In addition, the flexible exchange rates put the countries less at risk than when their currencies were pegged back in 1997. The decline in the exchange rates devalues the debt burden on the country. This greatly limits the damage from a falling currency.

Finally, it is important to note that these countries have not been on debt-fueled binges. Their growth has been below average, meaning potentially less of a growth bubble.

Dissecting Emerging Markets

Investors often tend to think of emerging market stocks as a homogenous asset class. But increasingly, emerging markets countries are showing their individual characteristics. While these countries may not experience a crisis like those of the 1990s, each country will feel the effects of reduced global liquidity differently—making some still worth avoiding and others potentially attractive.

The emerging markets most vulnerable are those with worsening current account deficits and those with excessive government budget deficits to fund. The most attractive countries have current account and budget balances or even surpluses. Dissecting the emerging markets asset class, we find some countries attractive and others that remain unattractive:

- **Unattractive:** South Africa, Turkey, India, Peru, Chile, Colombia, and Indonesia.
- **Attractive:** China, Taiwan, Thailand, Malaysia, Philippines, and South Korea.

Emerging Opportunities

A dovish Fed could be a positive for emerging markets this week. But, longer term, with the taper largely priced in to bond yields (and any further upside in interest rates driven more by improving global economic growth), the outlook for emerging markets turns to prospects for growth. However, as the global economy improves and increases demand for emerging market goods, it will also prompt a reduction in global liquidity that may act as a drag on growth. This drag helps make broad emerging markets stock exposure less attractive than U.S. stock exposure. However, there are attractive emerging market countries and regions that may fare well through this transition. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Currency Risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Liquidity Risk is the risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

Stock Exchange of Thailand Bangkok SET Index is a composite index which represents the price movement for all common stocks trading on the SET.

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