DBS Wealth

Investment Insights

Monday, 26 August 2013

Emerging Markets: No Contagion on the Horizon

SUMMARY

- **Emerging Markets lower on tapering concerns**
- **Full-blown crisis not imminent; markets better equipped to withstand external shocks**
- **EM current account and total reserves position has substantially improved since the 1990s**
- **External debt-to-GDP declines, led by improvement in Developing Asia**
- **Euro zone and China report strong PMI readings**

Last week's Emerging Markets currency sell-down re-ignited concerns over regional contagion risk. Indeed, some of the structural challenges facing the EM today are similar to those that preceded previous crises. However, financial systems and economic fundamentals have improved substantially since the Asian Financial Crisis of the late 1990s and systemic risk is much lower in Asia. While an outflow of funds puts a lot of pressure on economies, Asia is likely to avoid another full blown financial crisis. But equities and currencies are likely to see further downside, with the equities bear widening its embrace over the region. And there may be heightened financial stress on specific EM economies, particularly those with large current account deficits.

EM assets sharply lower on tapering concerns

Global equities were flat last week with mixed performances within Developed Markets (DM). While the US managed to eke out slight gains of 0.6%, Japan lost 1.4%. Meanwhile, Europe managed to end the week flat as sentiments were underpinned by economic recovery in the euro area as the Composite PMI data as compiled by Markit rebounded strongly to 51.7 in August compared to the 50.7 expected by analysts, and its highest in two years. Any figure above 50 indicates expansion. Improvement was seen across the board, particularly in Germany. At the moment, Developed Markets remain an oasis of calm amid turbulence in Emerging Markets, or EM. Last week, emerging markets saw major sell-offs/fund outflows on the prospects of a reduction in the amount of monetary support provided for by the US Federal Reserve and on rising Treasury yields.

The MSCI Emerging Markets index lost 2.6%. Economies with high current deficits bore the brunt of the sell-down. Indonesia and India, in particular, lost 14.6% and 3.6% respectively. Thailand and Philippines also corrected sharply. Last week's price action underscores the volatility within equities as investors were only a month ago starting to rotate from DM to EM. The reverse is now happening.

On the fixed income front, the US Treasury (UST) 2-year yield continued its ascent, rising four basis points to hit 0.38%. Volatility within EM also drove the JACI Composite blended spread higher by 10 basis points (bps).

Meanwhile, higher UST yields lifted the dollar slightly, with the US Dollar Index (DXY) up 0.1%, driven by gains against the yen.

