

Schroders Talking Point



Emerging markets in the credit crunch

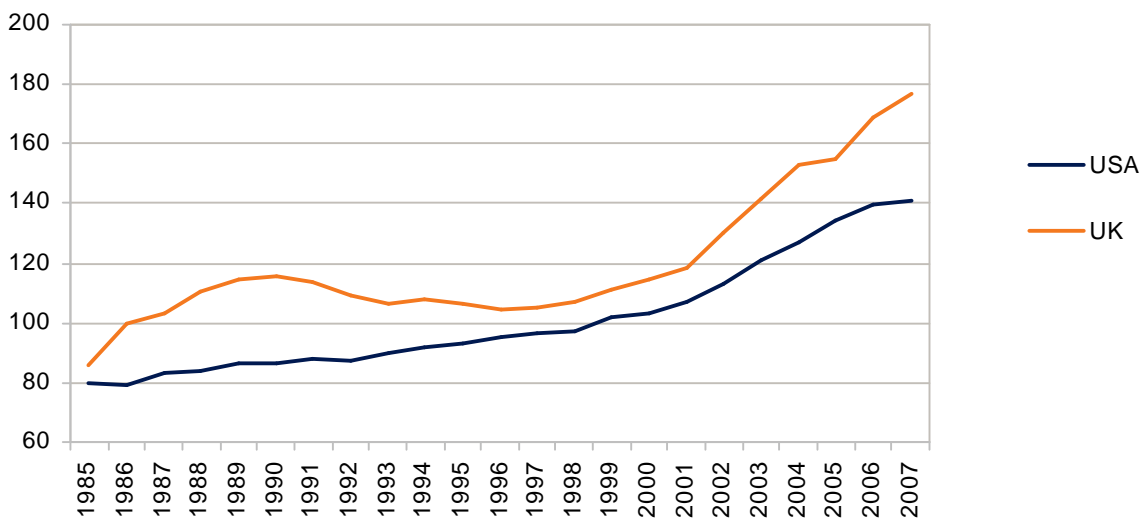
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The developed world is suffering from a severe credit crunch, with serious consequences for GDP growth over the next few years. This note takes a look at whether similar crises are likely to develop in emerging markets and what countries are worst affected by the fallout from the developed markets.

Origins of the Crunch

The causes and development of the credit crunch are the subject of intense debate right now, and will no doubt be the subject of continued economic work of decades to come. Explanations of the problem put forward so far range from the introduction of mark to market accounting to lax regulation, pure and simple greed and a host of other things in between. No doubt many things contributed, but whatever the causes, one thing is clear – too much debt was built up in the household sector in the US and UK and some other European countries.



Source: OECD

The value of this debt is fundamentally linked to the value of house prices. A bubble had developed in house prices fuelled by low interest rates in the developed world which followed the NASDAQ crash. As interest rates rose, and the bubble was pricked, problems soon began to develop in debt linked to house prices.

