The Evolution of Emerging Market Currencies and the Modern Currency Crisis

The term "currency crisis" has been creeping into the headlines with turmoil surfacing in select emerging market economies. Turkey has seen its currency lose nearly half its value this year, its stock market in bear market territory and the cost to insure its government debt (credit default swap) surge above that in Pakistan. Argentina's Peso hit an all-time low, the central bank hiked its benchmark rate over 2,500 bps to 52%, its debt burden became unmanageable and it is poised to receive the largest IMF bailout in history ($50 billion). As a result, emerging market stocks and bonds have suffered this year. The MSCI EM Index has entered bear market territory (chart 1) and the Bloomberg Emerging Market Local Bond Index is on pace to post its worst year on record.[1]

What is unfortunate is that currency crises are not that uncommon, especially as the world becomes more entwined with trade, investments and currency. When an investor sees headlines about a currency crisis looming, it may bring back memories of the 1990s when two major crises (i.e. Mexico and Thailand) disrupted global equity markets. The Mexican peso crisis and Asian currency crisis ended up reaching far beyond the economy where the problem originated. While the 1994 peso crisis brought on a severe recession in Mexico and drove 69% of the economy into poverty - the damage did not stop there. Investor skepticism spread to the rest of Latin America resulting in major instability in countries such as Brazil, Argentina, Chile and Peru. As a result, historians have commonly referred to this period as the "Tequila Effect." Within a few years, a similar occurrence transpired on the other side of the world when, in 1997, the Thailand Baht plummeted and set off a domino effect that crippled many ASEAN markets and resulted in a major bailout from the International Monetary Fund.[2] With the Mexican peso crisis so fresh in investor's minds in 1997, capital flows fled not only the Asian emerging markets but markets in Eastern Europe and, once again, Latin America. It also brought anguish to the U.S. government as the Federal Reserve and a consortium of banks were forced to save a failing hedge fund (i.e. Long-Term Capital Management) to avoid a more systemic problem.

Chart 1: Emerging Market Equities Enter Bear Market Territory

Footnotes: Data as of September 10, 2018.
Source: Bloomberg Finance LP, Verdence Capital Advisors.

In this white paper we will give a brief history of the foreign exchange market, explain the difference between fixed and floating rate currency regimes, show how a currency crisis can evolve, educate investors on those economies that may be at risk, describe how the emerging markets are different now than in the 1990's and give our view on whether or not the recent weakness is a buying opportunity.

History of the foreign exchange market

Before the 1980's, the value of most currencies was pegged to the U.S. dollar and the dollar was pegged to the price of gold. The reason to use gold was because it is a physical source with a definitive amount in circulation. This mitigated the risk that a central bank could irresponsibly print money to circulate in their economy which could spur growth but ultimately bring unwanted inflation and destabilize the economy. However, after 1971, the gold standard was abandoned, and currencies were no longer tied to a commodity. Instead the fiat currency market was established globally. The fiat currency market allows the value of a currency to float in the open market against other currencies. By floating, the free market dictates the value of the currency by evaluating many factors including supply/demand, the economic outlook, inflation and interest rates, government debt and political stability.

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Differences between fixed and floating rate currency regimes

While most developed economies use a true floating rate exchange regime (e.g. USD, EUR), there are some economies whose government manages their currency in a set rate or range against a foreign currency (typically the U.S. dollar). This is also known as a fixed rate currency or pegged regime (with varying degrees such as soft pegs, hard pegs or crawling pegs). This type of currency regime is primarily seen in the emerging markets as they prefer to maintain a stable currency to anchor inflation and set the rate low enough to make their goods competitive in global trade.

