FUND MANAGEMENT DIARY
Meeting held on 31st July 2018

Why are EMs less vulnerable to external shocks?

- Previous financial crises in emerging markets have typically been caused by a build-up of external liabilities

- External financing vulnerabilities are greatest in Argentina and Turkey, which explains why they have been hit hardest in financial market sell-offs this year

- Most emerging markets are more resilient to external shocks today than in the past, largely because of improved policymaking. Nevertheless, domestic vulnerabilities are building

EM crises in the 1980s and 1990s were typically caused by a build-up of external liabilities

The turmoil in financial markets in Argentina and Turkey this year has invoked comparisons to the emerging market debt crises of the 1980s and 1990s, which all had their roots in a large build-up of external liabilities (i.e. debt owed to foreigners).

In the Latin American crises of the 1980s (and in Mexico in 1994) these liabilities were predominantly in the public sector. In the Asia crisis of 1997-98 they were mainly in the private sector. But in each case they were the necessary counterpart to large current account deficits. And, because fixed exchange rates encouraged borrowers to assume away currency risk, most of the debt was issued in (or linked to) United States dollars.

All of this required maintaining the confidence of foreign investors. In each crisis, this was ultimately punctured by some form of shock which caused investors to pull the plug and set in motion a familiar sequence of events: exchange rates collapsed, the local currency cost of servicing foreign debt soared, domestic financial conditions tightened dramatically, banks ran into trouble and economies fell into recession.

What's more, because many emerging markets suffered from similar vulnerabilities, problems in one quickly spread to others. For this reason, a devaluation in Thailand – which at the time accounted for just 0.5 per cent of world gross domestic product – proved to be the trigger for the broader financial crisis in Asia and then Russia in 1997-98.

External financing vulnerabilities are greatest in Argentina and Turkey

The key lesson, then, is that the crises of the past were primarily a function of large external liabilities. There are several ways to assess external financing vulnerabilities, but the broadest is to look at the gross external financing requirement as a share of foreign exchange reserves. The gross external financing requirement is the sum of the current account balance plus external debt that is due to mature over the next twelve months. By comparing this to foreign exchange reserves we can get a sense of external financing needs against a country's foreign exchange assets.

The latest data show that Turkey and Argentina have by far the largest gross external financing requirement-to-foreign reserve ratio in the emerging world – 150 and 137 per cent respectively. This explains why they were hit hardest in the emerging market sell-off earlier this year. But external financing vulnerabilities elsewhere are less severe. For example, the ratio is much lower in India (32 per cent), China (27 per cent), Brazil (sixteen per cent) and Russia (two per cent).

Turkey and Argentina aside, the biggest risks lie in the likes of Venezuela (which is hardly surprising given that it has already missed coupon payments on public debt) and Ukraine (which already has an International Monetary Fund programme). South Africa is next in line, which is a key reason why the central bank will have to keep policy relatively tight over the next 6-12 months, but the narrowing of the current account deficit over the past couple of years has reduced the risks of a full-blown balance of payments crisis.

But most EMs are much more resilient now than they were a few decades ago

As a general point, emerging markets are more resilient now than they were a few decades ago. Indeed, it is striking how the number of emerging market crises has diminished since the late 1990s. In that decade, there were eleven incidents each year on average of financial crises – defined as a currency, banking or fiscal crisis. This compares to just two per annum on average since 2010.

This reflects several positive developments: fiscal positions are more sustainable; the shift to inflation targeting has improved the conduct of monetary policymaking; currency pegs have been ditched in favour of floating exchange rates; and better financial sector regulation has strengthened banking sectors and constrained the growth of foreign currency debt (particularly to households). The result has been that, since the Asian crisis in 1997-98, emerging market crises have tended to be isolated rather than systemic events.

None of this is to say that it will be plain sailing for emerging markets in the years ahead. For a start, emerging markets (like all economies) live in a state of constant

flux, meaning that the situation can change quickly. Argentina is a case in point. Until recently, its external debt burden did not look particularly concerning. But a dollar debt binge over the past eighteen months or so has seen it issue almost four times as much foreign currency sovereign debt since the start of 2017 than the next largest emerging market issuer. The roots of the country's crisis run deep, but the proximate cause lies in decisions taken over the last year and a half.

However, while external vulnerabilities look low in most major emerging markets, domestic vulnerabilities are building. In Brazil, the fiscal trajectory over a 3-5 year horizon is unsettling. And in China, the sharp rise in private debt over the past decade could ultimately cause problems in the banking sector that the government will be forced to mop up. Given most debt is denominated in local currencies, domestic developments will determine how events play out rather than tightening by the Federal Reserve (or a rise in global yields more generally).

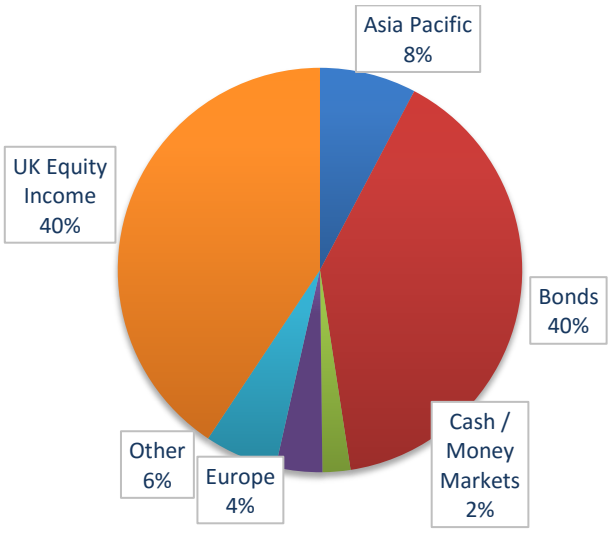
Strategy

Future Money currently invest in Emerging Markets equities in Dynamic Growth. It is our belief that Emerging Markets offer long term growth prospects at attractive valuations, although they are likely to experience relatively high levels of volatility.

