

Buying time?

Global equity indices suffered a rout yesterday (August 4) as a poorly-received Spanish bond auction, combined with jittery investors and unwelcome commentary out of the European Central Bank (ECB) highlighting downside risks to Euro Area growth, finally generated what appeared to be some panic selling. The MSCI All-Country World index slid 4.1% to close at 311.60 while the S&P 500 index suffered its worst slump since February 2009, tumbling 4.8%. Emerging market equities did not fare any better – MSCI Emerging Market index -2.7%, MSCI Asia ex-Japan index -1.3%.

Pummelled by DM events, but EM outperformance expected to continue

The buffeting suffered by emerging markets (EM) from developed market (DM) events continues. The Euro Area sovereign debt crisis has 'reared its ugly head' again, with rising bond yields in Italy and Spain, while the extended process of achieving agreement to raise the US debt ceiling threatens at least two negative 'knock-on' effects for global equity markets: i) the risk of a downgrade of the US debt rating; and ii) most importantly, a further weakening of activity as some economic agents, notably companies, reacted to the uncertainty of whether the US would default or not. Therefore, an apparently simple process for the markets – raise the debt ceiling and 'move on' – has become far more complicated and markets have become even more nervous in response.

However, despite some sharp falls in individual emerging markets through all of this, Citi analysts have made a positive observation – unusually in falling market conditions, EM equities have been outperforming. They highlight that the MSCI GEMs (-0.7%) outperformed DM equities (MSCI World -1.9%) in July by 120 bps. Since the US debt ceiling sell-off began on July 22, which translated into seven successive days of losses for the US market, the S&P Composite is down by 6.3% to August 3, MSCI World by 6.4% and MSCI GEMs by 4.4%. European shares have been particularly heavily hit, with the DJ Eurostoxx suffering a formal correction in under two weeks, down by 10.6% in USD terms since July 22. Only defensive Japan (-3.1%) within developed markets has outperformed EM equities. The result is that the long-standing underperformance of EM versus DM, going back to early October 2010, has been reduced again – although it still remains at 590 bps.

Citi analysts expect this EM outperformance to continue, even if the current selling is extended (which is not their base case). As the long-standing debt worries in the Euro Area have spread to the US – where, even if default has now been avoided, 'growth-negative' budget cuts are on the way – investors may finally be 'rewarding' emerging markets for their much better fundamentals. Although the main EM challenge of high inflation and rising interest rates remain at the forefront, Citi analysts believe inflation is likely to peak and monetary tightening could end in many major emerging markets before year-end, which supports the case for EM equities to outpace DM equities over the rest of the year.

The risk of a US rating downgrade

The US debt ceiling/budget-cutting agreement signed into law by President Obama on August 2 allows for debt ceiling increases of US\$2.4 trillion through the end of 2012. Spending cuts worth just over US\$900 billion will come into effect immediately and a special bi-partisan committee must agree on a further US\$1.5 trillion of cuts over the long term. If there is no agreement on the latter, then automatic spending cuts will be enacted. No tax increases are included in the package.

Citi's Chief Economist believes that this agreement is likely to lead to a downgrade by S&P. The rating agency cut its long-term rating on the US from 'stable' to 'negative' in April and then on July 14 put both the US's short-term and long-term credit ratings on 'CreditWatch Negative', implying at least a one in two chance of a downgrade within 90 days. Given that S&P called for the US not just to avoid default, but to address its long-term fiscal sustainability, it is not clear that the package will be enough to allow the US to retain its AAA rating.

In Citi's view, the immediate problems for EMs arising from this situation are twofold. First, the recent uncertainty tied to the whole debt ceiling process may remain intact until the S&P ratings decision is known. Secondly, there are the possible effects of the downgrade itself. Our Chief Economist argues that US yields could, with a US downgrade, potentially increase by up to 50 bps at the long end. Forced selling may be small (risk weights for government bonds under the Basel accords remain at zero for AA as well as AAA bonds), but voluntary selling may be heavier. At the very least, existing holders of US Treasuries may be reluctant to add more securities, leading to lower demand for future (heavy) issuance. Other assets could also be automatically downgraded (such as agency securities and municipal bonds), raising their yields. Most importantly for emerging markets, a downgrade may set off yet another 'risk-off' period with declines in equities, corporate bonds, and commodities.