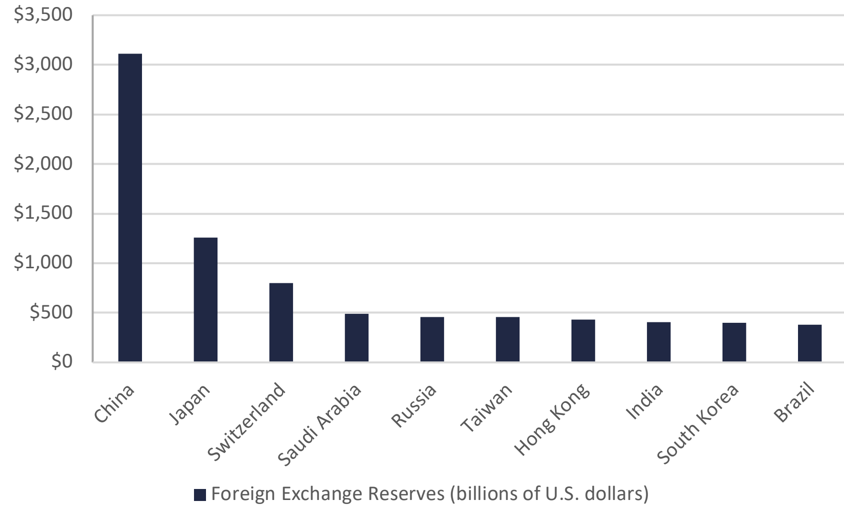
However, opting to fix a currency at a rate or range against another currency requires the country to have foreign exchange reserves of the opposing currency. Let's use the relationship between the U.S. and China as an example. While China has slowly adopted a more floating rate system, fixing (or pegging) it to the dollar for decades allowed China's economy to expand at a rapid pace and helped China displace the U.S. as the world's largest manufacturer.[3] China has been able to maintain the pre-determined rate for the yuan because the products, services and investments that the U.S. buys are paid to China in U.S. dollars. China stores those currencies as foreign exchange reserves and China can use them to control the yuan. If the yuan falls below or above its desired range, they use their dollar reserves to buy or sell the yuan in the open market to keep it within the desired rate/range. As can be seen in **chart 2**, those export driven countries that trade with other developed countries carry a large amount of foreign exchange reserves.

How a currency crisis evolves

A currency crisis is loosely defined as a rapid decline in the value of a country's currency where the central bank is unable to maintain its predetermined rate/range using its own foreign exchange reserves. Therefore, most currency crises develop in countries that have adopted a fixed/pegged rate exchange regime as opposed to a floating rate regime, most commonly the emerging economies.

Chart 2: Top 10 Countries With Foreign Exchange Reserves

Footnotes: Data time periods may vary but all are most recent as of September 5, 2018.
Source: International Monetary Fund, Verdence Capital Advisors.



To simplify the illustration of the evolution of a currency crisis, let's use Mexico as a proxy for an emerging market economy that uses a fixed rate currency regime and use the U.S. dollar as the opposing currency. Well before the crisis surfaces, Mexico enjoys a solid period of economic expansion. They attract foreign investors (in this case U.S investors) who purchase securities (stocks and bonds) and invest in businesses as they are comfortable with taking on the added currency and credit risk. Americans make purchases of Mexican assets in U.S. dollars and those U.S. dollars get stockpiled by the Mexican government as foreign exchange reserves. If U.S. investors are confident in Mexico's economic outlook, the currency exchange runs smoothly, and while the Mexican peso may fluctuate modestly, it typically remains within the predetermined rate/range set by the Mexican government. Where the cracks can begin to surface is if there is an event that hampers sentiment in Mexico (e.g. war, political instability, leverage concerns, growth deterioration). In the 1994 Mexican peso crisis it was the government's irresponsible fiscal and monetary expansion, careless increase of U.S. dollar denominated debt and political instability with the assassination of a Presidential candidate that contributed to the unraveling of the Mexican peso. Once investor confidence becomes uneasy, international investors pull money out of Mexico and force the Mexican peso below the rate/range set by the Mexican government. What is important to note is that the crisis can unfold rapidly because once confidence tumbles, the herd mentality sets in and investors flee en masse.

In the early stages of the crisis, the first step to take to stabilize the peso is for the Mexican government to sell U.S. dollar foreign exchange reserves and use them to buy the peso in the open market. This should, at least, slow the decline in the peso. If it does not stabilize the peso, the next step is for the Mexican central bank to raise interest rates. Their goal is to limit inflation pressures that arise from a weak currency and hopefully lure foreign investors back with the higher rate of return. The quagmire for Mexico is that reducing their reserves and raising interest rates may now be at the expense of future economic growth. If the outlook for economic growth deteriorates it makes it challenging to attract that foreign capital. If these options still fail to stabilize the peso, Mexico is likely forced to take the undesired step of devaluing their currency, meaning resetting the predetermined rate/range at

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a lower level (which occurred in 1994). As a result, inflation accelerates (as imports become more expensive), capital outflows multiply, and Mexico is likely forced to seek aid from a private investor and/or the International Monetary Fund. For example, in 1995, the U.S., the IMF and other G7 countries coordinated a $50 billion bailout package for Mexico.

Who is at Risk?