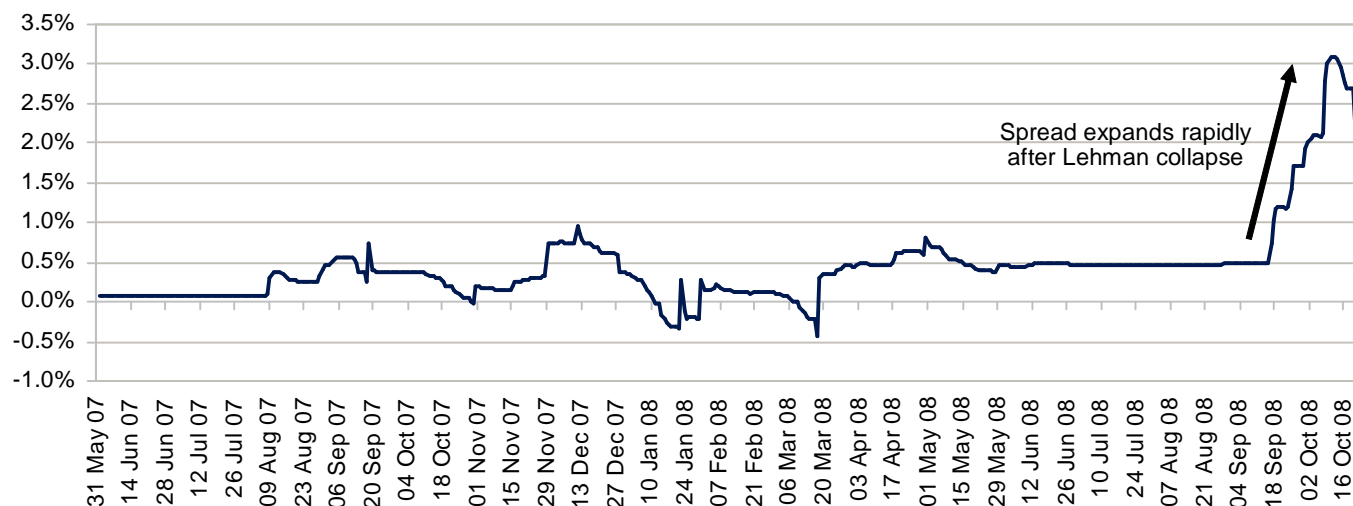
To this unpleasant mix we then have to add a loan to deposit ratio of well over 100% in the US and UK banks by the beginning of 2007. So when the inevitable losses came, banks did not have a secure enough funding base to support them. It is at this point that some form of official action became inevitable; it is also at this point that the story becomes more controversial. Whether Lehmans should have been allowed to fail and the nature of official support will remain controversial for years to come.



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It was only after Lehman's collapse that developed markets' woes became a serious concern for the whole world. This chart shows the gap between 1 month London US dollar interbank rates and the Federal Reserve target rate.

USD 1 month LIBOR spread over Fed Target Rate



Source: Bloomberg

Signs of credit stress were clearly apparent since August 2007. But it was only on September 15th, when Lehman declared bankruptcy, that credit spreads on even this short dated paper expanded massively. The banks were refusing to lend even on a short term basis to each other, or to anyone else. This cash hoarding was obviously suicidal for the banking system as a whole, but was explainable from an individual bank's point of view. Massive liquidity injections by the Federal Reserve only provided cash to the banking system, it did not get out to the wider economy.

This hoarding of cash by the US banking system caused a global lack of dollars. Any government or company that required dollars would find them hard to come by. If the need was desperate then sales of other currency assets into dollars would have to be done at firesale prices. Hence the aggressive strengthening of the dollar that we have seen.

Meanwhile, as large international banks with operations in the US saw their dollar funding and dollar liquidity dry up, they naturally began to hoard other major currencies to at least have liquid assets that could be converted into dollars, even if at low rates. Hence the credit crunch spreads to the euro area and beyond.

