Thoughts from the Driehaus Emerging Markets Team

Following the recent volatility in emerging markets, we offer some high level thoughts on what has transpired and how we see the landscape going forward. We will first describe what we view to be the root causes of the weakness and clarify some areas where the consensus is off base, in our view. To a large extent, the three main issues we see—US dollar liquidity environment, poor growth and a slowdown in China—are interrelated and ascribing causation to any one of them in isolation would be an oversimplification of recent events.

Liquidity. We continue to believe that because emerging markets are broadly capital importing nations (with several exceptions), periods of tightening dollar liquidity create headwinds for growth and asset prices. While the Federal Reserve hiking interest rates is a part of this, it is not the most important factor and thus the exact timing of the first hike is not of significant importance, in our view.

The main sources of dollar liquidity, historically, for emerging markets have been trade receipts and surplus liquidity generated by the US banking system in aggregate (money created by the Federal Reserve and commercial banks). As we have been highlighting for some time, both of these have been disappointing, most notably export volumes.

It is because of this that pressure on emerging market currencies has happened in spite of low nominal rates at all tenors in the US. An attractive nominal carry is not sufficient support in periods of higher interest rate volatility and lower overall money creation. As such, we are not surprised by broad EM FX weakness but believe the sharp weakness in recent weeks was a function of rapidly worsening terms of trade as a result of the commodity selloff.

Growth. While the growth environment has been soft for several quarters, the survey data showing a renewed downturn in Chinese manufacturing following a brief period of stability was the spark for a renewed bout of negativity. The EM growth model, for better or worse, is more geared to China than it used to be, and for most countries less geared to the US than it once was. The soft trend driven by weak Chinese growth has been in place for a while and despite the sharp reaction in August, was not really new information.

There have been two recent changes in the growth outlook that are worth noting. First, a confluence of factors (including weaker EM consumption) has chilled tech demand, which is a major source of north Asian EM growth and has been a bright spot until recently. Secondly, just as central bank interventions to keep currencies weaker in the huge capital inflow years stimulated domestic liquidity, recent interventions to strengthen currencies are causing tightening liquidity in most markets, further reducing credit growth amid already high risk aversion by domestic banks.

China. We won't rehash the well-appreciated headwinds to Chinese industrial growth. However, we find the timing and extremity of the China negativity a bit puzzling given that most of the non-manufacturing areas of the economy (property transactions improving, retail sales +10%, services PMI at 53.8) have improved in recent months. Though those indicators aren't enough to counteract the slowdown in the manufacturing base, they are enough to use as evidence that the economy is not collapsing. We would take it as a meaningful negative sign if the ongoing weakness in the manufacturing sector does start to have a bigger adverse impact on the domestic services sector.

The recent depreciation of the yuan increased the panic, despite it being a sensible, controlled and inevitable move by the PBOC. The depreciation of the yuan versus the dollar is inevitable in an environment of a liberalizing capital account and a growing monetary policy divergence with the US. Though inevitable, we still believe the PBOC has the tools to keep the depreciation from growing disorderly and we maintain an assumption of yuan weakness over the coming years, which is ultimately a positive for China and EM. We do note, however, that managing the yuan in a period of heavy capital outflows requires significant sales of US Treasurys, an event that will likely have bigger impact outside of EM than within it.

The final point is an important one that we feel has been overlooked. The high levels of market distortions in China by the government, such as restricting selling and short-selling, have forced participants into other assets to reduce exposure to China, namely aggressively shorting commodities, which has caused a chilling effect on global and EM-specific risk in excess of the underlying fundamentals.

Going forward

While we have highlighted several negative factors driving the current environment within emerging markets, looking ahead we are actually more worried about something we have not yet discussed. Namely, that the poor growth environment has led to an extreme level of crowding within the asset class, making some of the better performing companies and countries at tactical risk of sharper weakness. We fear that many of the areas that have been hit hardest have underperformed relative to underlying fundamentals because of misperceptions surrounding China and, as such, could see a reversal despite still generally poor medium-term earnings growth outlooks.

We still believe that emerging markets face numerous headwinds, specifically that the challenge of tighter US dollar liquidity is not going away and economic growth is not likely to sharply recover. Despite that, as the US equity markets showed us, in the early stages of a recovery equities can do well without strong top-line growth, provided there is a profit recovery driven by margin improvements.

We believe many of the EM companies and countries are in the very early stages of a healthy and necessary rebalancing. At the country level, this means we welcome some weakness in the Brazilian labor market as a sign that the economy is finally responding to the weak environment and creating spare capacity and improving competitiveness again. Similarly, we are watching trade balances for evidence that the currency weakness is starting to stabilize external deficits. At the company level, this means that we may finally see the 10-year cyclical decline in emerging market operating margins stabilize (though, to date, it remains elusive) as companies readjust to the new reality.

It is clear to us that the rebalancing of EM has begun and it is also clear that it is not entrenched enough to lift the whole asset class yet. As such, with growth still scarce across the asset class, finding companies capable of delivering superior growth and selectively finding countries in more advanced, underappreciated stages of rebalancing, should continue to garner superior performance.