The countries that can be the most at risk of falling into an uncontrollable currency position are those countries whom take on a substantial amount of debt and/or have high current account deficits and an uncertain economic outlook. Having a budget deficit and a current account deficit is referred to as "twin deficits." While a budget deficit is easier to understand (revenues-outlays=surplus/deficit), a current account deficit is a bit more complex. A simple explanation of a current account deficit is that a country imports more goods, services and capital than they export. By carrying a high current account deficit, a country is heavily reliant on foreign investment. In addition, some countries with "twin deficits" are leveraged with external debt (debt denominated in a different currency) because debt denominated in a foreign, typically more stable currency (e.g. USD and EUR), is more marketable. In good times when the emerging market currency is stable, it is typically not an issue to repay debt in a foreign currency. It becomes a challenge when the emerging market's local currency weakens. In this instance, it becomes more expensive for the emerging economy to buy the foreign currency (with their weaker currency) to pay the interest and principal on their foreign denominated debt. Below we analyzed a broad range of emerging market economies and listed the emerging market countries that may be at risk due to having high "twin deficits" and seeing their currency fall more than 5% over the past year **(table 1).**

Table 1. Countries in Poorest Fiscal Health

Footnotes: Current account and fiscal data is most recent as of 2Q18. Currency change is as of September 7, 2018 Data source: Bloomberg Finance LP, Verdence Capital Advisors.

	Current Account Deficit as % GDP	1 YR Change in Currency vs. USD	Fiscal Surplus/Deficit as % GDP
Turkey	-6.3%	-47.3%	-1.6%
Argentina	-5.2%	-54.0%	-0.1%
South Africa	-4.8%	-14.7%	-4.2%
Indonesia	-2.4%	-11.4%	-1.8%
India	-1.9%	-11.8%	-3.7%

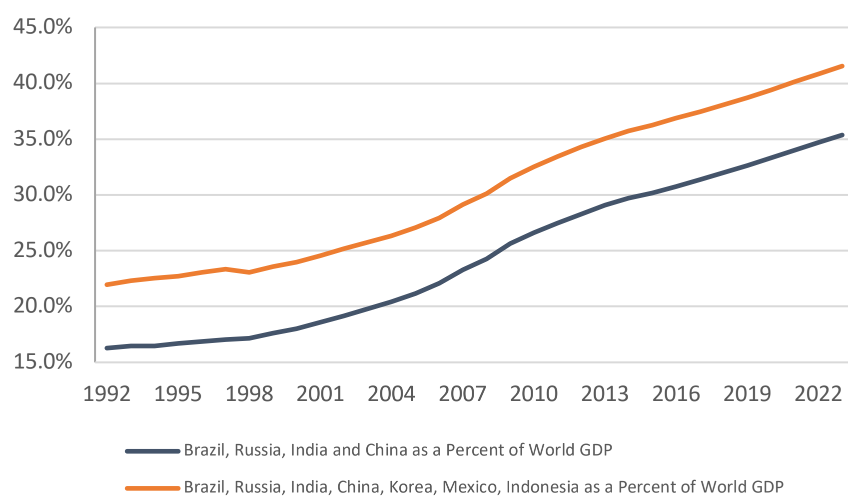
Why emerging markets are different now than in the 1990s

While recent events have brought about renewed fears of investing in the emerging markets, it is important to highlight several differences in today's emerging markets compared to the emerging markets of the 1990s.

- **Globalization leads to lower tolerance for crisis:** Globalization and the more diverse composition of global trade has made the emerging markets a much larger and important portion of world GDP. As can be seen in **chart 3,** not only are the traditional BRIC (i.e. Brazil, Russia, India and China) emerging market economies making up an increasing amount of world GDP, but when you add the next top three emerging economies (Korea, Mexico and Indonesia) those seven economies are expected to make up ~40% of global GDP by 2023. The expansion of the global economy from just the major developed economies has made the role of the International Monetary Fund (IMF) even more meaningful today than in the 1990s. The IMF is in place to preserve global stability and improve the global economy through advancing international trade, maintaining exchange rate stability and helping member countries in times of financial distress.

Chart 3: Emerging Markets More Important to World GDP Than in 1990s

Footnotes: Estimates as of April 2018 per IMF.
Source: International Monetary Fund, Bloomberg Finance LP, Verdence Capital Advisors.



