



## Fragile five to one

*Four years on, much has changed for Indonesia, South Africa, Brazil and India, while Turkey remains the ‘fragile one’. Investment opportunities nestle within the collective, while a new raft of fragility candidates for 2018 face up to geopolitical and economic challenges.*

Fear of Federal Reserve (Fed) monetary tightening triggered the coining of the infamous ‘fragile five’ tag line back in 2013. As Chairman Ben Bernanke announced that the Fed would move to slow the purchase of bonds that formed a key part of its quantitative easing (QE) programme, mass market panic ensued. Many emerging markets (EM) had become reliant on foreign flows to finance their growth and cover deficits, leaving them vulnerable to the end of QE, a rising interest rate environment and a strong US dollar.

Indonesia, South Africa, Brazil, Turkey and India were identified as the five markets with currencies most under pressure against the US dollar, as a result of having significant current account deficits and being heavily reliant on external financing.

Four years on and we are facing further action by the Fed to tighten monetary conditions – most recently in the form of the December 2017 interest rate hike – the third for 2017 with a further three projected for 2018.

### Market Insight



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But the situation has changed a lot, with EM as a whole in a better state than 2013. We revisit the fragile five to see if economic and political changes have resulted in potential investment opportunities.

<b>Current account deficit (% of GDP)</b>	<b>Indonesia</b>	<b>South Africa</b>	<b>Brazil</b>	<b>India</b>	<b>Turkey</b>
Year to Q3 2013	-3.6%	-6.0%	-3.2%	-4.1%	-6.4%
Year to Q3 2017	-1.3%	-2.5%	-0.6%	-1.2%	-4.8%

Source: Macrobond and local sources

In 2013 the five economies were running hot; inflated by QE-fuelled international inflows, a strong global liquidity environment, record-high oil prices (USD91.17 a barrel annual average) and a loose monetary stance by central banks around the world. The taper tantrum hit EM hard. Yields soared and markets sold off as asset flows left the region in favour of developed market economics.

Over the subsequent four years, EM economies have undergone significant change. Financial structures are in better shape with balance sheets notably cleaned up, aided by rising long-term foreign participation in local currency debt markets. Local currency bonds had a particularly strong 2017 – JPMorgan GBI-EM Global Diversified index was up 15.2% to 31 December – partly reflecting the impact of FX adjustments. Domestic contraction has been evident across the five, with Brazil in recession through 2015–2017. Although current account deficits remain in four of the five economies, with Brazil hovering around neutral at the close of 2017, levels are now in line with those seen in the mid-2000s. Overall there has been a clear move toward tighter monetary policy and domestic adjustment.

## **Indonesia**

Arguably the least problematic of the pack back in 2013, Indonesia demonstrated the fastest return to relative economic stability. The current account deficit has narrowed by over 50% in reaction to currency adjustment and improved trade terms. Regional demand has strengthened thanks to China, where economic growth has regenerated Indonesia's export economy. This, combined with the positive impact of improving commodity prices, largely accounts for the improved trade environment.

At the governing level, the stance has been disciplined. President Joko Widodo replaced Susilo Bambang Yudhoyono in 2014, and began implementing a set of reformist policies, including the abolition of gasoline subsidies in 2014 and the 2017 tax amnesty programme. The result is a growth outlook of 5% for 2018.

We believe Indonesia has a positive outlook. While valuations are tight, against its Asian peers, we view it as an attractive proposition and a worthy regional overweight.

## **South Africa**

Rand weakness of 19% against the US dollar and a current account deficit of 6.8% put South Africa on the fragility list four years ago and concerns, albeit of a different nature, remain today. Political uncertainty has now become the country's shackle.

The economy suffered a sharp growth slowdown as a result of a marked softening in investment and a weakening in consumer and business confidence since 2013. The growth slowdown and cheapened rand helped narrow the current account deficit as import demand slowed, but arguably moved the problems elsewhere, as seen in a deterioration in public finances. The budget deficit widened and public debt increased, with so-called 'state capture' undermining the management of SOEs and raising concerns over growing contingent liabilities to the public purse.

International investors have become wary of South Africa's political and policy environment, weak economic outlook and deteriorating public finance profile. These concerns have been shared by ratings agencies. S&P downgraded South African local debt to sub-investment grade in late November 2017, cutting the rating from BBB to BB+. Moody's maintains its local currency investment grade rating for now, albeit on negative watch. If a downgrade ensues, South African debt will be ejected from the major global bond indices, risking bond outflows and pressure on the rand and local rates.

The African National Congress party (ANC) presidential election in December provided something of an opportunity for a break in the cycle. The pro-business candidate Cyril Ramaphosa won the vote, making him party leader and the ANC nominee for the national elections in 2019, where the successful candidate will replace Jacob Zuma. But with the top-six party leadership equally split between those loyal to Zuma versus the anti-corruption-focused Ramaphosa supporters, it could still be challenging for the new party leader to overcome ideological divisions and implement meaningful reforms. That said, Zuma was the primary driver of this internal factionalism and state capture, and now there is some optimism that Ramaphosa will at least stop the rot. The installation of better management in SOEs and re-enforcing good practice at the National Treasury could relieve the downward pressure on public finances and consequently prevent further negative ratings adjustments. As such, we have moved cautiously optimistic on the outlook for South Africa.