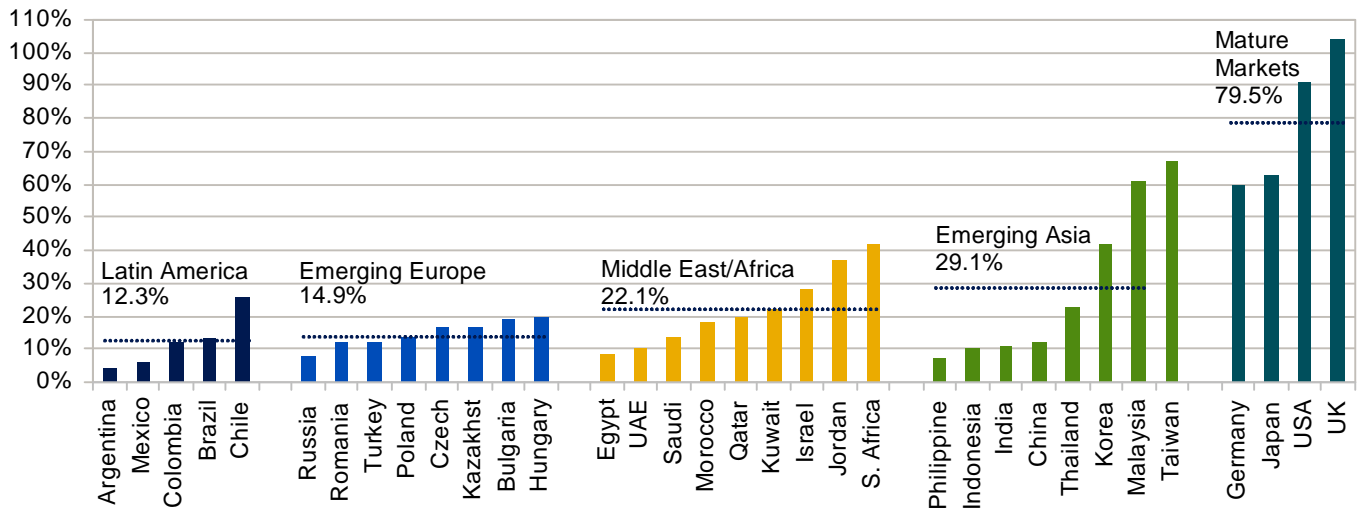
The US dollar's position as the world's reserve currency has meant that a serious lack of availability of dollars has created a global credit crunch. So now we need to look at the particular effect on emerging markets.

Emerging Market Implications

Internal Funding

As the chart below shows, there is little fundamental problem in the banking systems of most emerging countries – there is simply not the level of internal consumer debt.

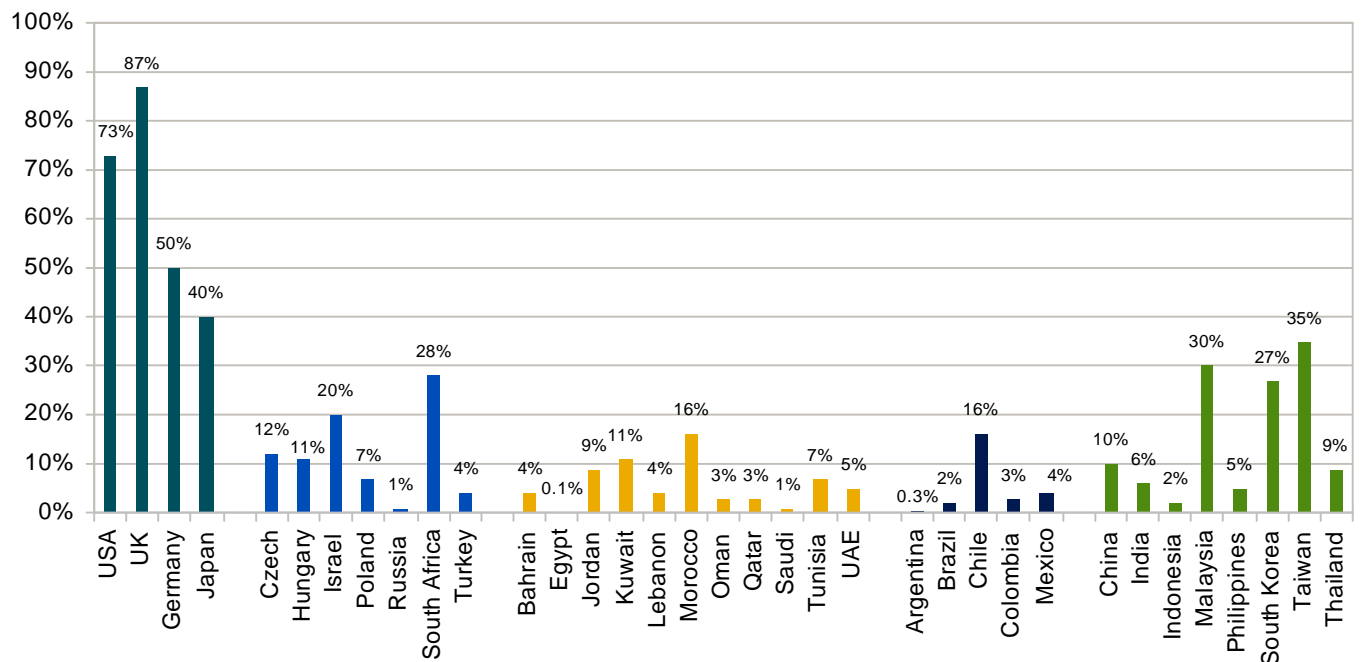
Household debt as a % of GDP (2006)



Source: IMF, Morgan Stanley

In particular mortgage markets are not yet significant in most emerging markets.