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What has been seen since the turn of the century is that, while it is cyclical, the IMF is being called upon frequently as the global economy evolves and individual country/corporate risk can prove to quickly turn into broad systemic risk (e.g. Greece, Lehman Brothers) **(chart 4).** This is likely to continue as the global economy grows and the IMF is less inclined to let a crisis fester. Instead they prefer to coordinate a rescue before it can turn into a global crisis.

- **Foreign reserves are better today than in the 1990s:** The emerging market countries are in a much better reserve position now than in the 1990s. Foreign exchange reserves as a percent of nominal GDP in the major emerging markets was, on average, less than 5% in 1980.[4] However, in 2017 that percentage had increased to ~20% **(chart 5)** as emerging markets repaired their FX reserve positions after the Asian currency crisis in the late 1990s.

- **Greater central bank flexibility:** A stable inflation environment gives a central bank flexibility in times of turmoil. Since the 1990s, the major emerging market economies have been able to reduce their inflation to a more stable year over year growth rate **(chart 6).**

Chart 4: IMF Payouts Through History

Footnotes: Data as of August 2018. Includes total IMF disbursements including out of poverty and growth trust. Source: International Monetary Fund, Verdence Capital Advisors.

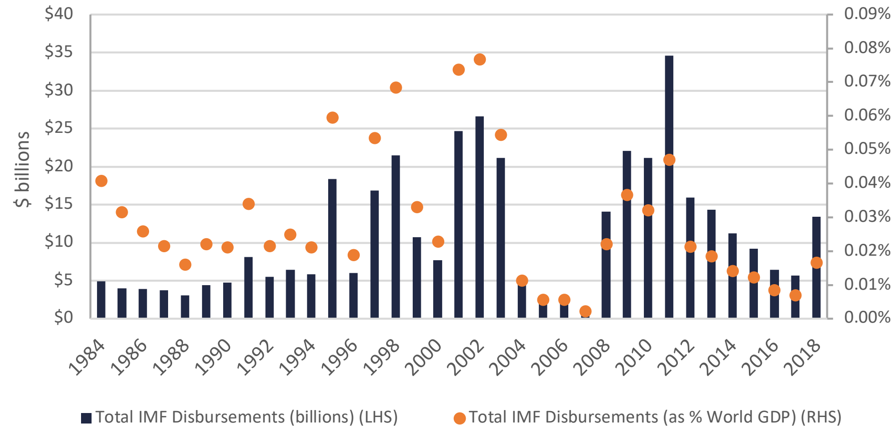


Chart 5: Emerging Market FX Reserves Historically

Footnotes: Most recent is as of 2017.
Source: International Monetary Fund, Verdence Capital Advisors.

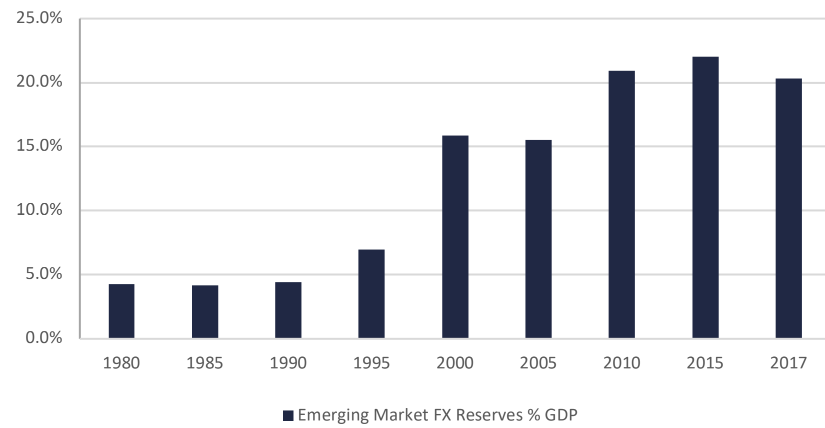
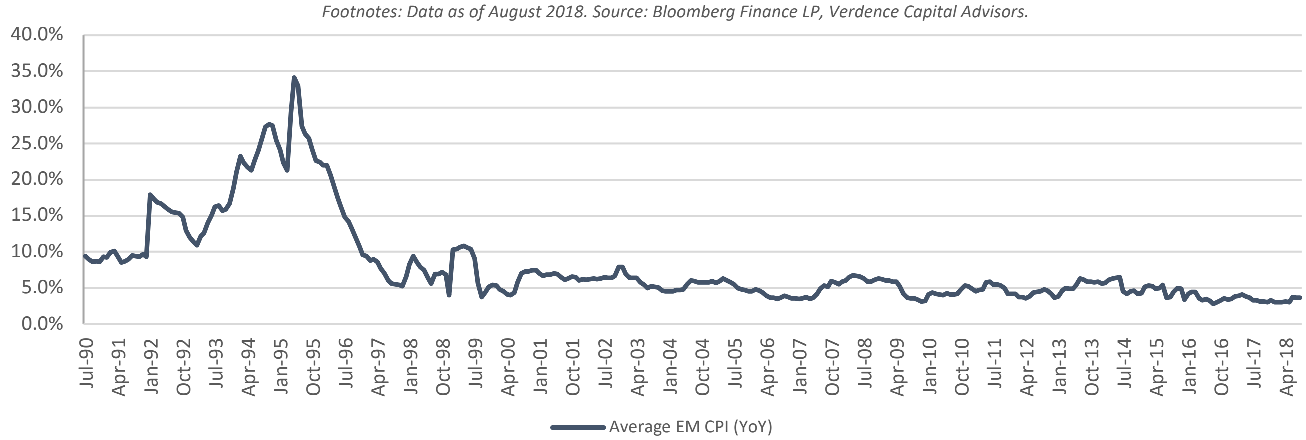


