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Mastering the Emerging Market Financial Vortex

By James Beadle

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January has been a trying month for investors across the world, but it is the emerging markets that have captured the most attention, with some dramatic currency moves and headlines evoking fears of a repeat of the 1997 Asian financial crisis, which triggered Russia's 1998 default.

The ruble has lost a worrying 6 percent against the dollar since the end of 2013. What should we make of all this? How has it come to pass that the emerging markets, key drivers of global economic growth in the post-crisis era, are suddenly looking so bad?

The reality is that they are not looking so bad. Headlines can be misleading, as can categorizations. Large investment firms have increasingly sought to differentiate between emerging markets in recent years, utilizing labels like "growth economies" or "middle income countries" to signify their divergent situations.

Sadly, many investors, or more specifically the financial media, still tend to dump them into a single messy box, especially during times of rising market volatility. As a result, some countries are experiencing dramatic financial market pressures that are totally unwarranted. Others are being punished appropriately, but seemingly belatedly, for ongoing mismanagement.

There were two triggers that motivated the recent negative shifts in the emerging sphere. First, the Chinese purchasing managers index compiled by HSBC fell short of economists' forecasts. Not only did it miss expectations, but it slipped to a level typically associated with economic contraction. Second, the U.S. Federal Reserve continued with its planned withdrawal of economic stimulus, even in the wake of disappointing job growth in December.

Ironically, neither of these data points directly justifies the acute market pressure seen in the emerging countries in recent weeks. The Chinese yuan remains a favored currency, and most analysts brushed off the weak number as part of the country's ongoing economic adjustment. Meanwhile, the U.S. employment report contradicted many other December statistics, and is widely expected to be revised upward in the months to come.

Yet, this is the way the market works. As events set off market reactions, facts rapidly lose relevance as particular assets trend. As a result, more investors get involved. Fear rapidly becomes a self-fulfilling prophecy.

This is not to say that there is no issue of concern anywhere in the emerging markets. As large investment managers have noticed, the block is increasingly diverging as countries differentiate themselves with their good or bad governance.

Much of the market concern, which has even contributed to declines in equity markets as far apart as Tokyo and New York, has been focused on Turkey — a classic example of a country with problems. Turkey's government has been in power since 2003 and has long been a source of economic controversy.

Increasingly, it has made news headlines for squeezing secular economic values and agents, and leaning inappropriately on its central bank to postpone interest rate hikes, despite a weak trade balance and rising inflation. In recent months, the government came into the spotlight for corruption scandals, which have seen it act determinedly to limit judicial independence. Another red flag has been Argentina, an economic outcast since its 2001 default led to the election of a populist and staunchly anti-market government.

Chronic concerns in countries like Turkey and Argentina have now come to a head as their central banks are finally running out of reserves to control the decline of their exchange rates. The depletion of reserves has coincided with increasing actions from the U.S. Federal Reserve to reduce monetary stimulus, a development that brings expectations of higher returns in safer developed markets.

The coincidence in timing is not random — investors have been chipping away at badly managed emerging markets since the prospect of changing U.S. monetary policy first surfaced last spring. Markets have been engaged in a drawn-out war of attrition. Now, as the apocalyptic headlines attest, this war is finally reaching its conclusion.

Oddly, this is where the story begins to improve, at least relative to the doomsday headlines.

Although emerging markets are currently all being tarnished with the same brush, this is nothing like 1997, and investors should sooner, rather than later, start to sort the good from the bad.

The good includes countries like Mexico, which is well connected to the U.S. economy and enjoying a comparable economic upturn. It is also at long last pursuing reform of its all-important oil and gas sector, which many investors hope reflects a determination to fix the economic roof while the sun is still shining.

The good also includes Russia, which enjoys a very low level of government indebtedness and a positive trade balance, especially when oil prices hold up. Russia looks attractive at historically low valuations, while the government is working actively to improve the investment climate.

Other countries are less clear cut. India has huge structural problems and neglected to use the good times to enact reforms that would now propel it ahead. However, it has recruited one of the most respected central bank heads in the world, who is thus far succeeding in containing the damage. It is also worth recalling that the Indian economy is far from a fully open liberal system. Similar to Russia, it has not been subject to oversized capital inflows, and thus should experience less pain on the way down.

This all goes to show that the emerging market space is a mixed bag, currently being unjustly treated as a single asset class. Investors should mind their history when reading tabloid financial headlines.

This is not 1997. Most emerging markets are strong enough to weather the storm. Even the weaker countries are better prepared than they were 17 years ago.

According to the International Monetary Fund, Turkey's debt amounts to only 26 percent of gross domestic product, which is a very manageable level.

What is at stake, as its flexible currency devalues — another positive compared to the fixed exchange rates of old — is its potential to contribute to global economic growth this year. Not its potential to declare a default that sends the global financial system into a devastating tailspin.

This is the second bout of acute pressure on emerging financial markets in less than a year. There will likely be more to come, as markets continue to rebalance toward stronger U.S. growth. Astute investors should use these dislocations to pick up assets at bargain prices and hold them through the ensuing economic cycle.

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