Mortgage Loans as a % of GDP (2006)



Source: Central bank data, Morgan Stanley

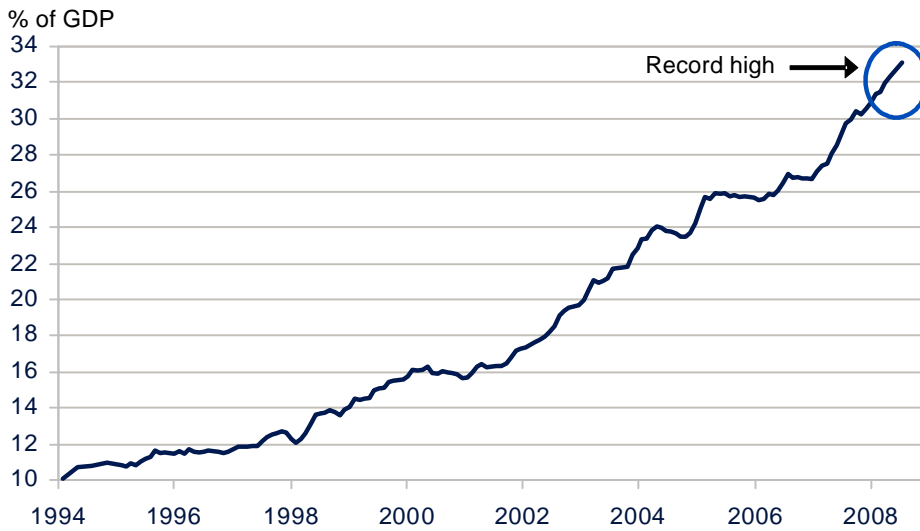
But the replication of the problems in the developed markets is a possibility in emerging markets. An internal credit squeeze emanating from the banking system could happen if the banking system was itself extended. The squeeze in dollar availability could act as the catalyst for realisation of these problems even if a banking system had relatively low exposure to dollar liabilities.

If a problem does develop in the banking system, the only way to fix it is, as for developed markets, for governments to step in. Not all emerging markets have the same tax base, investment base and hence capacity for intervention that developed markets do however. We will look at specific markets' vulnerability to these factors later on in this piece.

External Funding

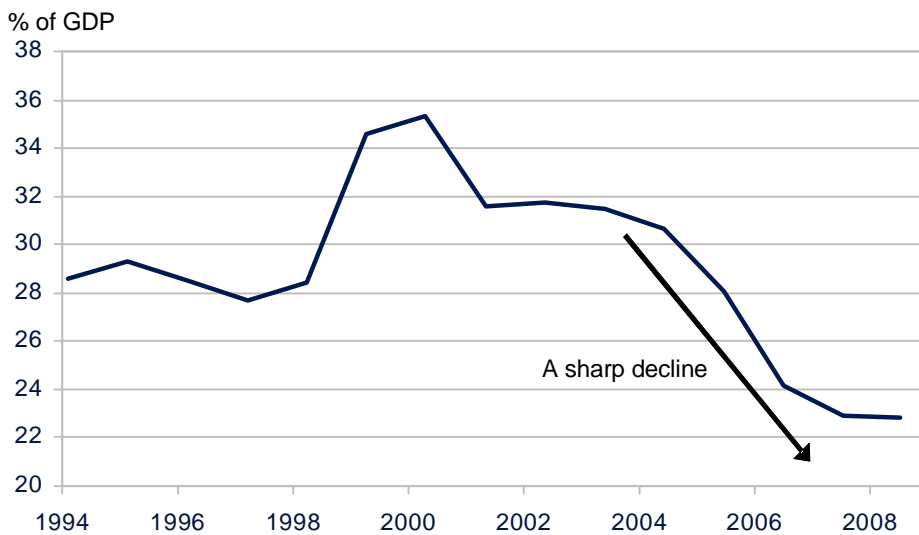
Whilst emerging markets may not have the same banking problems as developed markets, they could be severely affected by a severe shortage of external funding. At first glance emerging markets do not look likely to suffer from these effects. They have abundant reserves, and as of earlier this year, substantial current account surpluses.

