The Case for Asian Emerging Markets

January 25, 2019

Back in May, Harvard economist Carmen Reinhart painted a gloomy picture for Emerging Markets (EMs), claiming they are more vulnerable today than during the 2008 Global Financial Crisis (GFC).

She said, "*The overall shape they're in has a lot more cracks now than it did five years ago and certainly at the time of the global financial crisis. It's both external and internal conditions. This is not gloom-and-doom, but there are a lot of internal and external vulnerabilities now that were not there during the taper tantrum.*"[1]

Ms. Reinhart's comments came on the heels of an emerging market sell-off spurred by a stronger US dollar and massive devaluations in the Argentine peso and Turkish lira. It would be unfair, however, to paint all emerging markets with the same brush. Idiosyncrasies in one emerging market country due to geopolitical issues or poor balance of payments should not be extrapolated to all emerging markets as a whole. Indeed, the MSCI Emerging Markets Index alone counts 24 countries spanning Latin America, Europe, the Middle East, Africa and Asia, as its constituents.

We contend that the investor concerns stemming from the crisis in Latin America should have little relevance to the Asian markets. Asian economies are in a much stronger position today and are less vulnerable to contagion, than they were during the 1997 Asian Financial Crisis and the 2008 GFC.

Key indicators

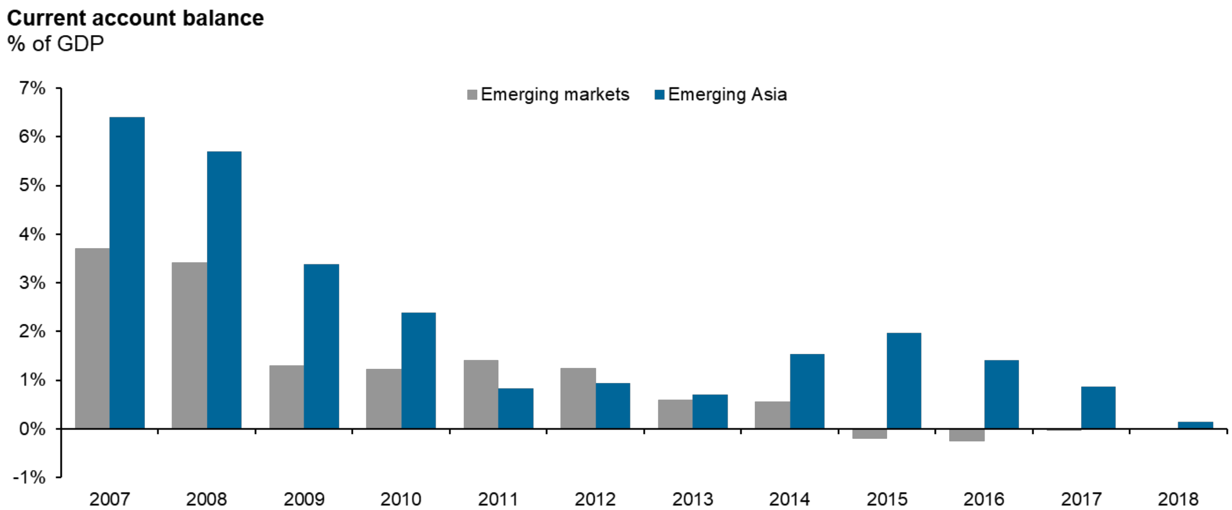
Current Accounts

Although Emerging Markets as a group displayed a sizeable current account surplus in 2008, it is now showing a small current account deficit. Emerging Asia fares slightly better with a slight current account surplus.

---

[1] "Harvard's Reinhart says emerging markets are in tougher spot than during '08 crisis", *Bloomberg,* May 17, 2018.

Exhibit 1: Current account balances as a % of GDP for emerging economies[2]

