SINGALLIANCE

Letter n°13

Which stock market approach in emerging countries facing crisis?

« How much more grievous are the consequences of anger than the causes of it. » Marc Aurèle

In everyone's life, excluding the hypothesis of a new wave, the confinement will have lasted one out of an average lifespan of 320 quarters. Financial markets want to believe that companies had also the same brief activity halt, hence were expecting a V-shaped recovery. The footprint for OECD members and China will be more pronounced and lasting as their debt ratios as a percentage of GDP will deteriorate by 15 - 20%. For emerging countries, excluding China and Russia, which are the focus of this note, the crisis is deeper, and in the words of **Marc Aurèle** in incipit, we can replace anger by crisis and thus better appreciate the extent of the problems. There is no single cause, such as the temporary halt in supply in developed countries, but a combination of causes. There is no obvious remedy either, as zero interest rate financing of the recovery is not an option, and as social shock absorbers, such as the welfare state or partial unemployment compensation, do not exist.

To get a better understanding of the problems, the immediate causes and remedies will be analysed. Many examples will be taken from large countries such as India, Brazil, South Africa, Turkey, Middle Eastern and African countries. For the sake of brevity, an analysis of the structural shortcomings of many of these countries will be kept for a later note, but the conclusion is the same, be it economic or structural. It will be a challenge for most of these countries to catch up with the GDP per capita of OECD countries. In fact, it is more likely to diverge than converge in the coming years.

Causes:

In OECD countries, the recent growth cycle has been the longest in the post-war period (since mid-2009 in the United States), and the recession is the consequence of a voluntary halt in economies to stop the spread of the virus. In emerging countries, there are two main causes: capital flight and falling incomes, which have various contributing factors.

Falling incomes:

Most emerging countries are more dependent on the outside world than the major developed countries.

For some, the fall in income is due to the price crash in commodities, especially oil; for some due to a reduction in tourism; for some due to the decreased money remittances from overseas workers; and for the most part, due to the temporary halt in investments made by large multinational companies.

Countries dependent on commodities: Saudi Arabia is often mentioned, as its foreign exchange reserves have fallen by $200 billion, its budget deficit will exceed 10% of GDP, and the major equipment projects led by Crown Prince MBS are necessarily put on hold. However this neglects the fact that apart from a few recent borrowings, the country has no debt, holds a quarter of the world's oil reserves, benefits from a low production cost of just a few dollars per barrel, and has a population of 30 million, which is certainly growing rapidly but is still manageable in view of the country's potential. The analysis is similar for the other Gulf nations, and it should be recalled that if Saudi Arabia's rating is A, Qatar's is AA-, Kuwait's is AA and Bahrain's is B+. The problems are obviously more acute for Algeria, Ecuador, Angola with a debt at 120% of GDP and many other African countries because their oil reserves are less sustainable, production costs are higher, and their financial situation is more precarious. Let us put aside the dramatic situation of those countries under sanctions, such as Iran and Venezuela, or those at war or unstable, such as Libya and Iraq.

Countries dependent on tourism: Thailand, Cambodia, the Philippines, Indonesia, and many others come to mind. Tourism receipts frequently account for 20% or more of GDP. This activity is halted, and the year is virtually lost.

Countries dependent on external investments: large countries such as India, Brazil, South Africa, and Turkey share a potentially attractive domestic market but suffer from low savings rate and dependency on external capital to finance infrastructure projects. An indicator of this dependence is the size of their current account deficits, often at 4 - 5% of GDP.

Countries dependent on overseas workers' incomes: Egypt and the Philippines, both with a large population of workers based in the Persian Gulf, are therefore reliant on economies affected by a decrease in resources, which are in the process of reflection to become less dependent on foreign labour.

Countries dependent on exports to developed countries: for several producers of manufactured products or components, textiles or automobiles, the disruption in production and lower consumption in OECD countries was fatal, as subcontracting activity was halted. In countries such as Vietnam, Malaysia and Thailand, exports to the European Union and the United States alone respectively account for 30%, 12% and 11% of GDP. Significant proportion of exports to a recessionary Japan further add to the problem.