Fig1: Private Flows Into EM Have Been Robust

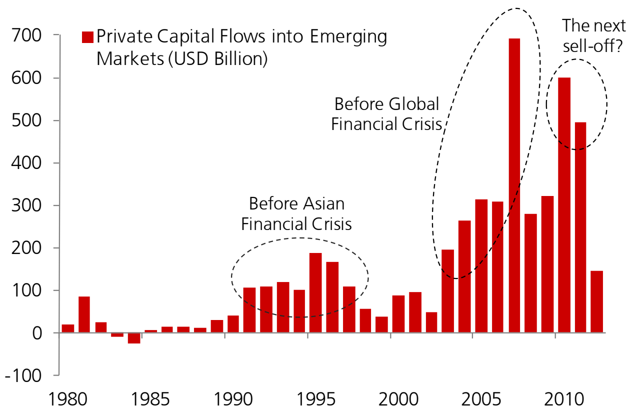


Fig2: Current Account (as % of GDP) Remains in Surplus

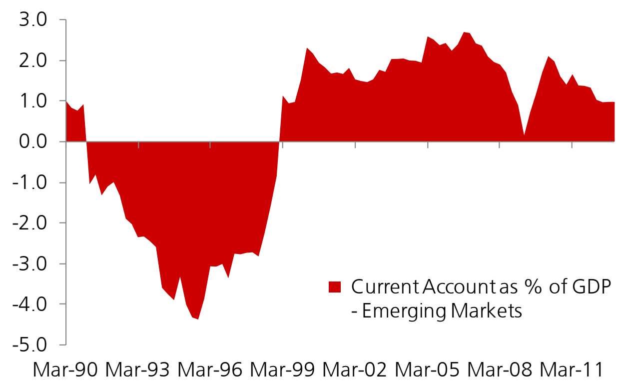
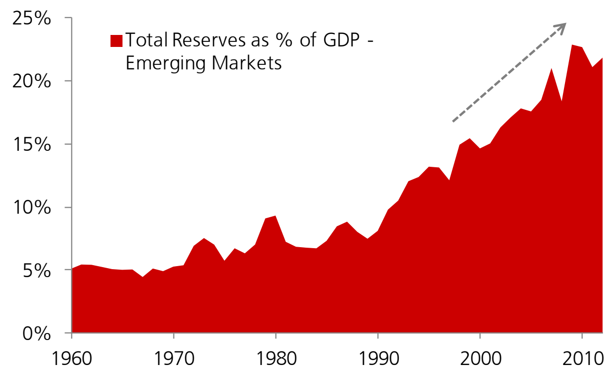


Fig 3: Emerging Markets' Total Reserves On the Rise



Source: Bloomberg, World Bank, DBS CIO Office as of 23 August 2013.

In commodities, the ThomsonReuters/Jefferies CRB index declined 0.6% helped down by weakness in benchmark West Texas Intermediate oil futures which lost 0.8% for the week despite supply concerns because of violence in the Middle East. The London Metals Exchange (LMEX) index also fell 1.3% despite the better-than-expected flash estimate for the HSBC/Markit China Manufacturing PMI for August. The latest reading suggests China manufacturing is back in expansion mode again.

EM risk assets sell-off: A contagion imminent?

Last week's EM currency sell-down reignited concerns over systemic risk. Indeed, some of the structural challenges facing the emerging markets today are similar to those that preceded previous financial crises. Large private capital fund inflows have preceded every financial crisis since 1980 (Figure 1). In the run-up to the Asian Financial Crisis of the late 1990s, EM private flows totalled USD891 billion from 1991-97. Prior to the Global Financial Crisis (GFC) of 2008, private flows shot up to USD1.8 trillion from 2003-07. Post-GFC, loose monetary policies in the US encouraged the "EM carry trade" and between 2009 and 2012, private investment flows into EM totalled USD1.6 trillion. A sudden stop or a "disorderly" exit of these flows on easy money concerns will cause substantial upheaval in EM asset markets, with flow-on shocks to their economies.

EM better equipped to withstand external shocks

Asset prices in these economies may experience further downside ahead as investors grapple with an outflow of funds and incrementally price in a higher cost of capital. Indeed, the equities bear, already in China, Indonesia and the Philippines, could extend to other markets. But we believe that this will probably stop short of another full-blown, systemic crisis because emerging markets are structurally different today and are better equipped to withstand external shocks. While there are pockets of weakness – e.g. the most evident today being India and Indonesia – current account positions are generally stronger; external debt to GDP is lower; international reserves are generally higher relative to GDP; and international banks' claims are lower relative to GDP

Substantial improvement in EM current accounts

There is substantial improvement made over the years in their current account positions (Figure 2). During the mid-1990s, EMs ran current account deficits of 4-5% of GDP on average. However it returned to surplus near the turn of the millennium, peaking at 2-3% of GDP by 2006. Since then, the level of the current account surplus has trended lower but nonetheless, it is still in an overall surplus at around 1% of GDP.

The robust current account situation in EMs is helped by developing Asian economies like Taiwan that possess huge surpluses. In the case of Middle East and Africa, it is a tale of two halves. While countries like Qatar and UAE have large current account surplus averaging at 19% of GDP, this is offset by large deficits in South Africa and Turkey (at 6% on average). The one region that possesses consistent current account deficits across the board is Latin America (Latam).