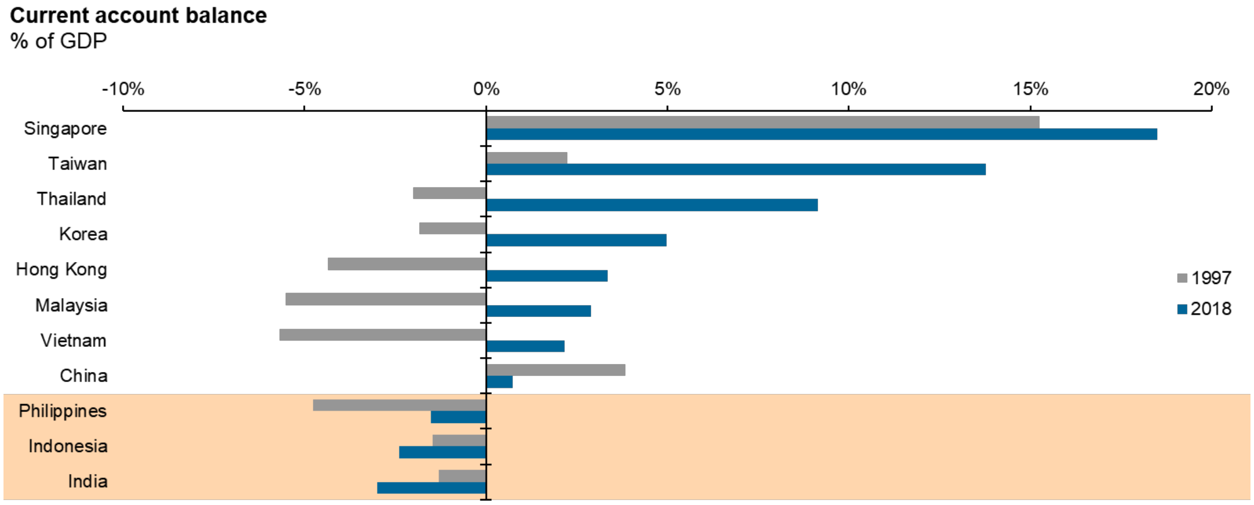


Source: IMF, World Economic Database (Oct 2018).

If we drill down to Asian economies however, eight out of the eleven major economies in Asia ex-Japan enjoy current account surpluses. This is a reversal from the 1990s when Southeast Asia experienced rapid growth coupled with huge current account deficits, culminating in the outbreak of the Asian Financial Crisis in 1997. Today, the only Asian countries that have deficits are Indonesia, India and the Philippines.

[2] "Worse than 2008? Here's what the emerging market numbers show", *Bloomberg,* May 17, 2018.

Exhibit 2: Current account balances as a % of GDP for major Asia-ex Japan economies[2]



Source: IMF, World Economic Database (Oct 2018).

Strong positive current account balances are indicative of Asia's excess savings and demonstrates its ability to meet its foreign exchange obligations.

Debt

One of Ms. Reinhart's chief gripes is the mounting levels of debt that emerging markets have taken on, particularly in Sub-Saharan Africa and the Middle East – which have become increasingly indebted to China. While government debt to GDP in emerging markets has certainly increased from 34% in 2008 to 50% today, it is still less than half the level of debt in developed economies, whose ratios have gone from 78% in 2008 to 103% of GDP today.[3]

We have also discussed and written about China's debt at length in various thought pieces so we will not go into detail on that subject in this write-up. Suffice to say that the Chinese government has been actively deleveraging by instituting various initiatives for State-Owned Enterprise (SOE) reform and financial reform.

[3] "A gentle rebuttal to Carmen Reinhart', *Ashmore Weekly Investor Research,* May 29, 2018.

Exhibit 3: Chinese Central Government guidelines to strengthen asset and liability constraints on state-owned enterprises (SOEs)

Timeline	Target
By 2020	Average debt-to-asset ratio of SOEs reduced by 2 percentage points vs that of end-2017.
After 2020	Debt-to-asset ratio should be kept at the average level of companies in the same industry with the same scale
Other initiatives	• Establish warning and monitoring systems for companies' assets and liabilities. • Set time limit for companies with high leverage to reduce their debt-to-asset ratio. • Set clear boundaries separating government debt from corporate debt. • Strict ban on local governments from borrowing in the form of corporate debt.

Source: Xinhuanet.

Growth

Another reason for Ms. Reinhart's pessimistic outlook on emerging markets is the notion that there is a growth slowdown. She points to Brazil, Chile and Turkey as countries that were doing well before but have been facing a growth slowdown in recent years, revealing vulnerabilities in their fiscal accounts.

This is not what we are seeing in Asia. The International Monetary Fund has estimated that Asia's developing economies are poised to grow at 6.3% in 2019 compared to those in LatAm (2.6%), Middle East (2.7%) and Sub-Saharan Africa (3.8%).