The risk of a 'Double-Dip'

And then there is the US economy itself. The direct impact of the budget cuts themselves may be small. Citi's US Economist argues that this could knock some 0.25% off US growth in 2012, currently forecast at 2.7%. However, there is a more short-term worry than this. There is much anecdotal evidence that the prolonged budget impasse has delayed hiring by companies and even by the government itself and has hurt consumer sentiment. The sharp fall in the July ISM index, in particular, appeared to embed evidence that the debt ceiling impasse has affected business attitudes.

While Citi analysts expect a solid rebound in the second half of 2011 from anaemic growth of little more than 1% in the first half of 2011, the risk now is that the forecast bounce to 3% growth may be too optimistic. On the positive side, if growth turns out to be 'too weak', resorting to QE3 is something that Citi analysts see as increasingly possible. Meanwhile, the overall economic situation in Europe has remained resilient. The recent savage decline in European stocks appears to have had far more to do with the debt worries over Spain and Italy than anything else.

What does all this mean for emerging markets?

Citi analysts believe that EM equities are in relatively good shape to outperform developed markets over the rest of this year and also to show solid absolute gains. Market weakness may as such present investment opportunities. In their view, a downgrade by S&P appears virtually priced in; it would hardly be a surprise if that were to occur. Moreover, even if their US growth forecasts are cut for the next six quarters, a 'double-dip' back into recession remains very unlikely.

▪ The growth picture

The fear for emerging markets is that the risk to growth in developed markets, especially in the US, will spill over into much weaker growth in emerging markets as the global economy slows markedly. In Citi analysts' view, the growth outlook in many emerging markets remains very robust and this is likely to support the asset class as well as the world economy as a whole. They continue to expect China to grow at 9.2% in 2011 and 9% in 2012, with signs now that the slowdown earlier in 2011 has ended.

They also highlight that corporate earnings are driven, in part, by top-line growth; which is in turn driven by nominal, not real GDP growth. Nominal GDP growth (real GDP growth plus inflation) remains very high in EM, estimated at 12.8% in 2011 and 12% in 2012. Most importantly, nominal GDP growth in EM remains far above that in DM of 4.3% in 2011 and 4.0% in 2012. This premium growth trend is expected to support EM equities.

▪ Narrow US exposure

The main source of the current growth worries around the world is the US. But just how exposed are emerging markets to weaker US growth?

- Mexico has by far the highest exposure to the US economy, with 23% of the country's GDP being accounted for by exports to the US;
- The next most exposed countries are Malaysia (10.2%), Taiwan (7.3%), and Thailand (6.3%);
- By region, Latin America has the most exposure (with 7.8% of GDP being accounted for by exports to the US), largely due to Mexico, although Colombia also has some fairly high exposure at 5.1%. Just 4.5% of Asian GDP is accounted for by exports to the US, while EMEA is the most sheltered with a ratio of just 1.2%;

- None of the BRICs have particularly high ratios of exports to the US relative to their GDP. China's ratio is at 4.9%, while those of Russia, India and, especially Brazil, are below 2% of GDP.

The main conclusion is that there is some exposure in emerging markets to the US economy and there are some places to avoid in this respect (such as Mexico). However, with intra-regional trade growing across the emerging market universe, especially in Asia, the effect on emerging markets of negative growth surprises in the US may be less than feared and certainly less than in the past.

▪ **Attractive valuations**

As EM equities have dropped to the bottom of their recent trading range, valuations have fallen, with the forward price-to-earnings ratio (P/E) now down to 10.2x, a discount of 12% to its recent history. Moreover, falling debt yields and weak equity markets have caused the gap between the (trailing) earnings yield (now at 8.2%) and the average debt yield (4.06%) to widen. This, in Citi analysts' opinion, shows how very attractively valued EM equities have become relative to EM debt.

Conclusion

Citi analysts believe the market panic seems overdone and continue to expect emerging market equities to rebound from their current sell-off and to return solid gains over the rest of this year. In their view, the risk of a US recession remains low and global growth is likely to remain solid (especially in emerging markets). China is forecast to grow at a 9% rate in both 2011 and 2012, and with the approach of the peak in inflation and rates in key emerging markets, Citi analysts believe current market weakness presents investment opportunities. Within the emerging market space, they continue to favour North Asia (Hong Kong, Taiwan and Korea) and EMEA (Russia and Turkey).

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