(Note: DBS follows the MSCI definition of an Emerging Market economy, of which China and India are the largest of the 23 on the list)

External debt to GDP is on the mend, led by improvement in Developing Asia

Years of excessive borrowing by the private sector saw EM external debt to GDP rising to 41% by 1999. In "Developing Asia", foreign indebtedness rose from 19% in 1981 to peak at 35% by the time of the Asian Financial Crisis. However, since the turn of the millennium, EM has made substantial improvement on this front, bringing its external debt to GDP down to 20-30%. A breakdown of this data shows that much of the improvement is attributable to "Developing Asia". It is worth noting that on a global basis, the level of foreign indebtedness for EM remains significantly lower than their G-7 peers where external debt to GDP reached 126% in 2011.

Reserves on the rise; bigger war chest to buffer against external shocks

EM economies have substantially increased their holdings of international reserves. As Figure 3 shows, in the 1990s, total reserves as a percentage of GDP ranged between 10-15%. This ratio has since increased to 20-25%. The improvement is again mainly led by "developing" Asia, where the reserves ratio rebounded sharply from 12% in 1997 to 31% currently. That said, less obvious improvement is evident in other regions, such as Middle East and Africa for instance.

Despite heightened volatility, another major EM crisis remains unlikely

Another crisis is unlikely. Financial systems and economic fundamentals have improved substantially. This is not uniform across the board but overall, the EM basket as a whole is better positioned to withstand external shocks today.

These economies will still face two major challenges. Firstly, the withdrawal of foreign flows will persist on concerns over normalising US monetary policies. Much as the inflow of foreign capital previously drove EM assets higher, conversely, their outflow will now be a drag on the markets. The other major challenge is potential policy missteps – particularly misplaced attempts to hold up currency values. This could both deplete FX reserves and delay currency realignment with changing economic circumstances.

The turbulence is far from over. We maintain our preference for developed markets.

Euro zone and China reported strong PMI readings

Last week, Markit PMI data for the euro area reported strong flash readings of 51.7 for August, coming in above consensus estimates of 50.9. This is the highest since mid-2011 and the improvement was evident in both manufacturing and services. In China, the HSBC/Markit Flash PMI for August also came in better than expected at 50.1 (vs. 47.7 in July). The rebound likely reflects recent stimulus measures undertaken to boost the economy as well as the normalization of liquidity flows.

Asian Insights Feature

Singapore: On Track to Higher Income and Productivity

Singapore has embarked on a restructuring path initiated by the Economic Strategies Committee (ESC) in 2010. The objective is to enhance productivity and to foster inclusive growth.

This is the fourth year of the restructuring. So far, measured productivity has languished. The change in productivity has averaged -0.6% per annum in 2011-2012 and has dipped further to -2.0% in 1H-13. This is a far cry from the original target of 2%-3% set by the ESC. Is restructuring working?

The answer is yes, restructuring is raising productivity and real incomes. The average number of hours worked per employee has been fairly stable. At around 46 hours per week, the figure is among the highest in the world.

It may seem difficult to reconcile the persistent contraction in productivity growth when the average number of hours clocked by workers here has remained the same for more than a decade.

Also, the productivity measure adopted by Singapore is probably not a good indicator of how productive workers actually are.

In Singapore, as in other countries, productivity growth is defined by the difference between GDP growth and labour growth. But measured productivity can be very different from actual productivity – i.e., how efficient the workforce is – because Singapore is a small ship in a big sea. GDP jumps around a lot, especially in short-term, for reasons not relating to Singapore or the efficiency of its workforce.

Historically, measured productivity growth has been more correlated to GDP growth than employment growth. And graphically, except for the period between 2005-2008, when employment accelerated, measured productivity growth usually moves in tandem with GDP growth.

Hence, the measured productivity that is widely quoted in Singapore is not a good gauge of the success of the restructuring effort, especially in the short-term.