Emerging markets : Foreign reserves



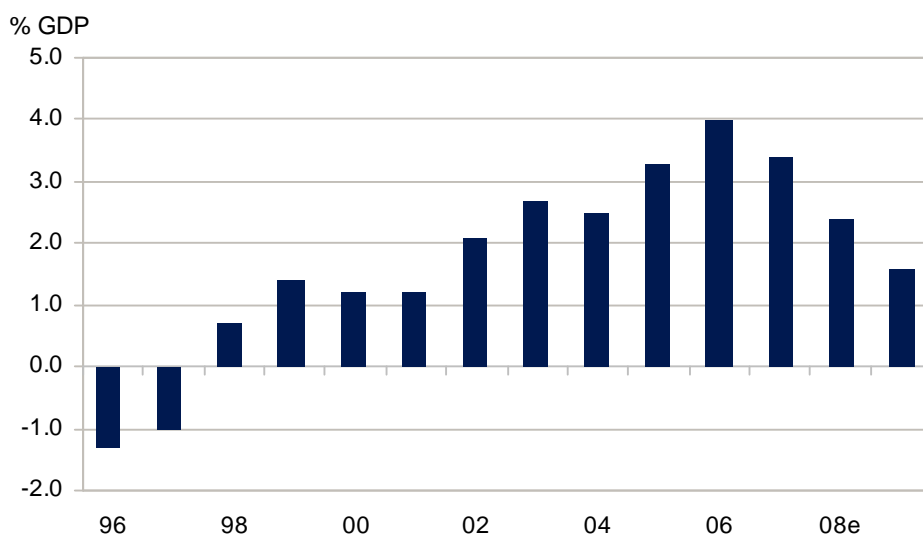
Source: BCA Research

Foreign debt



Source: BCA Research

Current accounts now in surplus



Source: IMF, Morgan Stanley

But while the overall picture looks good, it masks some problems in individual countries. So let's look at the way that external funding problems can hit a country in a little more detail.

Countries which have relied on external funding, will find that it will no longer be available. So countries with large current account deficits will not be able to fund them. Inevitably, the current account deficit will have to close. Since a current account deficit represents a country spending more externally than it is receiving, closing a deficit involves reducing a countries' spending - in other words a drop in GDP. It also implies rapid depreciation of the currency to enable trade balances to equalise.

So a large growth slowdown is the outcome for countries with high external funding needs in a credit crunch environment. If countries also have a high level of external debt then a rapid drop in the currency increases the risk of default in the government or corporate sector. To protect against this, countries with high levels of foreign exchange reserves should be able to use these to avoid default risks, assuming that these reserves have not been built up by short term capital inflow (implying likely short term capital outflow).

Which Countries are Vulnerable?

So which countries in the emerging world face these risks? The annex to this paper has a number of indicators of vulnerability. On internal stresses there are two indicators that look at possible stress in the banking system – loan to deposit ratios and credit growth over the previous 4 years. We also look at two indicators on the ability of government to spend money to bail out banks – fiscal deficit and total government debt.

Once again, the overall picture for emerging markets looks reasonable. Loan to deposit ratios of under 100% indicate a banking system that is not particularly stretched. Credit growth of less than 30% does not look too high from a cyclical low point. Average fiscal deficits are more or less zero and gross public debt is, on average under 40%.

