

September 25, 2020

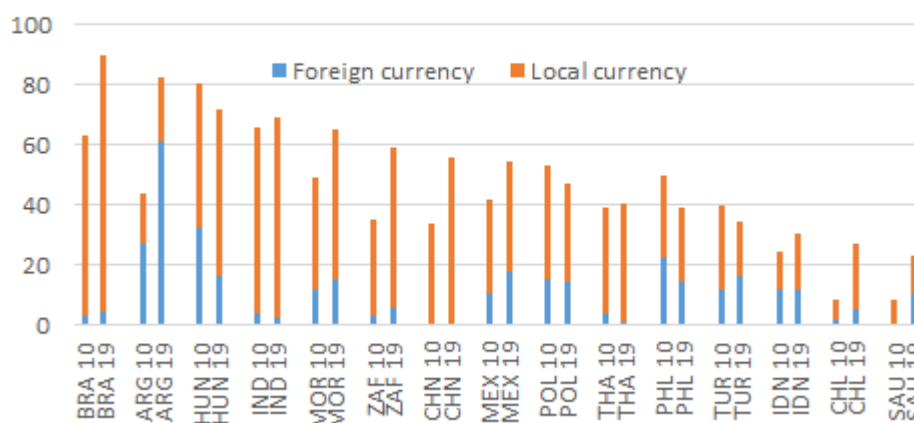
## Dear Clients and Colleagues:

Compared to other global crises in the post-war era, emerging markets (EM) weathered the 2008 global financial crisis (GFC) relatively well. However, they are unlikely to do as well during the COVID-19 pandemic.

Much like their developed counterparts, EM countries' domestic demand and supply chains will be crippled by sanitary measures. The generally more open EM countries will be additionally impacted by the unprecedented reduction in exports to developed countries and the diminished flow of capital from them. The net effect is that many parts of EM will slump to their worse economic contraction on record.

Unlike in 2008, EM countries entered 2020 with feeble economic momentum, weaker balance sheets and more vulnerable external positions. This will not only constrain the provision of relief and support during the pandemic but also hinder the recovery afterwards. As illustrated below (Figure 1), many EM countries have seen a steady rise in public debt between 2010 and 2019. In fact, EM countries were not running a primary fiscal balance adequate to stabilize their public debt levels at the onset of the pandemic. The cyclically-adjusted fiscal and current account balances in EM are also in a more precarious position than during the GFC.

**Figure 1: Emerging Market Government Debt, 2010 and 2019**  
(% of GDP)  
Source: IMF



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China's role as a stabilizing force for global growth in the aftermath of the 2008 crisis cannot be understated; through aggressive policy action, China was able to maintain its own economic expansion above 9%, accounting for almost 30% of global growth during the depths of the GFC. This time around, China will struggle to achieve 5% economic growth despite sizable and swift policy support, which will in turn depress the demand for inputs and goods from other EM countries, whose reliance on China as an export destination has increased meaningfully over the last decade.

Lower oil prices, which typically serve as a buffer during periods of economic weaknesses, will not have a similar salutary effect in 2020. While the majority of EM countries are net importers of oil, industrial and household demand have retreated due to the curtailment in manufacturing and sanitary restrictions. Several EM countries, such as India, Lebanon and the Philippines are moreover dependent on remittances of nationals based in oil exporting countries, which are themselves under severe fiscal and economic stress.

Many EM had vulnerable external positions, even prior to COVID-19. Business and tourism cross-border travel, a key source of hard currency for many countries, is currently near zero. The flow of capital to EM has slumped to far worse lows than during the GFC or the taper tantrum (2013). When combined with the weaker remittances and effect of lower oil prices (for exporters), these result in funding shortfalls too large for the foreign currency reserves to cover. Thus, unless access to private external markets improve, these countries will have recourse to official external sources such as the International Monetary Fund (IMF) in coming months. It remains to be seen whether the IMF will impose policy conditionality in exchange of funding support and whether the domestic politics will accept such conditions.

EM also have much less room for fiscal stimulus in 2020 compared to 2008 due to lower growth, wider fiscal deficits and higher debt levels, which are mitigated to some extent, by lower interest rates. This leaves monetary support as the main policy instrument available to EM countries who will be relying heavily on rate cuts. Some EM countries have started bond-buying programs, which in some instances are unfunded, and generally aimed at restoring liquidity in the bond market. The capacity for EM to engage in quantitative easing is limited as they do not have the benefit of possessing reserve currencies.

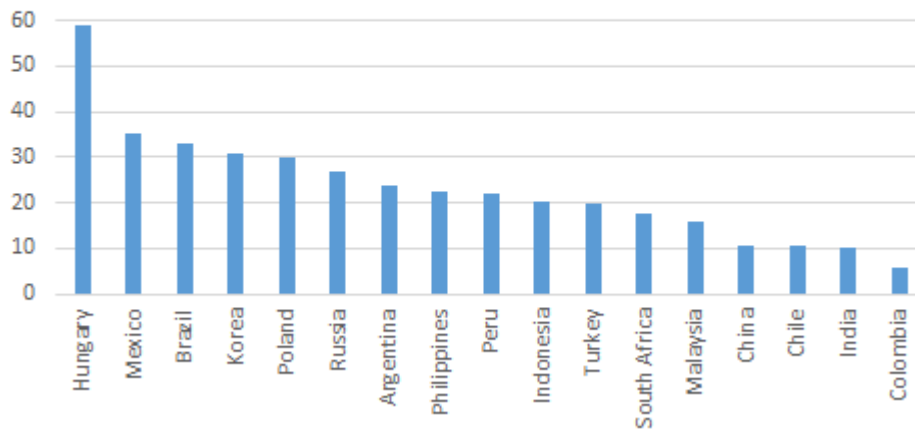
A massive exogenous shock in the form of a global pandemic can only compound the above-mentioned pre-existing structural challenges in EM. While reforms can address those deficiencies, there is typically little popular and political appetite for reforms after a protracted period of hardship. This suggests that the cyclical recovery will most likely be gradual and uneven. The absence of a

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compelling domestic backdrop along with the fact that foreigners often own significant parts of EM market capitalizations (Figure 2) make the outlook for EM equities fraught with uncertainty.

**Figure 2: Equity International Investment Position  
(% of market capitalization)**  
Source: IMF



Have a great weekend.

The Global Alpha team

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