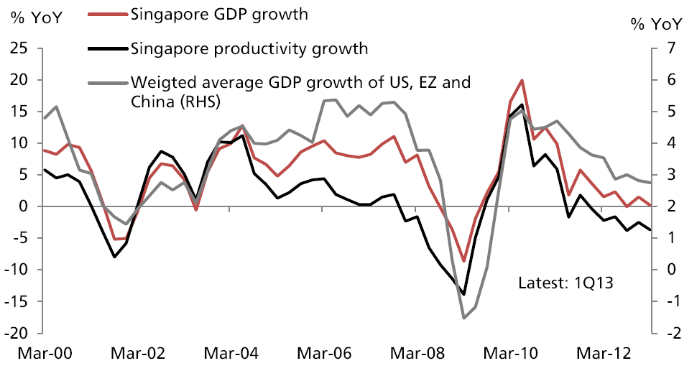
Granted the counter-argument is that if workers are more efficient, GDP growth should be faster. In the medium-term, this is so. But in the shorter-term, Singapore's GDP growth performance is determined by global outlook. Not surprisingly, GDP growth and measured productivity growth are highly linked to global economic cycles rather than to true underlying efficiency of the work force.

Income should increase along with the improvement in real underlying productivity. This is different from the macro level measured productivity mentioned earlier. For example, a worker who is more proficient and hence more productive than others, should see his income rising faster over time. Technology and innovation can make a big difference in boosting such micro level productivity, which will thus raise income. But the main point to note is that real income should always increase along with gains in such type of productivity.

So this brings us to the ultimate end goal of this entire restructuring exercise. The restructuring is aimed at increasing the real median income of Singaporeans by 30% in the current decade. Therefore, a better gauge on the success of the restructuring would then be the improvement made in the real median income.

In this regard, real median income has increased by an average pace of 3.1% per annum since the announcement of the ESC recommendations. At the current pace, real median income will be 35% higher than what it was in 2010. This is precisely what policymakers have aimed for. By this measure, restructuring is smack on track.

SG's GDP and productivity growth tied to global economic cycle

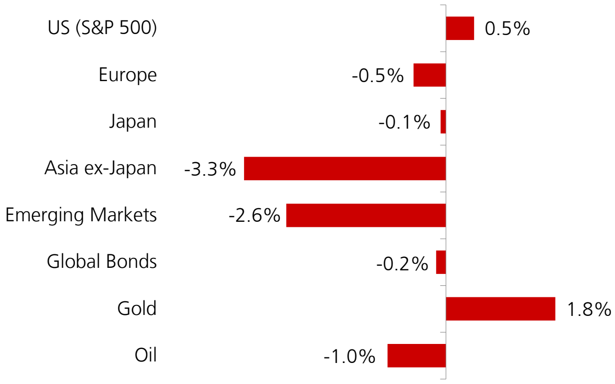


Source: DBS Group Research

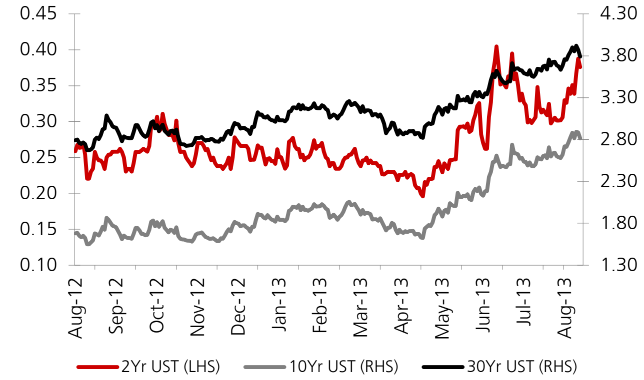
Source report: DBS Group Research. Economics. SG: Restructuring on track. 16 August 2013.
Summarised by DBS Group Wealth Management /CIO Office. An edited version appeared in 19 August 2013's *Market Snapshot.*

