Global growth is unlikely to become as EM friendly as in 2002-07

In the wake of the global financial crisis, the majority of economists and investors failed to anticipate the resilience of the US economic and corporate governance models, which has underpinned the massive outperformance of US equities over the past three years. Whilst we retain a structurally bullish view on the US economy, the growth cycle will continue to be qualitatively different to the consumer debt driven growth that proved so beneficial for emerging market exports between 2002 and 2007. There has been a further shift of pricing power away from emerging market producers, which is currently being exacerbated by the ongoing depreciation of the yen. The US will become more competitive in industrial goods due to more favourable cost comparisons in energy and labour as well as a technological shift to more distributed manufacturing techniques. Meanwhile the structural slowdown in emerging market economic growth is likely to have a pronounced impact on the commodity intensive exporters which are a much bigger constituent of the emerging market universe.

Micro structural factors threaten EM economies more than Fed taper

Investors are currently fixated on the impact of potential shifts in funds flows on EM financial assets, through the Fed tapering policy and have a largely one-dimensional view of risk based on the level of current account deficits in the respective GEM economies. We believe that the real risk is that we are starting to see a greater reluctance by foreign investors to put money to work in EM because they are increasingly focusing on the underlying structural issues, which up to now have been much more obvious at a corporate micro level than in the macro-economic aggregates. The sudden break in correlation between DM and EM equities at the start of 2013 preceded talk of Fed tapering by several months and was the direct result of investors beginning to discount more favourable structural factors for the US against the bulk of the EM universe. The biggest risks are in those economies with weak hard budget constraints, often as a result of a dysfunctional relationship between the state and the corporate sector, as the absence of enforceable exit mechanisms ultimately undermines returns on capital.

BRICs most at risk – beware short FX/long commodities across GEM

On this basis the BRIC markets with the possible exception of India are eventually more liable to a 'classic' emerging type crisis compared to Indonesia, South Africa or Turkey, though we accept that there is a risk with Indonesia in particular, that predictions of a crisis, which lead to a rapid run-down in FX reserves, could become self-fulfilling. China in particular has become much more dependent on foreign funding to prop up 'acceptable' rates of economic growth against a steady deterioration of the underlying return on invested capital across much of the listed corporate sector. There is also a risk across all emerging markets that any sustained rally in the dollar will reveal 'hidden' short FX exposure, often linked to exposure to commodity related assets, which were acquired at top of the market prices. Whilst some EM currencies are now cheap, we would expect widespread further weakness against the dollar in 2014 to include the Korean won and possibly the Renminbi. Although Beijing's post-Plenum drive to attract foreign fund flows depends on a stronger currency, it is difficult to think of many emerging economies which have undergone a significant level of structural reforms without the benefits of either an undervalued currency or a devaluation to bring liquidity into the corporate sector – the renminbi is no longer undervalued in our view and is becoming increasingly vulnerable.