But, there are countries with problems. A number are in Eastern Europe. The Baltic countries, in particular, have had high credit growth and a banking system with a lot of loans made, but a small deposit base. Hungary also has a poor loan to deposit ratio and all of these countries have stretched public finances. About the only positive thing that can be said here is that all of these countries are in the EU and are relatively small. They are more likely to be "rescued" than others and the costs of a rescue to the rest of Europe are small.

Brazil and Colombia also rate highly as potential problems. We think, particularly in Brazil, that there are some statistical quirks that mean the loan to deposit ratio is not as bad as it appears. Colombia has been having a downturn for some time already, and so is a way through its bad debt cycle. Nonetheless, should things worsen in either country the government is relatively constrained in actions it can take.

We should also look at Korea and Russia. Although these countries have reasonably strong public finances, they both have relatively exposed banking systems with weak loan to deposit ratios and high credit growth in recent years. Indeed we have already seen pressure on the banking systems in both countries cause severe currency weakness and stock market problems. Liquidity shortfalls in the banks are causing a credit crunch among business and consumers in both countries and government action is required to ease the situation. Although both governments have reasonable firepower, they have not directed it effectively so far. So, a solvable problem, but a problem nonetheless.

On external vulnerability we look at five indicators – current account; reserves built up due to portfolio flows; reserves; and foreign debt, total and short term.

Again the position for emerging markets as a whole is relatively strong. Just over half the countries have a current account surplus. Very few have seen the majority of recent reserve growth due to “hot money” inflows. Average reserves, at 24% of GDP, are high, and total foreign debt is historically low. For all but three countries, reserves levels are greater than short term foreign debt.

The countries at risk of a foreign funding squeeze seem to be Eastern European, South Africa and Turkey. Eastern Europe looks particularly vulnerable, with large current account problems and a lot of external debt. This raises the risk of not only currency devaluation, but also sovereign default, with dire consequences for GDP.

South Africa and Turkey both look likely to see a squeeze in the current account, currency devaluation and consequent GDP effects. However, without much external debt, they should both avoid the very worst of a balance of payments crisis.

We would also highlight Mexico and Indonesia as potential concerns. Neither country is likely to suffer too much from current account problems. But both countries have benefited from inflows recently and have low reserves, which could put currencies under pressure if capital outflows are persistent.

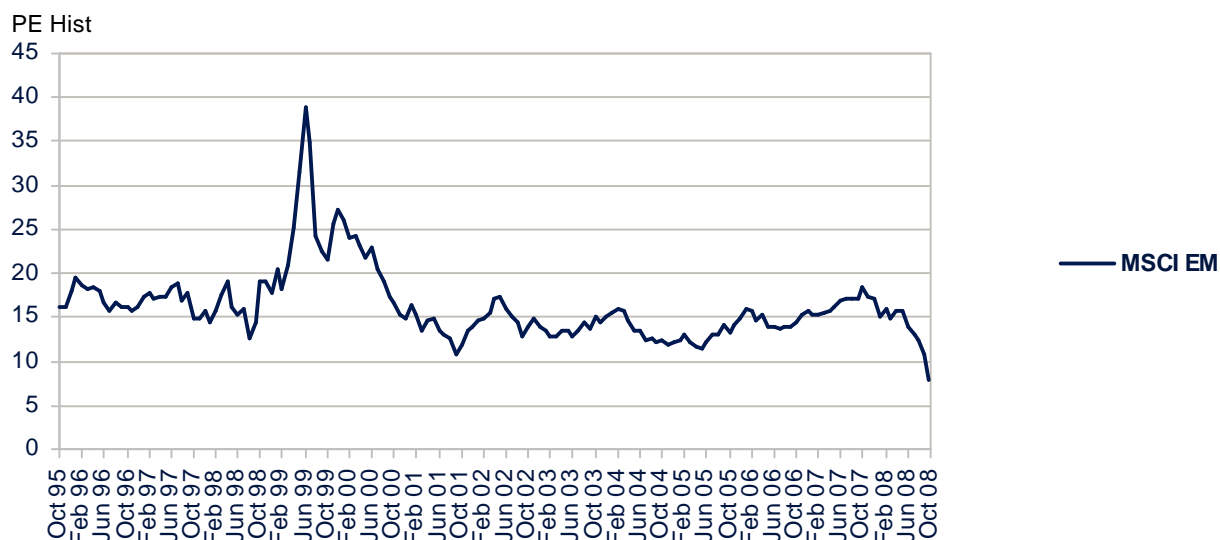
Overall, the biggest risk looks to come from Eastern Europe. Many countries are suffering both internal and external stress. Of the most at risk countries only Hungary is actually in the MSCI emerging markets index. However, a major problem in other countries would undoubtedly be a blow for Poland and the Czech Republic both economically and for sentiment. Other EU members, particularly those with banking operations in the region (eg, Sweden and Austria) may also suffer knock-on effects. It is for this reason some sort of financial assistance is likely to be forthcoming. No set of countries needs it more.

