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Financial Market Outlook

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No collective “emerging market crash”

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NO COLLECTIVE "EMERGING MARKET CRASH"

For the emerging markets, 2014 has got off to a pretty dramatic start. Numerous emerging market currencies are under hefty selling pressure. Concern about a marked slowdown in the Chinese economy and the steep slide in the Argentine peso against the US dollar were the triggers behind the current flight from emerging market currencies. In fact the problems currently dogging Argentina are anything but surprising. They are the almost inevitable upshot of years of economic policy mismanagement that, among other things, has spawned high inflation, a badly overvalued currency and a massive erosion of currency reserves.

In our view the current ructions are not portents of a sustained slowdown in growth in the emerging markets as a whole. Differentiation is needed, and that is what the financial markets are currently doing. The scale of the depreciation varies widely from country to country. The currencies of the Eastern European emerging markets are relatively stable. For some time now the Polish zloty, for instance, has been broadly stable against the euro thanks to the country's robust economic constitution. Since the beginning of 2014 it has slipped 2.3%. The Hungarian forint, which in the past has always reacted sharply to changes in capital market sentiment given its macroeconomic problems, has lost close to 5% against the single currency. On the one hand, the overall fairly moderate exchange rate reactions are linked to the stabilization of the economy and the reduction of imbalances in the eurozone. That improves the growth outlook for the Eastern European countries. On the other, most Central and Eastern European countries have made progress taming their own imbalances. In both the Czech Republic and the Slovak Republic, for instance, the government deficit has fallen substantially in recent years. In Poland and the Czech Republic the current account deficit has been falling fast, Hungary has been registering surpluses for three years now. The Russian ruble has fared worse than most currencies of the Eastern European EU countries, tumbling by more than 4½% against the euro since the beginning of the year. The reasons are mainly home-made: poor investment climate, capital outflows, shrinking current account surpluses.

A look at Latin America also reveals wide regional differences. The Argentine peso has plummeted by almost 20% against the US dollar since the beginning of 2014. In Brazil the losses amount to slightly more than 2% on the heels of the hefty depreciation already seen last year. Capital is also heading for the exit in Mexico and Chile. Among other things, the reliance on commodities is casting a pall. If, as some evidently fear, Chinese economic growth turns out to be weaker than expected, commodity prices and exports are likely to fall, undermining growth in the Latin American countries. But with global industrial production indicators climbing since the second half of 2013, pointing especially to improvements in the industrial countries, grim forecasts for global commodity markets seem misplaced.

Asian currency losses have so far been limited. With a loss of close to 3% since the start of the year, the South Korean won has seen the largest slide, following a longer upward trend. The Indian and Indonesian currencies have been fairly stable this year, but both had already fallen steeply in the course of last year. Up to the end of 2013 the Indian rupee lost no less than an accumulated 11%, plagued by a chronic current account deficit and stubbornly high inflation along with a sharp slowdown in growth. The only currency to have risen slightly against the US dollar since the beginning of the year is precisely that of the country currently under the spotlight, namely China. Given the enormous challenges the country faces (catchwords: overhaul of Chinese growth model, lending

and real estate bubbles), this is remarkable. In all likelihood, the Chinese government will introduce restrictive monetary policy and regulatory measures in order to curb debt momentum. This is bound to have a detrimental impact on economic growth, but in our view is the only way to get growth back on a sound footing.

Turkey is one of the countries with enormous growth potential but also major imbalances. The Turkish lira is under massive selling pressure, at the peak sliding more than 7% against the euro since the beginning of the year and by 24% since mid-May 2013. However, the vulnerability of Turkey in the event of an abrupt shift from risk on to risk off on the financial markets was foreseeable. Yawning current account deficits for years, funded mainly by short-term capital inflows, the difficult domestic political situation and the somewhat unorthodox monetary policy in the past have all served to undermine investor confidence in recent months. In the short term we believe the necessary adjustment processes will weigh on economic growth in Turkey, as evidenced by last week's interest rate hike. But this does not alter our fundamentally positive assessment of the country's medium and long-term growth potential.