Chart 6: Emerging Markets Have Reduced Inflation to a Stable Level

Footnotes: Data as of August 2018. Source: Bloomberg Finance LP, Verdence Capital Advisors.



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- **Stable economic growth:** The emerging markets are expected to be the drivers of global growth in the coming decades. As these economies mature, their annual growth rates naturally slow but experience consistent growth as opposed to short business cycles that may result in more recessions, poverty or even depression **(chart 7).** The long-term strength in the emerging markets should be led by the growth in the middle class. By 2025, annual emerging market consumption is expected to rise to $30 trillion which is ~50% of the global consumption up from $12 trillion in 2010.

- **Changing dynamics within emerging markets:** Emerging markets were once considered a way to capitalize on commodities. However, these economies are becoming much less dependent on exports and commodities (which can be highly cyclical) as a source of economic growth. For example, in 1995, materials made up 20% of the MSCI Emerging Market Index but make up less than 10% of the index currently. In addition, the emerging markets are much more tech oriented which is a source for long term growth. In 1995, info tech made up 2% of the index. Tech now makes up 28% and is the largest sector in the emerging markets.[5]

Verdence View: Full Blown Currency Crisis Fears Overdone; Active Management and Patience Crucial

We have outlined the many differences between the emerging markets in the 1990s and those of today, and it is important to clarify that we do not expect a major currency crisis to materialize that could disrupt the global expansion. Given that emerging markets represent ~60% of global growth but the market cap of the MSCI Emerging Market Index is only 25% of the market cap of the MSCI AC World Index, the long-term upside looks attractive for emerging market investments.[6] Therefore, it is valuable to have exposure in emerging market stocks and bonds as a portion of your overall portfolio allocation despite the short term volatility that investors may endure.

However, active management is more important than ever as there is a clear divergence in fiscal health among many emerging market economies. This can be seen by **chart 8** that shows since 1980, the difference between the emerging market country with the highest FX reserves and the lowest FX reserves was much narrower than it is today.[7] Successful managers can pick the most fiscally sound countries with the best upside potential in earnings and economic growth. This differs from simply using a passive investment which would have exposure across the broad emerging markets, including those countries that are in fiscal despair.

Chart 8: Changing Dynamics in Health of Emerging Markets

Footnotes: Data is as of 2017. Source: International Monetary Fund, Verdence Capital Advisors.