Emerging Stockmarket Effects

If emerging markets are, on average, well placed to weather the storm, why are they doing so badly? We think there are a number of reasons

- The principle reason is that the developed market banking crisis has caused a global de-leveraging cycle that is damaging all assets and certainly all equities. As people are forced to reduce debt they are selling any asset that can be realised for cash quickly, even at depressed levels. In particular:
 - Emerging markets have seen a lot of inflows over the previous 4 years. Many of these investors still have or had profits, which was not the case in other asset classes. Although outflows this years from mutual funds have been fierce, they are still less than the inflow, so this could continue
 - Emerging markets are seen as one of the riskier equity asset classes. In times of trouble investors return to their home markets and reduce riskier assets, which can make the risky thesis a self-fulfilling one
- Emerging market stocks often have more operational leverage than developed markets stocks and/or are involved in “undesirable sectors” such as materials. In a time when uncertainty over earnings is at its height, this weighs heavily on the markets.

That said, markets are at historically cheap levels. Below is a chart of the historic P/E ratio for emerging markets.



Source: FactSet , MSCI

With such uncertainty about earnings at present, it could be argued that this chart means little, because no-one is willing to predict what earnings and hence P/E will be. This uncertainty will cause a massive de-rating of uncertain size until clarity returns. Instead, perhaps we should look at a simpler valuation measure.

Below is a chart of the price to book ratio – a measure of the ability of companies on a longer term basis to turn their basic assets into something more – i.e. to grow at all over the long term.



Source: FactSet, MSCI

This measure is back to the levels seen during the Argentine default of 2001 and subsequent stress of the following year. It is not far off the levels seen after the Asian and Russian crises of 1997/98 when investors effectively assumed that emerging markets had no growth in them.

These valuations can only be justified if the majority of emerging markets are going to have a crisis – in other words a prolonged GDP growth shock on a par with developed markets, or with previous emerging crises. As the analysis above shows, we do not believe things are as bad as they were in 1998. We think a number of key variables have dramatically improved. A large cyclical slowdown is clearly on the cards but not a complete macro-economic disaster. If that is the case then these valuations are cheap. Emerging may still get buffeted by the storm as it rages around, but it should be able to recover quicker and stronger than developed markets.

Conclusion

The credit crunch is a developed market phenomenon. It did not originate from emerging markets. Furthermore, with a few exceptions, emerging markets are not leveraged and have strong balance sheets, so are at low risk of developing their own credit crunch.

Developed markets have to go through a major de-leveraging process which may take years rather than months to fully unwind. Emerging markets do not have to do this – they are suffering from a severe liquidity crunch, but this storm should pass over more quickly.

Finally, and most importantly, emerging markets are trading at record low valuations. Indeed these valuations are comparable with valuations that developed markets reached in the worst times of the last 50 years (in 1982 US equities bottomed at just below 7x P/E ratio on cyclically adjusted earnings). Valuations may not matter in the short term, as liquidity remains scarce, but they will ultimately provide the base for recovery.

Important Information:

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