While the World Trade Organization (WTO) anticipates a 10 - 30% drop in international trade this year, countries such as Turkey or Morocco, at the gateway to Europe, or even the countries of Southeast Asia, are sometimes more impacted.

Capital flight and currency depreciation:

While emerging countries have always been subjected to erratic movements in capital inflows, in times of international euphoria, or outflows during times of anxiety, the capital flight recently observed has weakened their currencies and increased debt servicing costs. The International Institute of Finance (IIF) estimates capital outflows in recent months at $100 billion.

The countries that have had the highest levels of debt in recent years are the most vulnerable: such as Brazil and Argentina with debt standing at 90% of GDP, Mexico with a debt of 55% of GDP, and South Africa with a debt of almost 100% of GDP. We could add India, structurally hampered in their development by a low domestic savings rate which has an impact on the investment rate, at a low of 25% of GDP, compared to China at more than 40%.

In summary, the crisis is widespread. The recession is expected to be more than 7% in Latin America, nearly 10% in Mexico, 5 - 6% in Turkey, India and South-East Asia, more than 4% in the Middle East and barely less in Africa, figures that are sometimes insignificant when compared to the already lacklustre 2019 results for some. Among the few that can show positive growth is Vietnam, an attractive market with a population of around 100 million, interesting candidate for relocations of Chinese companies and for Western companies anxious to reduce their dependence on China, and even more attractive since the ratification of a free trade agreement with the European Union.

Remedies:

The difficult recourse to the budget deficit:

In large countries, budget deficits of 10 - 20% of GDP will not be uncommon this year. Nothing like this is possible in emerging countries unless one takes risks on monetary stability. Thus, OECD countries are able to compensate for the decline in GDP with at least an equivalent deficit. All these measures are designed to finance partial unemployment, to reduce the burden on companies, and to guarantee loans to prevent bankruptcy risk. There is nothing like this for emerging countries, which would ironically need it. Public spending normally represents only an average of 27% of GDP, compared with 42% in OECD countries. There is no question of unemployment compensation, nor support for consumption. And, even when compensation exists, most workers are in the informal economy and therefore would receive no support. The informal sector is frequently 50% of the economy in sub-Saharan Africa and India, still 35% in Latin America and Turkey, and in China, few of the 280 million migrants receive unemployment benefits. To this, we can add the low health expenditure, for example it is 2.5% of the federal budget in India, and 1.2% of GDP in Egypt. These

deficiencies in the development of the welfare state explain the use of precautionary savings for those who are able to accumulate or a relapse into poverty, perhaps even famine.

The impossibility of "Quantitative easing" and zero rates:

Zero rates are the immense privilege of OECD countries: Switzerland with its negative official rate of -0.7%, the Eurozone at -0.5%, Japan at -0.1%, the United States and England at zero. They enjoy an incomparable advantage which allows their low economic growth to absorb the debt burden. There is nothing like this in emerging countries, because they cannot rely on a key currency, thereby being exposed to a loss of confidence, which can lead to capital outflows causing its currency to weaken, imports to become more expensive and inflation to spread. Turkey lowered its rate from 24% to 8%, but its currency collapsed. Brazil has tried to ignore the same constraint, and its currency has depreciated sharply this year. India has just lowered its rate from 4.4% to 4%, but this will have no positive impact.

The appeal to the IMF and the quest for longer repayment terms:

Since the beginning of the year, nearly 30 countries have had their debt ratings downgraded by Fitch. Among them are Mexico, South Africa, Angola, Gabon. In Africa, a moratorium has been granted for debt interest repayment. In concrete terms, the 2020 deadlines are postponed for three years to 2022. This is just the beginning, but some countries such as Syria or Sudan do not benefit because they are already late with their repayments. According to the IMF, $2.5 trillion should be mobilized to help emerging countries. The World Bank has granted $12 billion in "facilities" for countries in difficulty and the IMF, in response to aid requests from 110 countries, has made available $50 billion of the $100 billion in emergency aid that could be granted. The first countries to be assisted included Madagascar, Gambia, Jordan, and other African countries. Soon, Ecuador, Senegal, Pakistan, Ghana, and Chad will also receive aid.