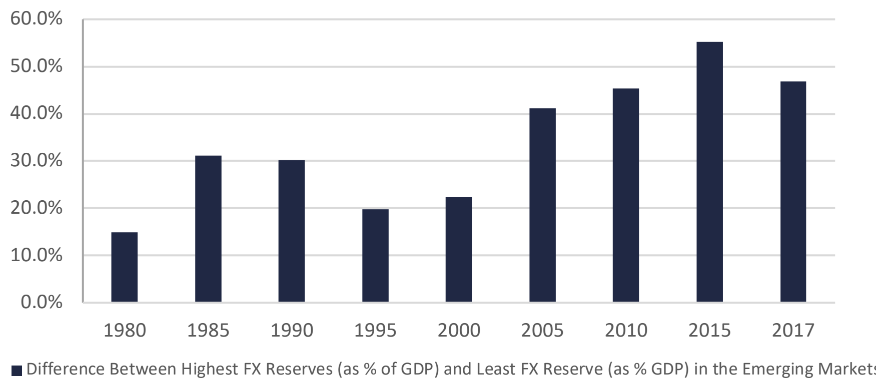
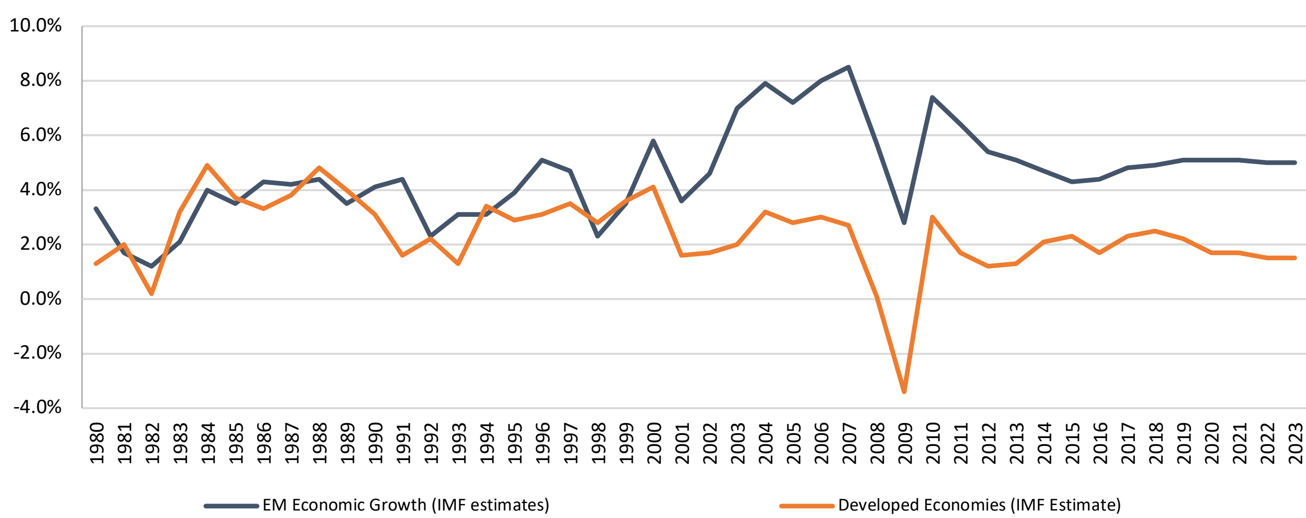


Chart 7: Estimates for EM Growth Compared to Developed Growth

Footnotes: Data is as of April 2018 Source: International Monetary Fund, Verdence Capital Advisors.



Given our optimistic view on emerging markets for the long run and the weakness year-to-date in both bonds and stocks there is clearly value in these assets. However, predicting the bottom in such a volatile and risky asset class is a daunting task. We would prefer to evaluate periods of weakness as potential buying opportunities and add to these asset classes in a slow and gradual manner. Currently, we would prefer to add to emerging market debt first. While both emerging market bonds and equity are highly dependent on sentiment, we do not see a risk for wide spread defaults in the emerging markets. Since emerging market bonds offer attractive yields and most large EM countries have low default risk, they are an attractive way to ease into EM investments for investors that can withstand the short-term volatility. We will continue to evaluate emerging market equity and consider the economic outlook, earnings revisions and currency volatility before incrementally adding to this asset class. It is also important to note that emerging markets are risky and prone to disruption and at Verdence we consider an individual investor's risk tolerance before deciding on the appropriate portfolio allocation changes. ■

[1] *Return is annualized as of August 31, 2018. The Index has history beginning in 2008.*

[2] *ASEAN stands for Association of Southeast Asian Nations which includes Indonesia, Malaysia, Philippines, Singapore and Thailand.*

[3] *China displaced the U.S. as the world's largest manufacturer in 2010.*

[4] *The emerging market economies illustrated are equally weighted and include Mexico, China, India, Indonesia, Malaysia, Philippines, Korea, Taiwan, Thailand, Argentina, Brazil, Chile, Peru and Turkey*

[5] *Lazard Asset Management, Changing for the Better. March 2018*

[6] *As of September 4, 2018.*

[7] *The emerging market economies observed are Mexico, China, India, Indonesia, Malaysia, Philippines, Korea, Taiwan, Thailand, Argentina, Brazil, Chile, Peru and Turkey.*

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