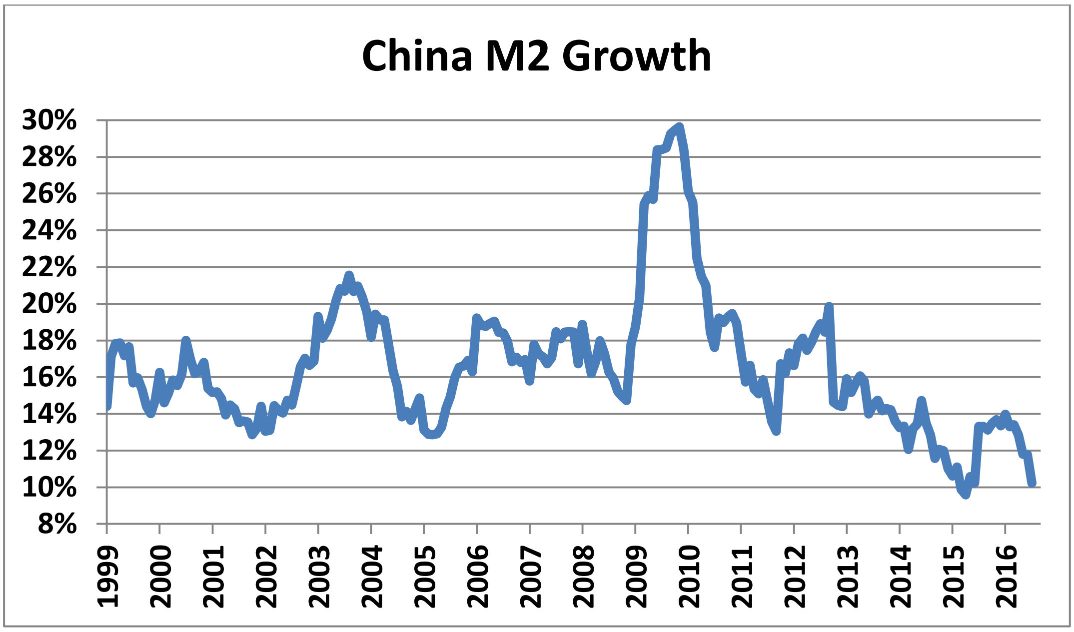
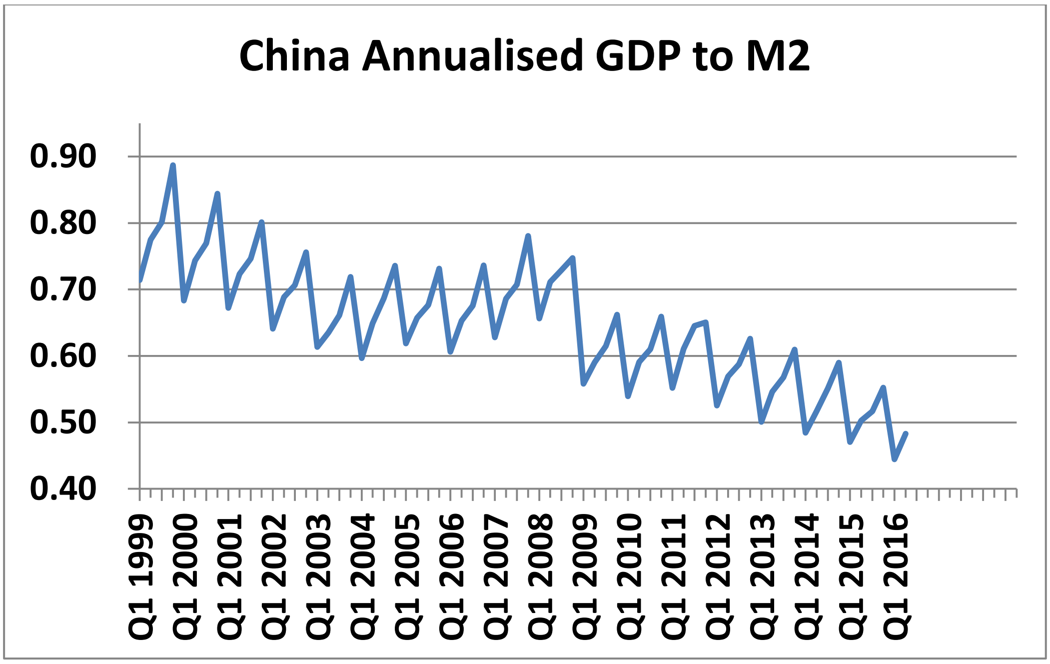
## Can More Bad Times Be Ahead for EM?

It has become increasingly popular to turn bullish on Emerging Markets (EM). I am not a believer.