Economic & Market Data Monitor

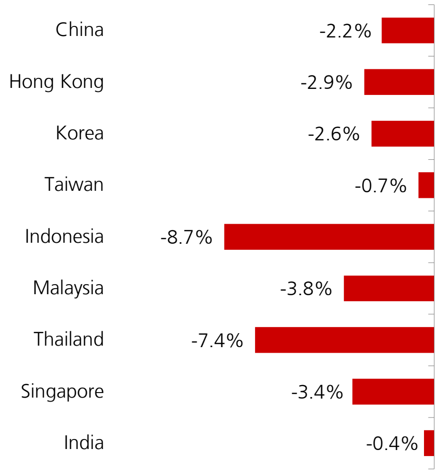
Leading Global Returns



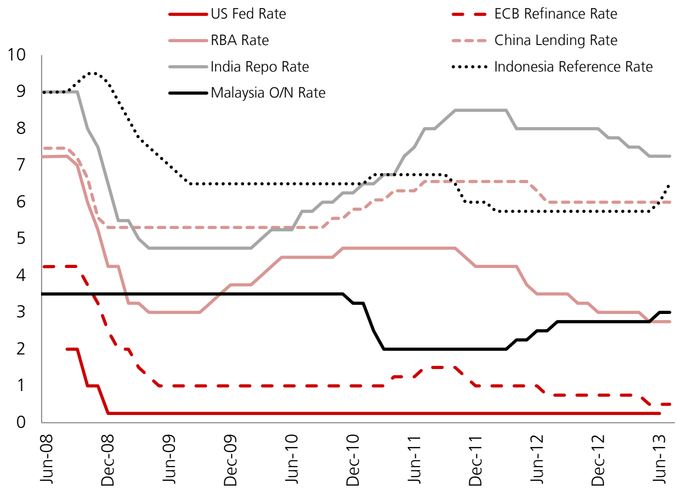
US Treasury Yields (%)



Asia Country Returns



Key Benchmark Rates (%)



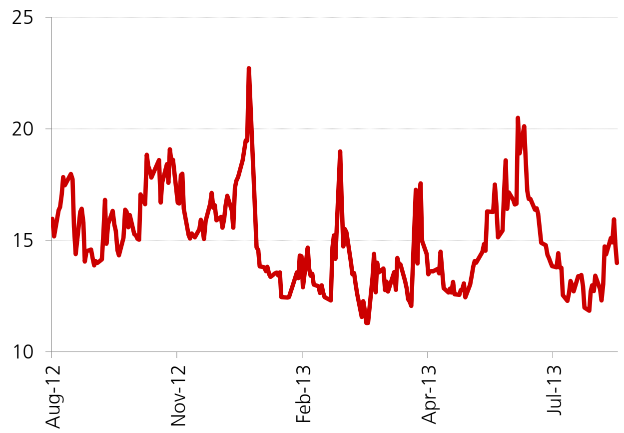
Key Forward PE & Earnings Growth

	YTD Returns	Fwd P/E 2013	10-Year Average	Earnings Growth 2013
US (S&P 500)	16.6%	16.6	14.0	6.8%
Europe	8.9%	37.0	12.1	1.9%
Japan	32.8%	23.8	16.3	59.1%
Asia ex-Japan	-8.0%	11.4	12.1	15.4%
Emerging Mkt	-11.6%	10.6	10.8	9.7%
Global Bonds	-4.0%	n.a.	n.a.	n.a.
China	-7.3%	8.7	12.0	11.0%
Hong Kong	-3.5%	10.0	13.1	10.2%
Korea	-6.4%	9.4	9.5	23.3%
Taiwan	2.3%	18.7	13.9	36.1%
Indonesia	-3.4%	13.4	13.5	15.4%
Malaysia	1.9%	16.2	14.0	-0.7%
Thailand	-3.9%	12.5	10.4	18.8%
Singapore	-2.5%	12.8	13.9	0.5%
India	-4.7%	14.7	14.8	10.7%

^ YTD refers to Year-to-date; Returns in local currency.
Earning figures are as of 4 July 2013.

Source: Bloomberg, IBES, DBS. Data as of 23 August 2013.