## **Brazil**

Brazil has earned the accolade of golden child of the adjustment process for a number of reasons – both positive and negative for its population.

Both the currency and prices have adjusted. Corruption allegations built against former President Dilma Rousseff through 2015, resulting in her impeachment in August 2016.

The replacement government, led by President Temer, has worked to liberalise prices that had been held down by Dilma's unsustainable policies of nationalisation and government subsidies. The economy now benefits from greater free price movement and a more open market structure.

On the downside, Brazil's economy sunk into recession, contracting by 2.8% in 2015 and 3.16% in 2016. Unemployment brushed 12% while investment plummeted 10.2% in 2016, due to a combination of chronically high interest rates and pessimism over the medium-term outlook. The central bank began a rate cutting programme in 2016 from a base of 14.25% to the current all-time low of 7% for the Selic (as at the close of 2017).

Today Brazil has a balanced current account and foreign direct investment has held up despite weakened commodity demand. Brazilian assets are cheap for international buyers thanks to the currency adjustment, and policy reorientation has resulted in more assets available in the private market. Temer is following through on his pledge to stabilise the economy, launching a USD 14 billion privatisation programme, including the sale of utility giant Eletrobras in an attempt to down-size the public sector.

Other reform efforts include a successful austerity-led 20-year public spending cap and ongoing attempts to restructure the costly pension system – although the latter looks likely to remain in the next government's in-tray.

2018 will be a year focused on general election campaigning, which presents a risk for investors. Traditional politicians are unpopular, tainted by corruption as well as the poor recent economic record. An anti-establishment message is likely to resonate, although we do not expect the electorate to be tempted by radical economic policies.

We anticipate 2018 delivering a broadly centre-right government with a push toward reform, which is fuelling our cautiously constructive outlook on the market. There is value in local interest rates and US dollar credit spreads, while the currency also offers opportunistic value pockets.

## **India**

Despite growing pressure on Prime Minister Modi to deliver on his emotive election vows of bringing good times to India, growth has slowed in the first half of his tenure. With a 6.3% year-on-year expansion in Q3 2017, his supporters say there is much to celebrate. A host of economic reforms, including the deregulation of diesel prices, cuts in cooking gas subsidies, demonetisation and the introduction of the goods & services tax (GST), have been passed under his leadership, although there remains a lack of jobs and income inequality is vast. Conversely, his critics cite the orthodox central bank monetary policy and strong focus on curbing inflation as factors responsible for slowing growth, sparking calls for a more adventurous successor.

The Indian current account has improved since 2013, as has the quality of financing, reducing vulnerabilities and allowing the central bank to trim policy rates. Combined, these factors drive India's ongoing reform story, lifting it out of the fragile five category.

We have been cautious on the market although the rates universe looks to provide some value. With the currency securely anchored, positioning long rates unhedged is now a reasonable trade given India's improved financing position. The 2019 general elections may also provide investment optimism, while inflation will be the data point to watch throughout the year.

## **Turkey**

Of the five, Turkey remains the most troubled economy, with many of the fundamental vulnerabilities in focus in 2013 continuing today. Indeed inflation is even higher at 12%, which is more than double the central bank's 5% target, and undeterred by the central bank's low real rates. Third-quarter 2017 real GDP growth of 11% suggests an overheating economy. But the major economic issue is external financing: Turkey has a 12-month current account deficit of USD42 billion, with USD170 billion in short-term debt comprising a USD210 billion+ annual external financing requirement with low FX reserve cover (approximately 50%).

For a country so reliant on external financing to support its economy, Turkey's political landscape has become a major source of concern. Two-thirds of trade, investment and financing come from the West, yet linchpin diplomatic relationships are deteriorating. Pressure points are various but include differences over the Kurdish issue, Syria, its relationship with Russia, plus differences in approach towards the failed coup in July 2016. We believe it is fair to say that Turkey-Western relations are at a 50-year low point, and this could complicate Turkey's ability to cover its external financing needs.

In response to the above trends we have turned structurally more cautious on Turkey albeit recognising that as a high-beta play, investors need to be tactical in approach – remaining nimble while constantly monitoring data, political developments and positioning and market sentiment.

Four years have brought significant change for the five and they should face the next stage in the unwinding of QE with greater resilience than in 2013. While smooth sailing is rarely a trait of any EM economy, Indonesia, Brazil and India have largely shrugged off their fragile labels and face improved outlooks and interest from the international investment community. Despite economic cooling in South Africa, the country remains curtailed by its unpalatable political landscape, but is less vulnerable to monetary tightening in developed markets that it was in 2013. Turkey remains constrained by entwined geopolitical and economic factors, making it the 'fragile one'. New candidates for the 2018 line up could include Oman, Qatar, Bahrain, Lebanon, Ukraine and Pakistan, which all display signs of political and economic unrest and are markets we are closely monitoring.

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