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CAPITAL

There’s a reason emerging markets look cheap

It seems like we’re back where we were at the beginning of the year, with most asset classes looking rich. In these times some investors are tempted to expand their horizons to less popular asset classes which can look superficially cheap. However, in most cases investments that are cheap are cheap for a good reason with relatively few long term structural inefficiencies left in capital markets. Emerging markets are one of the classic “looks cheap” asset classes, offering higher credit spreads and lower P/E ratios than developed markets. However, they have a habit of dishing out painful investment lessons to naïve investors.

Assets consultants and fund managers that are strong supporters of emerging markets will always point out that not all emerging markets are the same. This is absolutely true, they are a very broad church. At the top end, Israel, South Korea and Taiwan are considered emerging markets by some and developed markets by others, but all three are heading in the right direction. Conversely, Greece is now a receding economy with its GDP per capita slumping by more than a third in the decade since its 2008 peak.

Towards the bottom end is India, a country with enormous potential if it can overcome its enormous structural problems. Then there’s a solid group in the middle with varying levels of institutional maturity and political freedoms. That level of diversity brings the potential for substantial upside but also the potential for significant losses. Having made that disclaimer here’s three current examples of what can go wrong when investing in emerging markets.

Nigeria

Foreign investors in Nigeria are stuck in a Hotel California situation; they have checked out but find they cannot leave. As the bonds they bought mature the government locks in the foreign currency through capital controls, giving the investors little option but to reinvest in short term government debt at interest rates below inflation. The central bank chief is assuring everyone they will be paid eventually, but with investors receiving a substantially negative real return the current situation is arguably a de facto default with losses being spread out over time.

Turkey

Turkey went on a classic emerging market debt binge. As is often the case in emerging markets, local borrowers took out loans in US dollars and Euros which would be ok if the Turkish Lira wasn’t collapsing. The government isn’t willing to increase interest rates or stop printing money, so currency controls have been implemented. Banks are in trouble as non-performing loans soar, Spanish and French banks in particular are heavily exposed. Without reform, Turkey could follow Argentina; a country with good prospects that are repeatedly squandered by mismanagement.

Argentina

I recently wrote about Argentina’s travails (debt boom, currency collapse and default) so this is a short update. The country is close to completing a restructure of its debts after its ninth default in less than 200 years and its fifth in the last 40 years. However, bond buyers are refusing to bid up the price of its debt, with the new debt expected to begin trading at distressed levels. The country doesn’t appear interested in adopting necessary economic reforms, instead it looks set to continue its deadbeat ways. With that attitude, a tenth default might not be too far away.

The three examples above aren’t exhaustive; there’s also been defaults recently by Barbados, Ecuador, Mozambique, Puerto Rico and Venezuela. Fitch sees Gabon, Mozambique, Republic of Congo, Suriname and Zambia at very high risk of default. There’s a long list of countries in Africa, the Middle East and Latin America running substantial budget deficits hoping for a massive increase in the oil price to save them from default and government spending cuts.

The low interest rate settings of central banks in developed markets have allowed emerging market economies to take on far more debt for spending on sub-optimal activities than would have otherwise occurred. This is one of the many detrimental impacts of ultra low interest rates and quantitative easing that are typically ignored.

One bizarre recent change in emerging market lending is the pressure on the IMF to be less stringent in the economic reforms it requires when lending to busted countries. This wrong-headed approach comes from Keynesian and MMT economists who refuse to study history and instead prefer shallow and debunked slogans such as "austerity doesn't work". One obvious example of this stupidity is the IMF lending to Argentina in the lead up to its default, with Argentina using the funds in a fruitless attempt to try to stop its currency from collapsing. Old school economics would have required the printing press to be turned off before the any new debt was granted and would have never allowed other people's money to be used for such insane purposes.

Whilst it is easy to criticise emerging market governments for repeatedly making dumb economic decisions, developed economies are adopting the very practices that have created emerging market crises and defaults. Many developed economies are printing money and running massive budget deficits, believing they have found some magic formula that no one ever thought of before. Few economists and capital managers are willing to call out this populist stupidity for what it is and where it inevitably leads to. If developed markets won't learn from the mistakes of emerging markets, they are doomed to suffer the same fate.

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