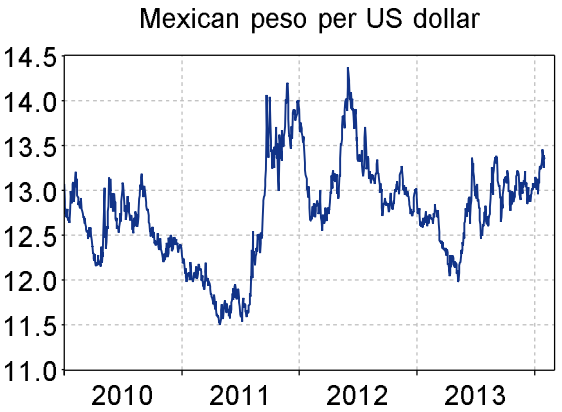
The financial markets are evidently punishing the currencies of those countries which, due to macroeconomic imbalances or the domestic political situation, are susceptible to external shocks of any kind. Some players fear that the spiral of depreciation, higher inflation and higher interest rates could broaden out into a full-scale confidence and economic crisis. Of course, the further withdrawal of capital cannot be ruled out. But neither is it correct that investors act only pro-cyclically. Confidence-building economic policy measures in the affected countries could quickly encourage anti-cyclically minded investors to clamber on board at what are now much more favorable prices.

Even if, given the complex mutual ties, the more stable emerging markets do not manage to fully escape the depreciation pressure, talk of a collective "emerging market problem" is misplaced. However, these countries also face economic policy challenges. Broadly speaking, devaluations can help boost competitiveness and reduce external deficits. But in the short term they can exacerbate economic problems and prompt higher wage demands, rising inflationary pressure and extra costs for foreign debt. Monetary policy has to perform a balancing act. In order to counter a devaluation-fueled rise in domestic inflation, the respective central bank actually needs to jack up key interest rates – but without throttling the economy while about it. This is all the more likely to succeed, the more aggressively macroeconomic imbalances and growth obstacles are tackled via domestic reforms.

Conclusion

After years of expansionary monetary policy by the Fed, bemoaned by many emerging markets, the task now is to adapt to a return to normal. This transition will not run smoothly everywhere. This should be feasible without major dislocations in countries without grave macroeconomic imbalances. This group includes the big economies Mexico, Brazil – which finances the bulk of its current account deficit via foreign direct investment – and South Korea along with, to a slightly lesser extent, Indonesia. China, with its still largely shielded capital market and only very limited currency convertibility, need not fear major disruptions from international market exposure. Among the smaller economies, most Central and Eastern European countries as well as the smaller Asian emerging markets such as the Philippines can be deemed robust. Given their unbalanced macroeconomic picture, India and especially Argentina face considerable adjustment problems. We think Turkey is headed for an awkward transitional phase. Not

least against the backdrop of demographic trends, we are still very upbeat about the country's medium and long-term growth outlook. In the short term, however, reducing private sector debt and the external deficit is likely to drag the economy down. Forecasting exactly how the adjustment processes will unfold is rendered more difficult by the fact that in some countries, such as Thailand and the Ukraine for instance, and not least in Turkey, the political situation is currently anything but stable and predictable.




Russian ruble per euro
49
47
45
43
41
39
37
2010
2011
2012
2013


Turkish lira per euro
3.25
3.00
2.75
2.50
2.25
2.00
1.75
2010
2011
2012
2013


Chinese renminbi per US dollar
7.0
6.8
6.6
6.4
6.2
6.0
2010
2011
2012
2013


Indian rupee per US dollar
70
66
62
58
54
50
46
42
2010
2011
2012
2013


Indonesian rupiah per US dollar
12500
12000
11500
11000
10500
10000
9500
9000
8500
8000
2010
2011
2012
2013


Thai baht per US dollar
34
33
32
31
30
29
28
2010
2011
2012
2013

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