EMERGING MARKETS: FOCUSING ON THE CURRENT ACCOUNT

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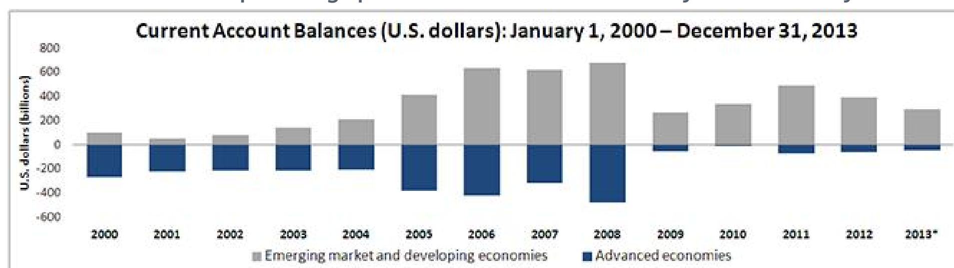
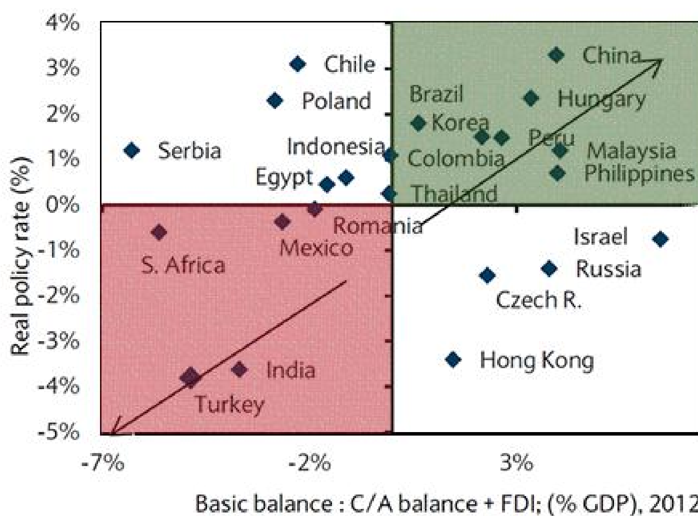
As investors and analysts seek to explain the negative performance in emerging market assets, most have centered their focus on external vulnerabilities, particularly current account (C/A) balances, international reserves and portfolio flows. As part of our discussion, we would like to not only present current data but also explain why investors should pay particular attention to the current account balance, especially in developing economies. For most investors, discussions about a country's current account balance appear to fall more in the realm of monetary economists and academics than of asset allocators and portfolio managers. Unfortunately, in today's global environment, focusing on the details can matter a great deal to your portfolio's bottom line. **Why Does a Country's Current Account Balance Matter?** Before jumping into the data, it may be useful to take a step back and review what the current account actually measures or implies. Essentially, the current account represents the difference between the value of the exports of goods and services and the value of the imports of goods and services. Put more simply, is a country buying more goods from abroad than it is supplying to global markets? The reason why investors and analysts are concerned about expanding current account deficits is that—as is the case for nearly all imbalances—eventually they will have to normalize, and potentially in a destabilizing way. This occurs because the balancing entry for a current account deficit is generally a capital account surplus, which essentially means borrowing from abroad to finance current consumption (more imports, fewer exports). If recent history has taught us anything, it is that credit-fueled consumption is unsustainable in the long run. Exports still account for the majority of the gross domestic product (GDP) of emerging markets (EM), and domestic consumption is likely not yet large enough to maintain attractive rates of growth, should exports decline. This has the potential to cause economic stress—the exact opposite of what creditors want to see when making the decision to lend. And what happens if short-term financing dries up? Investors rush for the exits, magnifying these external vulnerabilities and putting pressure on the country's currency and local asset markets.



Source: International Monetary Fund, April 2013. *Current IMF Forecast

The Macroeconomic Double Standard Given that many emerging market countries rely on exports to power their economic growth, a current account deficit (more imports than exports) can be particularly troubling for investors. In this scenario, the emerging economy is increasing its liabilities to its trading partners (through balancing financial account flows) that will eventually need to be repaid. During periods of market stress, investors become concerned about these deficits and reduce their exposure. This can have a particularly strong effect on the price of assets and the

value of the currency. As investors sell assets and convert the currency to U.S. dollars, simple effects of supply and demand decrease prices and weaken the currency. Yet for all the focus on emerging markets, the country with the largest current account deficit in the world is the United States! Also, Australia and New Zealand have been able to run current account deficits equivalent to 5% of GDP for the last 20 years.[1] Indeed, developed markets seem to be held to different standards. However, developed markets tend to have higher savings rates than developing economies and, generally, are much less likely to be as reliant on foreign capital to finance these trade imbalances. But reverting the focus to a topic we've discussed multiple times before, not all emerging markets are created equal. In addition to where they fall along the development continuum, EM countries also have varying degrees of external vulnerability. The countries that seem to have come under the most pressure so far are India, Indonesia, South Africa and Turkey. While each country's causes and positioning tell their own story, the market is focusing on these countries' current difficulties and extrapolating those challenges to essentially all emerging markets. In our view, although they may currently face headwinds, we believe that each of these countries will eventually correct course. **External Vulnerability**



Source: Barclays, 2013.

For definitions of the terms in the chart, please visit our Glossary. **Maintaining Perspective** As emerging markets continue to evolve, it is important to have an investment process in place that is capable of evolving with the market. In our view, looking to a single data point doesn't provide the necessary context to identify a potentially destabilizing trend. Looking at supporting evidence and more recent, market-based factors can also be beneficial when attempting to make investment decisions. While focusing on macroeconomic fundamentals may not always lead to investment gains in the short term, we believe that vigilant monitoring of external vulnerabilities can ultimately lead to a more intuitive approach to investing in emerging markets. [1]Source: International Monetary Fund (IMF), April 2013.

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DEFINITIONS

Current account : The difference between a nation’s total exports of goods, services and transfers, and its total imports of them.

Capital account : Sometimes referred to as the financial account—second component of a country’s balance of payments that reflects the net change in the nation’s ownership of assets.