Volatility (VIX Index)



In The Coming Week

26 Aug 2013	Event	Period	Survey	Actual	Prior
SI	Industrial Production (YoY)	Jul	1.80%	--	-5.90%
US	Durable Goods Orders	Jul	-3.60%	--	4.20%
US	Dallas Fed Mfg Activity	Aug	--	--	4.4
TH	Exports (YoY)	Jul	1.00%	--	-3.40%
27 Aug 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
HK	Exports (YoY)	Jul	4.00%	--	-0.20%
PH	Imports (YoY)	Jun	1.90%	--	-2.40%
US	S&P/Case Shiller Home Price (YoY)	Jun	12.10%	--	12.17%
US	Consumer Confidence Index	Aug	79.0	--	80.3
US	Richmond Fed Mfg Index	Aug	0	--	-11
28 Aug 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
US	Pending Home Sales (MoM)	Jul	0.00%	--	-0.40%
TH	Manufacturing Production (YoY)	Jul	-2.00%	--	-3.50%
SK	Business Survey Manufacturing	Sep	--	--	73
29 Aug 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
PH	GDP (YoY)	2Q	6.90%	--	7.80%
US	GDP Annualized (QoQ)	2Q S	2.30%	--	1.70%
US	Initial Jobless Claims	Aug-23	330K	--	336K
US	Core PCE (QoQ)	2Q S	0.80%	--	0.80%
30 Aug 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
SK	Industrial Production (YoY)	Jul	-1.00%	--	-2.60%
JP	Jobless Rate	Jul	3.90%	--	3.90%
JP	National CPI (YoY)	Jul	0.70%	--	0.20%
JP	Industrial Production (YoY)	Jul P	2.00%	--	-4.60%
EZ	Consumer Confidence	Aug F	--	--	--
EZ	Unemployment Rate	Jul	12.10%	--	12.10%
EZ	CPI (YoY)	Aug A	1.40%	--	1.60%
IN	GDP (YoY)	2Q	4.60%	--	4.80%
US	Personal Income	Jul	0.20%	--	0.30%
US	Chicago Purchasing Manager	Aug	53	--	52.3
US	Univ. of Michigan Confidence	Aug F	80.5	--	80

Source: Bloomberg News. Data as of 23 August 2013. Note: DBS Group Research (DBS)

IN THE COMING WEEK

Japan will release a slew of data this week, but focus will be on the CPI reading for July. Economists estimate the figure to accelerate to 0.7% on-year from 0.2% a month ago.

India's GDP is expected to expand 4.6% on-year in 2Q-13, slower than the 4.8% growth seen in 1Q.

In Singapore, Thailand and South Korea, all eyes will be on July industrial production numbers.

Unemployment rate in the euro zone is forecasted to remain stable at 12.10% in July. Also on tap: consumer confidence and inflation data.

Philippines' economic growth in 2Q-13 is expected to come in at 6.9% on-year from 7.8% a quarter ago.

Economists estimate Hong Kong's exports to rebound to 4.0% on-year in July from -0.2% last month.

In Review

- **Indonesia's** current account deficit widened to a record last quarter and the economy grew by less than 6% in 2Q – its lowest number since 2010. The country announced new policy measures to tackle its deficit issue and weakening rupiah. The government will increase the import tax on luxury cars, seek to reduce oil imports and provide tax incentives for investment in the agriculture and metal industries. It also revised Indonesia's GDP growth estimate for this year to 5.9%-6.0%, down from 6.3% estimated earlier.

- Elsewhere in Southeast Asia, **Malaysia's** inflation rose 2.0% on-year in June, while domestic growth slowed to a 4.3% pace in 2Q-13 (versus 4.7% in 1Q-13). This saw Bank Negara Malaysia cutting its GDP forecast to 4.5%-5% for 2013 from an earlier 6%. **Thailand** fell into an unexpected recession after reporting 2Q-13 GDP at -0.3% following a -1.7% figure in the previous quarter. A recession is technically defined as two consecutive quarters of negative GDP numbers.

- The preliminary reading for **China's** manufacturing activity rebounded to 50.1 in August from an 11-month low in July. A sub-index measuring new orders rose to a four-month high in the same month. Elsewhere in North Asia, **Taiwan's** industrial production unexpectedly jumped to 2.1% on-year in July, supported by upbeat export orders and improved manufacturing output.

Source: Bloomberg News, Dow Jones Newswires, Thomson Reuters. Data as of 23 August 2013.

Prepared by the CIO Office

Chief Investment Officer
Lim Say Boon

Investment Strategy
Manish Jaradi
Jason Low

Investment Communications
En-Lai Yeoh
Michele Lee
Zita Setiawan