The biggest EM market is China. But the most important driver of China's economy, the M2 monetary aggregate, has turned down again.



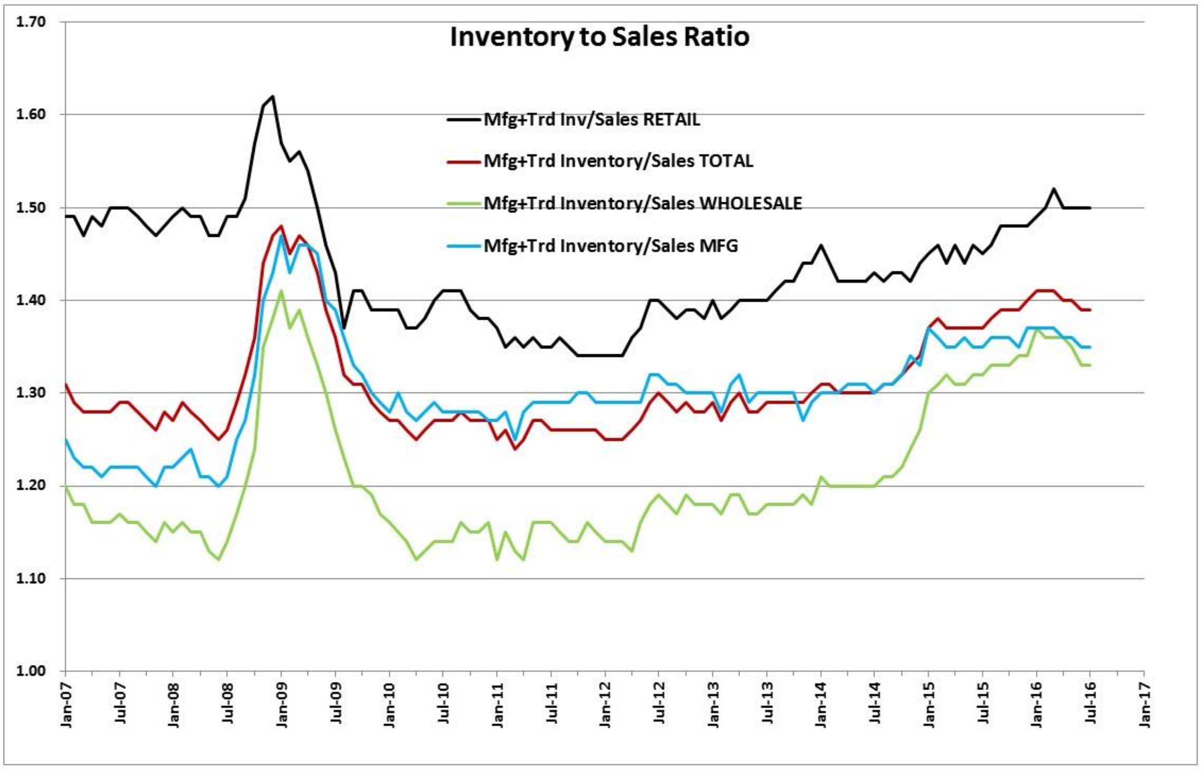

Not only has the spurt in M2 in 2015 failed to sustain, it is threatening to head to record lows. All the while, the GDP generated per dollar of M2 has been falling.



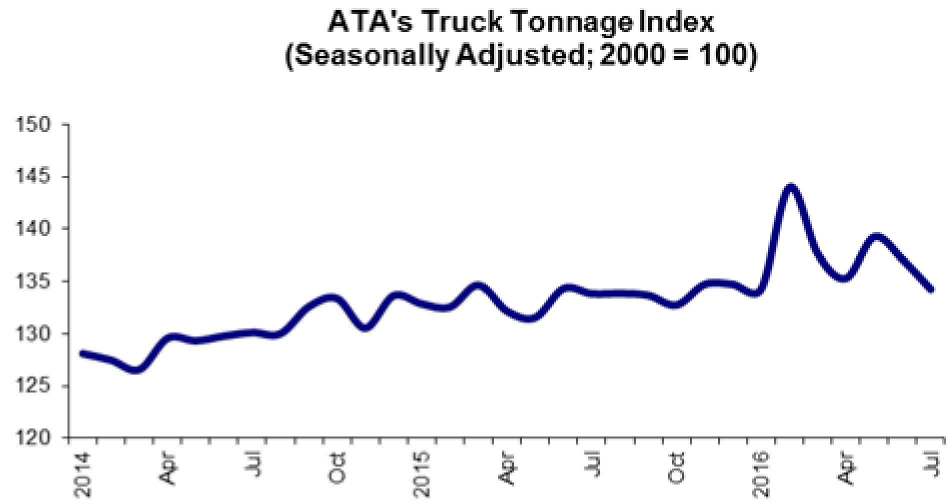
Already with each passing quarter, the Chinese economy is generating less GDP for every dollar of M2. And now, M2 growth is decelerating sharply.

