Macro Insight
‘Fortress’ emerging markets

The COVID-19 pandemic has presented a unique test for emerging market (EM) economies, which are a highly varied group

We have developed a ‘fortress’ rank to assess which EMs are better positioned

Our views

We think mainland China and industrialised Asian economies (Korea, Taiwan) are best positioned for recovery from the COVID-19 shock

This supports our strategic preference for Asia ex. Japan equities over other parts of EM

HSBC Global Asset Management

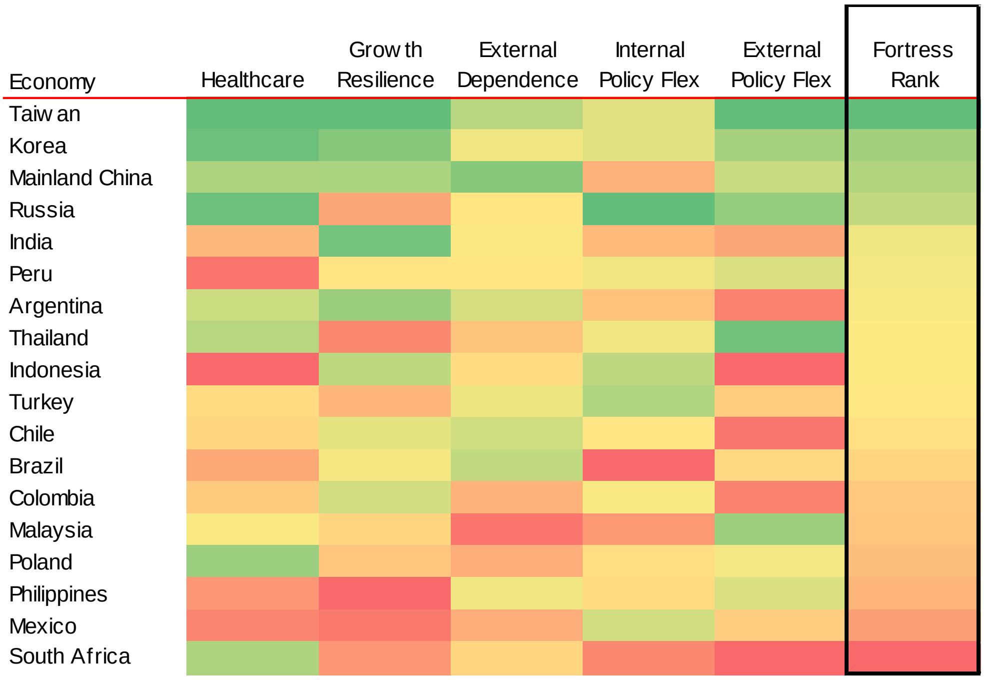
The COVID-19 pandemic has presented a unique test for emerging market (EM) economies. Some have withstood the challenge considerably better than others. This reflects the fact that they are a highly varied group. The industrial north Asian tigers of South Korea and Taiwan have little in common with the commodity exporters of Latin America. It is in this diversity that we see scope for ongoing divergence in EM performance as the crisis progresses.

Not all EMs are equal

In order to assess which countries are potentially better positioned to meet the test of COVID-19, we look through various lenses. These include a country's healthcare response, growth resiliency, external dependence, and capacity for economic policy support.

We have combined these five factors into a blended average to produce a ‘fortress rank’ (Figure 1). Notably, this shows North Asian economies such as Taiwan, Korea and mainland China at the top and a broad range of Latin American and non-Asian economies including Mexico and South Africa towards the bottom.

Figure 1: Our ‘fortress ranking’ framework



Source: HSBC Global Asset Management, as at 9 June 2020. Any views expressed were held at the time of preparation and are subject to change without notice.

With regard to the specific challenge posed by COVID-19, the **healthcare** response is a key factor in our framework. For example, widespread testing in Korea and Taiwan has contributed to a flattening of the virus case count (Figure 2) and the more rapid lifting of economically damaging lockdown measures.

This measure also incorporates the availability of hospital beds per capita. Again, North Asian countries score well here, whereas countries in Latin America, and India, show a poor availability of medical resources to deal with the crisis.

With this in mind, it is little surprise that countries in North Asia have shown reasonable **growth resilience** this year, with downgrades to their 2020 growth projections of around 1-4%. Figure 3 shows a clear ‘back to work’ dynamic taking place in various Chinese cities and in Taiwan’s capital, Taipei.