Emerging Markets also bring diversification to portfolios; many global benchmarks and funds are heavily skewed towards the US, which we believe is very highly valued and does not offer the attractive opportunities that Emerging Markets can offer.

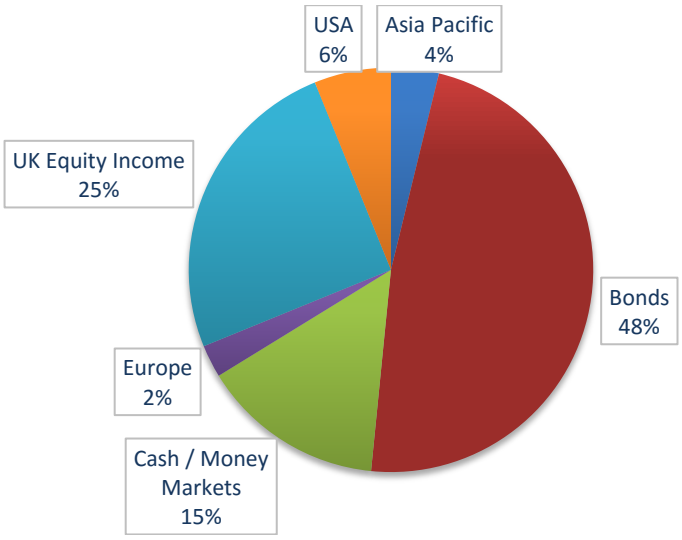
Income

Research is currently being undertaken on opportunities in the Emerging Market debt space, with the high yields available a potential opportunity for Future Money Income. No decisions have yet been taken.



Real Value

The move out of Majedie UK Income and into Man GLG UK Income continues this week, with a further tranche of deals being placed. This switch is being placed gradually given that no sudden changes are expected in the Majedie fund, despite it now being under the control of an interim manager.



Real Growth

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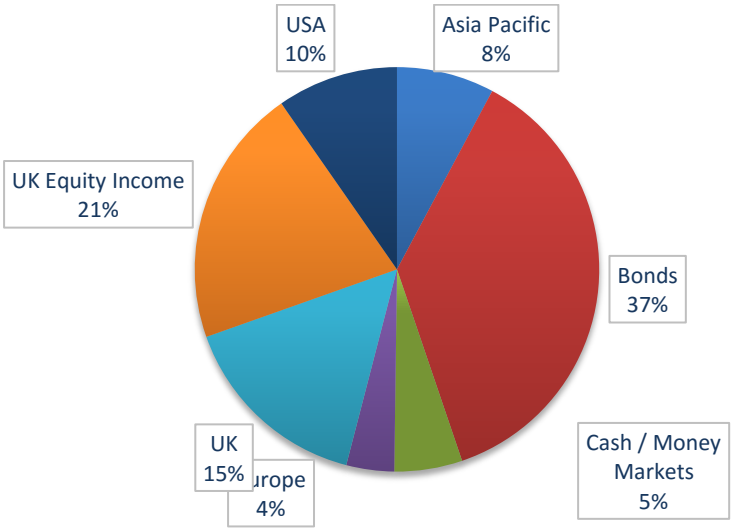
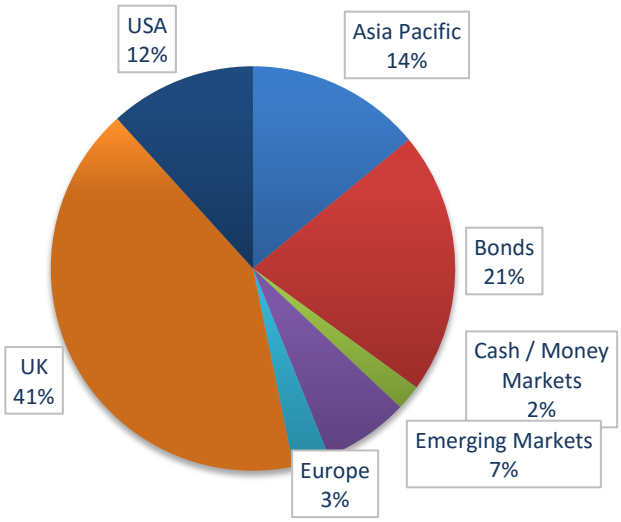


Dynamic Growth

BlackRock Asia has had a strong week, likely supported by the annoucement of fresh stimulus in China, with Beijing trying to stimulate the domestic economy. The fund still remains under its peer group average over three months, but as explained in last week's diary we remain confident in the fund's ability to perform well over the medium to long term.



Important Information

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Any research is for information only, does not constitute financial advice or necessarily reflect the views of the author and is subject to change.

It remains the responsibility of the financial adviser to verify the accuracy of the information and assess whether the fund is suitable and appropriate for their customer.

Past performance is not a reliable indicator of future performance. The value of investments and the income derived from them can fall as well as rise and investors may get back less than they invested.

Important information about the funds can be found in the Supplementary Information Document and NURS-KII Document which are available on our website or on request.

For any information about the Future Money funds please contact the authorised corporate director, Margetts Fund Management Ltd, on 0121 236 2380, admin@margetts.com or at 1 Sovereign Court, Graham Street, Birmingham B1 3JR. A copy of their Terms of Business which relates to investments into the funds can also be obtained using these contact details.

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