There's no big recovery ahead for China. Just more drift and struggle.

Meanwhile after rising relentlessly since 2010, the US inventory to sales ratio for various sectors like retail, wholesale and manufacturing have begun to fall, starting from Apr 2016.




This is backed up the American Trucking Association's own data with regard to trucking freight, which has been falling since early 2016.



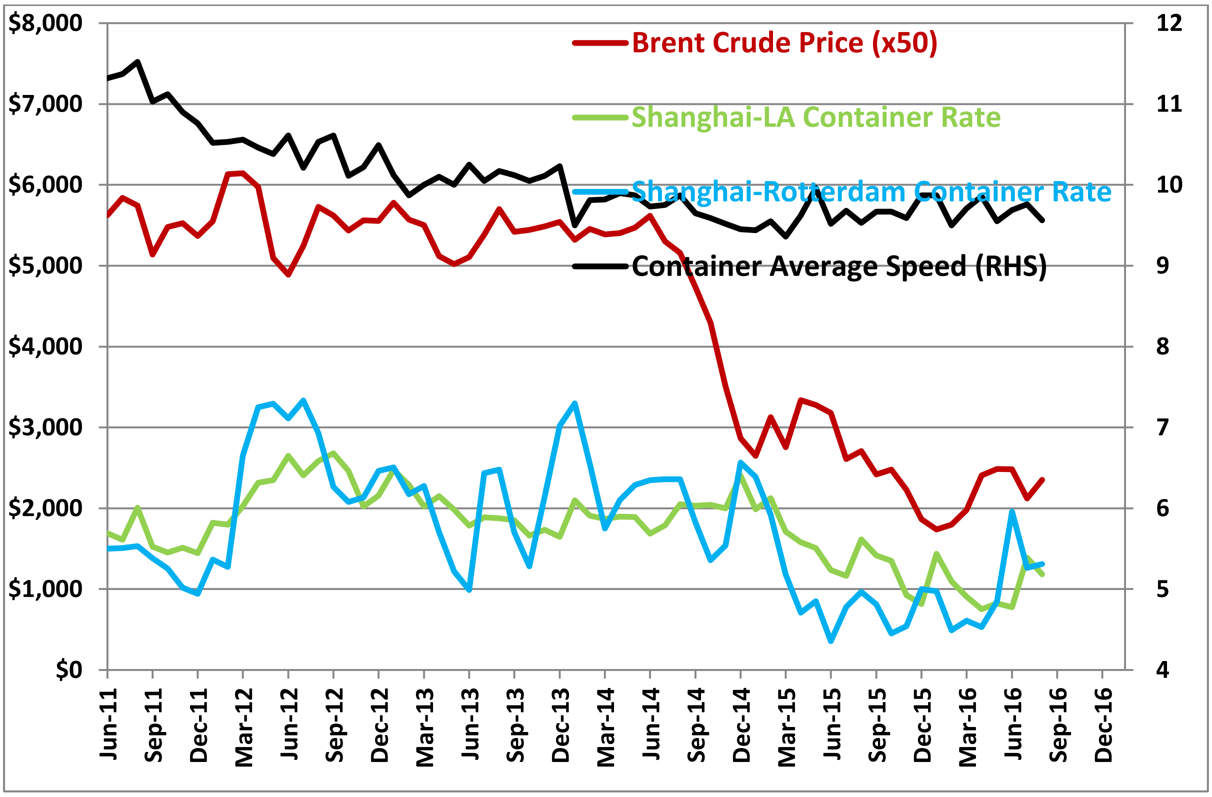

Anecdotal evidence suggests that American firms have begun to pare down inventory. I suspect companies are no longer comfortable with the high inventory to sales ratios which are approaching the heights reached during the 2008 financial crisis. The impending possibility of rising interest rates will make holding inventory more costly and it would only be prudent to pare now.

Remember that all through 2014-2016, as inventory to sales was rising, exports from most of the Asian countries was NEGATIVE yoy in US$ terms.

If American companies are paring inventory now, how can Asian exports recover?

There is a new dynamic – the bankruptcy of Hanjin Shipping. This has caused container shipping rates to skyrocket as 3% of the world's containership capacity has suddenly gone off-line. If one considers that Hanjin's business is mainly Asia-Europe and Asia-US, then within these sectors, the capacity affected would be much greater than 3%. From a 52 week average of around $1115, the Shanghai-LA route charter rate is now $1,700. Similarly, Shanghai Rotterdam has gone from a 52-week average of $1027 to $1,800.