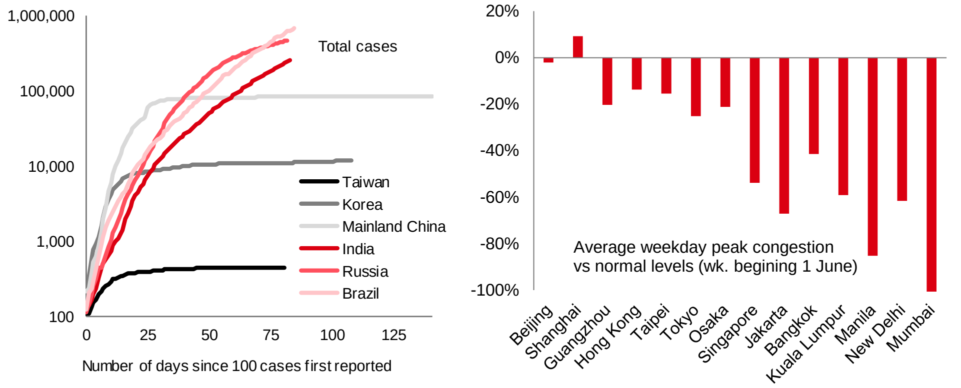
This compares favourably to various countries in Southeast Asia and Latin America which have seen larger downward revisions in the mid-to-high single digits.

Mainland China, Taiwan and Korea got on top of the virus quickly, allowing swifter easing of lockdown measures. This is reflected in road traffic indicators

Growth resilience can also be determined by a country's **external dependence**. In this sense, we think EM economies are vulnerable if they have a heavy dependency on oil and commodity exports (Russia), on trade in goods (Malaysia), or on remittances from abroad (Mexico).

Finally, **policy flexibility** offers an important remedy, and is typically determined by a combination of factors, both **internal** (fiscal and monetary policy) and **external** (trade balances and foreign currency reserves). Here too we find advantages for North Asia, and is reflected in Korea's government announcing support measures worth over 10% of GDP.

Figures 2 & 3: Covid-19 case developments, and road traffic congestion



Source: European Centre for Disease Prevention and Control, Bloomberg, HSBC Global Asset Management as at 9 June 2020. Any views expressed were held at the time of preparation and are subject to change without notice. For illustrative purpose only.

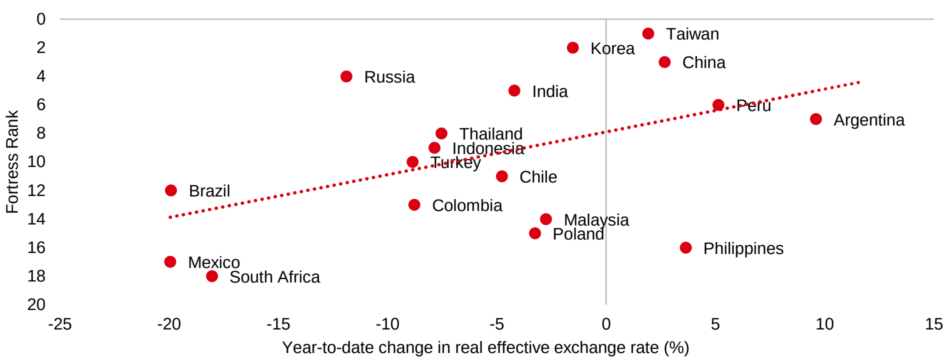
Countries with higher fortress rankings have seen relatively stronger asset performance, but there are some exceptions

What does this mean for valuations?

In Figure 4 we compare each country's fortress rank with year-to-date (to end-April) changes in its real effective exchange rate (a broad measure of a currency's value). This way we can understand if valuations adjusted according to underlying fundamentals as we assess them.

This analysis confirms that countries with higher fortress rankings broadly saw relatively stronger real exchange rate performance. However, there are notable exceptions, with valuations in Brazil and Russia arguably moving too low. This may be because of significant commodity price weakness and high case numbers in both countries (Figure 2 again).

Figure 4: Real exchange rate developments across EM economies



Source: Bank for International Settlements, HSBC Global Asset Management. Year-to-date period up to the end-April. Any views expressed were held at the time of preparation and are subject to change without notice. For illustrative purpose only.

Investment implications

We have a strategic preference for Asia ex. Japan equities given good prospects for mainland China, Korea, and Taiwan

Our 'fortress' methodology shows that the bright spot within EM is mainland China and industrialised Asia (especially Korea and Taiwan). In our view, this set of countries is well placed to benefit from a growth recovery in mainland China supported by strong policy action.

Therefore, we maintain our strategic preference for Asia ex. Japan equities over other parts of EM, and believe an overweight view on Asian high yield corporate bonds also makes sense. Our analysis also makes the case that currencies in mainland China, Korea, and Taiwan deserve to be stronger.

Meanwhile, although more vulnerable parts of EM - as highlighted in our framework - saw sharp selloffs earlier this year (Brazil, South Africa, Mexico), a recent recovery in these countries suggests that cheap valuations offer some 'fortress-like' protection to assets.

Being selective within EM assets is key

Overall, the varying resilience of EM economies to the COVID-19 pandemic and differing valuation context implies that being selective within EM assets is key.

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