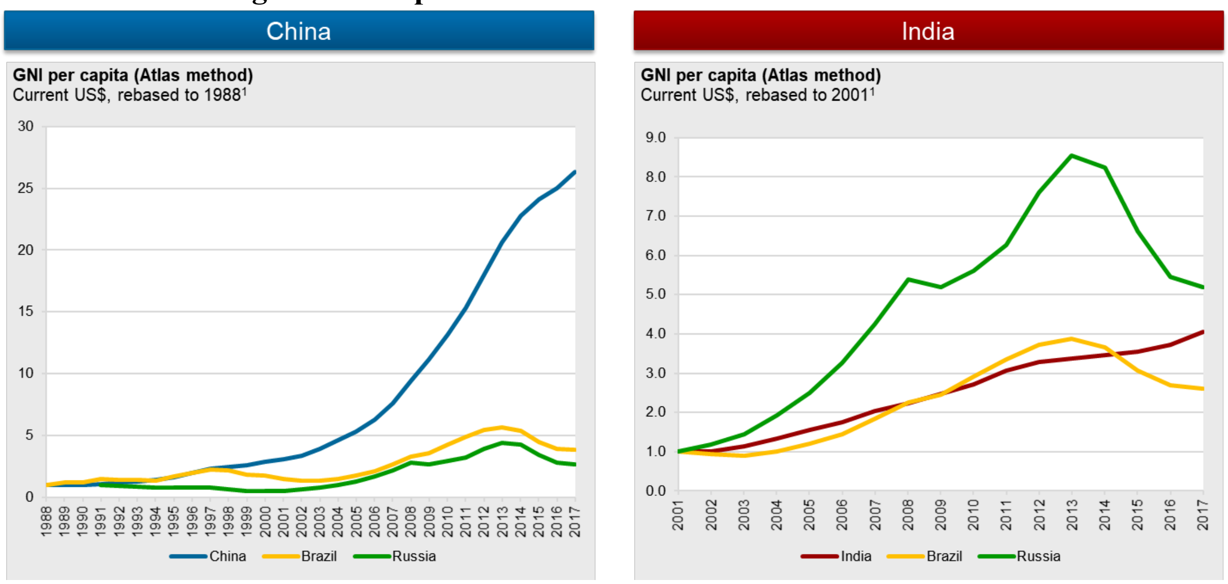
Exhibit 4: IMF Growth Projections (%)

		Projections	
	2017	**2018**	**2019**
World Output	**3.7**	**3.7**	**3.7**
Advanced Economies	**2,3**	**2.4**	**2.1**
United States	2.2	2.9	2.5
Canada	3.0	2.1	2.0
Euro Area	2.4	2.0	1.9
United Kingdom	1.7	1.4	1.5
Japan	1.7	1.1	1.9
Other Advanced Economies	2.8	2.8	2.5
Emerging Market and Developing Economies	**4.7**	**4.7**	**4.7**
Emerging and Developing Asia	6.5	6.5	6.3
China	6.9	6.6	6.2
India	6.7	7.3	7.4
ASEAN-5	5.3	5.3	5.2
Commonwealth of Independent States	2.1	2.3	2.4
Emerging and Developing Europe	6.0	3.8	2.0
Latin America and the Caribbean	1.3	1.2	2.2
Middle East, North Africa, Afghanistan and Pakistan	2.2	2.4	2.7
Sub Saharan Africa	2.7	3.1	3.8

Source: IMF, World Economic Outlook (Oct 2018).

Asia looks to be the most dynamic region by a wide margin and is expected to account for a substantial share of global growth. This points to the fundamentals in Asia being better than other regions, providing a buffer against rising interest rates in the US and ongoing trade war disputes. The income growth of China and India are driven mainly by human capital, whereas their BRIC counterparts, Russia and Brazil, were more commodity-driven. The former is more sustainable and makes China and India better places for investment over the long term.

Exhibit 5: Income growth comparison between the BRICs



[1] Base year is determined as a decade after economic reforms. China's reforms began in 1978 when Deng Xiaoping opened up China's economy. India's reforms started in 1991.
Source: World Bank, World Development Indicators.

Asian economies have learnt their lessons from the Asian Financial Crisis and the sound monetary and fiscal policies since have ensured they have stood out from the EM malaise that has taken hold in other regions such as Latin America. In addition to this, the domestic consumer story is very much still in force throughout the region (home to around one third of the world's population) and with the trend of rising incomes and higher life expectancy, this story is only set to continue growing.

Private equity in Asia is gaining traction in tandem. Accessing these hard-to-reach stories usually comes in the form of private capital funding young and hungry entrepreneurial startups. Given the lack of developed, and deep, capital markets in Asia, private equity is the perfect provider of much-needed capital to grow businesses and take them to the next level.