The debt cancellation sought by several organizations will meet with resistance from China, which has granted $350 billion in loans in recent years according to IMF statistics, and some countries owe it the equivalent of 15 - 20% of their GDP. China cannot refuse gestures because its image would be badly damaged, but today it does not have the financial means to afford large sacrifices.

Turkey, despite its low foreign exchange reserves of less than $90 billion of gross reserves (including gold), does not want to consider an appeal to the IMF for more than $70 billion of commitments. However, its swap agreement with Qatar for $5 billion will not be enough because banks are heavily indebted in foreign currency and must repay $80 billion next year, the equivalent of more than 10% of GDP.

The default risks:

The G20 would like to alleviate debts. The most critical situations are in Argentina and Lebanon. The former, following a collapse of its currency, has endured official inflation of more than 50% in 2019 and sees no way to cope with a debt of 90% of its GDP, or $310 billion and a poverty rate of 45%. The country defaulted in May 2020, would like to restructure $66 billion, suspend payments until 2023, benefit from substantial interest relief and partial debt write-off. But negotiations are difficult because Argentina is a repeat offender. Ten defaults and debt restructuring in the 20th century did not deter investors from subscribing to a 100-year issue at a rate of just over 7% a few years ago, but the latest IMF assistance, a record $44 billion, dates only from the last Macri government. The situation in Lebanon is no more enviable and is compounded by an inextricable political situation. The currency has collapsed by some 75% against the US dollar. A cut of at least 70% on the bonds is envisaged to halve the current ratio of public debt/GDP of 175%, or a debt of $90bn by the end of the year. Drastic measures were taken, but an agreement has yet to be reached and the poverty rate is exploding.

Conclusion: *« We like to be called the continent of hope... This hope is like the promise of a paradise, a debt whose payment is always postponed. »*
Pablo Neruda

From a financial perspective, the reasoning developed by the European Commission to help the countries of southern Europe is valid for examining the situation of emerging countries. A pandemic is a global crisis that calls for international cooperation. Failing to qualify for zero-interest financing, emerging countries must be able to expect debt rescheduling, or even write-offs for the most fragile countries.

From an industrial perspective, some producers fear relocations within the OECD, but as analysed in our previous letter, we do not anticipate a large-scale movement.

From a trade perspective, some people are concerned about new taxes, such as possible carbon tax at the borders of the European Union, which would affect their competitiveness.

From a social perspective, thanks to globalization, the percentage of poor people in emerging countries has been reduced from more than 40% of the population in 1980 to 15% in 2015, and it is expected to worsen significantly in 2020. The G20 talks about a 50% increase in the number of poor people, 400 million more in a world of 7.7 billion, and the World Bank fears a resurgence of famine.

From an environmental perspective, a tightening of ESG standards in Europe, for example, could affect the competitiveness of many companies in emerging countries.

From an economic perspective, without growth, there is no job creation, and African countries with 60% of their population under 25 years of age or India with 45% are facing a challenge. These two regions need to create some 13 million jobs every year. In India, unemployment affects 25% of the working population, or 120 million people. Brazil is the most problematic case, with a recession of almost 10%, after years of recession or low growth, two-thirds of its population in a precarious situation, a halt in international investment and a President in political limbo.

From a political perspective, we can see the setback suffered by populist governments, skilled at playing demagogy in good times but struggling to transparently manage a crisis situation. Brazil, Turkey, the Philippines, and India come to mind.

From a geopolitical perspective, some populist regimes are looking beyond their borders for a way to make people forget the economic difficulties. Turkey and its interventions in Libya and Syria are just one example.

These developments show the volatility, beta and the upward or downward amplification of investments in the financial markets of emerging countries. With prudence guiding our investments, our current preference in allocation is to OECD countries and China. If we stick to the three traditional investment profiles of mandates, we will not expose the "defensive" profiles to these erratic variations, and we will select a few stocks and themes to invest 5% in the "balanced" profiles and a little more than 10% in the "growth" profiles.

Geneva, June 18th, 2020

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