If these rates are sustained and they could well be since bankruptcy process is usually long and drawn out, the shipping companies may finally have the incentive to speed up their ship travelling speeds, especially now that oil prices have fallen to multi-year lows.



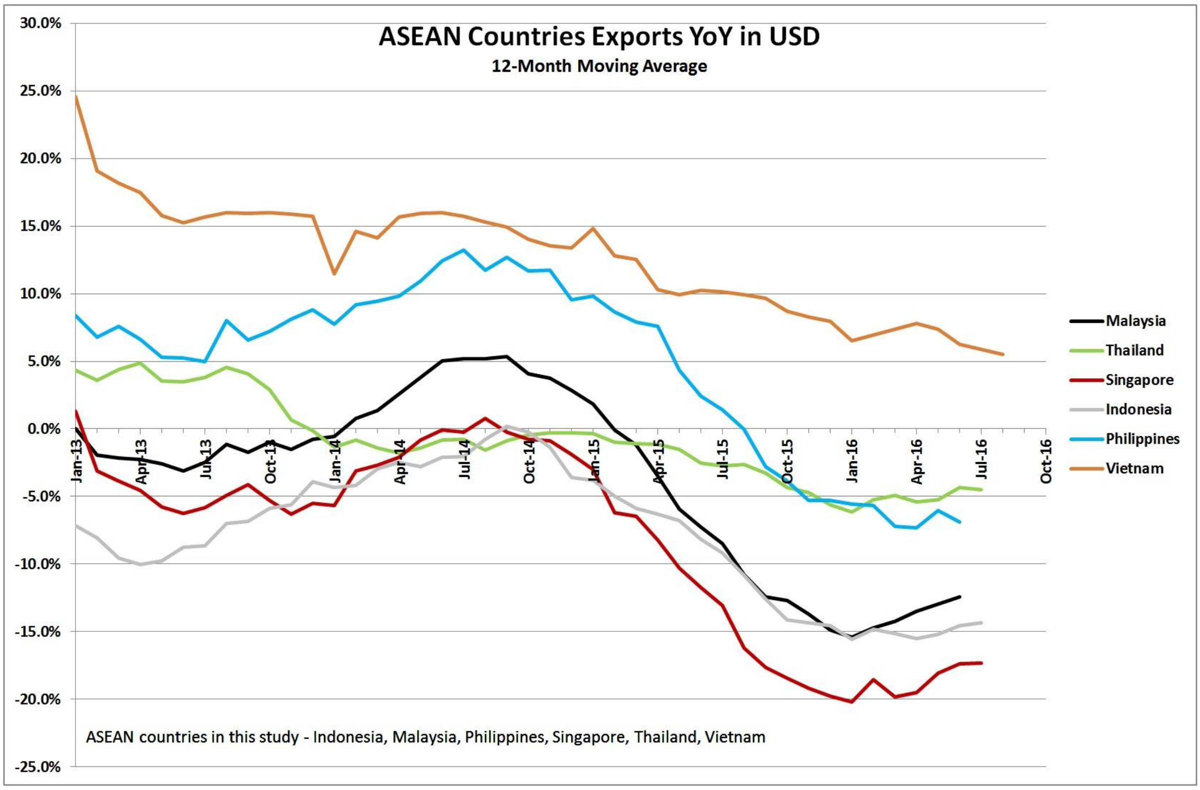

As I highlighted before in my essay entitled "Why Slow Steaming May Have Killed The World Economy", when oil prices were high, shipping companies found that by sailing their ships at a slower speed, they could reduce their fuel costs. This practice of "slow steaming" became even more popular after container rates began to weaken, as a way to maintain profitability.

Slow steaming resulted in more inventory being kept on the sea, effectively lengthening the supply chain. This was a boon for all manufacturing/exporting nations i.e. EM.

However, fuel prices are now much lower than a few years ago. And if there is a sharp and sustained recovery in container rates, shipping companies may begin to find that they can make more money if they make more trips i.e. sail faster.

If average speeds rise, the amount of inventory kept on the sea will fall and while this adjustment is taking place, some of the end demand will be satisfied from the inventory at sea i.e. leading to a reduction in orders to manufacturing/exporting nations, in spite of robust end demand.

ASEAN exports have been falling for several years now. It is natural to assume that it can't get worse, especially with robust end demand conditions in key developed markets like the US and EU. However, as I demonstrated above, there are dynamics at work that can make this assumption fall flat on its face.




Huge chunks of ASEAN's economy (manufacturing/export) have already been struggling to get by for several years. Low interest rates have helped many companies survive these lean times. What if the Fed really raises interest rates?

Could it get worse? Absolutely.