INSIGHT

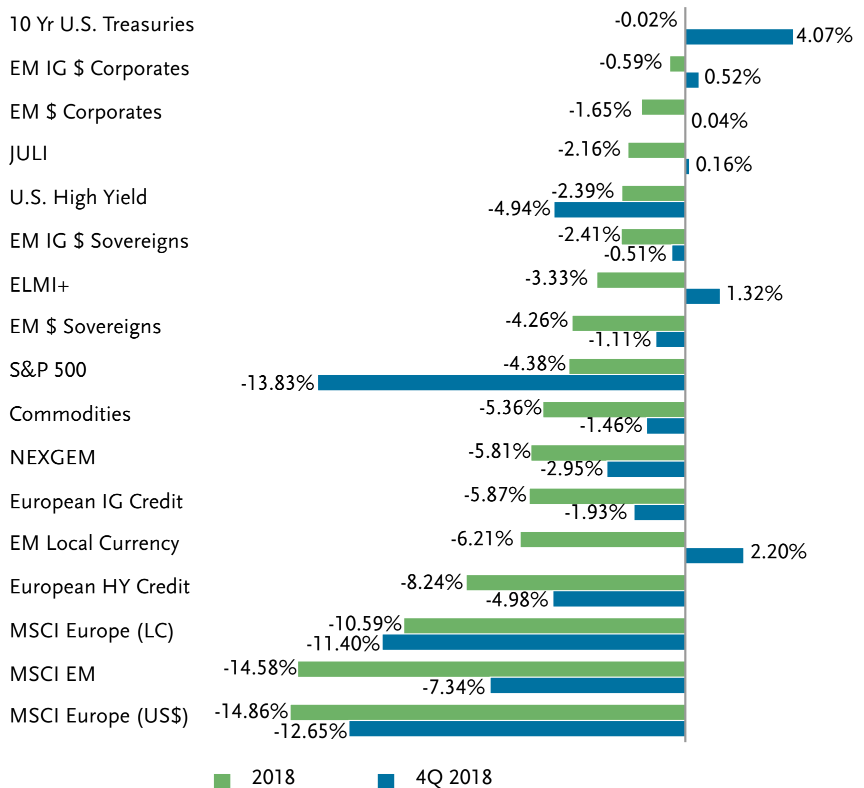
MONTHLY COMMENTARY

December Emerging Markets Update

ANISHA GOODLY | 10 JANUARY 2019

2018 was certainly a challenging year for global assets. Emerging Markets (EM) was no exception, with EM equities ending the year down 14.6%, EM local currency debt down 6.2% (in dollar terms), and EM dollar-denominated sovereign debt down 4.3%.

Total Returns Across Asset Classes



Source: Bloomberg, JP Morgan; Data as of December 31, 2018

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Ms. Goodly is the Portfolio Specialist for the TCW Emerging Markets and International Equities Groups. In this role, she serves as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals and is responsible for communicating investment strategies, performance and outlook to clients. Prior to joining TCW in 2013, Ms. Goodly spent eleven years at Morgan Stanley, most recently as an EM Fixed Income institutional salesperson. At Morgan Stanley, she also served as the Asia Credit Product Manager, marketing Asian credit products globally to the firm's largest institutional clients. In addition, she spent several years working as part of Morgan Stanley's Institutional Investor-ranked U.S. Credit Strategy research team. Ms. Goodly currently serves on the board of Consano. Ms. Goodly graduated with a BA in Economics from Stanford University.

EMBI spreads ended 2018 at recent wides of 415 basis points (bps), after trading as tight as 260 bps at the peak in early 2018. Even with the rally at the start of January[1], EMBI spreads of 390 bps are around 45 bps cheap to the long term median back to 2000. In addition, EMFX is down around 35% on average since the 2013 taper tantrum with the spread between EM and Developing Markets (DM) real rates near the wider end of the range.

EM debt generally outperformed DM debt in the fourth quarter and has had a strong start to the year. However, the market needs a catalyst for a meaningful turnaround. That being said, we believe some of the headwinds that hurt in 2018 are starting to improve.

- **Slower U.S. growth/US dollar weakness:** In early 2018, stronger U.S. growth fueled by tax cuts and fiscal spending, along with perceptions of a more aggressive Fed[2] led to a stronger dollar. We believe U.S. growth has peaked and as fiscal stimulus wanes, growth will slow and lead to a less aggressive Fed in 2019. As we have seen, recently released Fed minutes suggest a dovish tilt, given growth concerns and market volatility. Furthermore, as the market starts to focus more on structural issues facing the U.S. economy – a rising U.S. current account and fiscal deficit – the dollar should come under downward pressure. As such, we believe that 2019 could present opportunities to add EM local currency exposure.
- **Stable but slower Chinese growth:** Deleveraging, and to a lesser extent, trade headwinds have weighed on Chinese growth. In our view, growth in China will continue to slow in 2019 to around 6% (with the possibility of a quarter or two of growth below 6% early in the year). However, we believe that the impact of past, and forthcoming, China stimulus should stabilize demand around mid-2019. With banks reluctant to lend due to rising credit risks, fiscal policy is likely to play a bigger role in supporting growth.
- **EM/DM growth differential widening:** Against this backdrop of slower global, and Chinese, growth, our forecast for EM growth remains relatively stable, but less uniform than before, with several large countries accelerating (Brazil, Indonesia and South Africa), and/or relatively unchanged (e.g. India, Russia). As such, the spread between U.S. and EM growth will in our view widen marginally, which could result in flows out of U.S. assets and into international assets (not just EM).
- **China/U.S. trade war:** The Trump-Xi[3] dinner in late 2018 went better than expected, with the U.S. holding off on raising tariffs and expanding them to more products. Given the negative market and economic impact of higher tariffs, and with China taking some actions to address U.S. concerns, we believe chances are rising that further tariffs will be put off again. As negotiations continue, we expect broad CNY stability, helping to anchor other EM currencies, particularly in Asia. While the markets have responded constructively to the January negotiations, we believe that the chances of a broad agreement, and rollback of existing tariffs, remain low and the U.S. is likely to tighten restrictions on U.S. exports of, and Chinese investment in, U.S. technology. Uncertainty over the extent of trade and investment restrictions is likely to continue to weigh on business confidence and capex in both the U.S. and China and divert some investments into other emerging markets.
- **The idiosyncratic stories of Argentina and Turkey** that unraveled in early 2018 also hurt EM. Both of these countries have started to address their issues: Argentina via a large IMF[4] program and Turkey via slightly better policy. Both countries will experience significant growth declines in 2019, in our view. But importantly, Argentina and Turkey, which were punished for having large external financing gaps, do not represent the norm. Average debt/GDP is around 50% for EM countries – well below the developed world, which is over 100%. In addition, the bulk of EM sovereign debt is denominated in local currency, rather than dollars, making the asset class less vulnerable to periods of dollar strength such as we experienced in 2018.

In the near term, we believe markets globally are likely to remain volatile and without direction until there is more clarity on the U.S. economy, the direction of U.S. interest rates, trade policy and Chinese stimulus. Nonetheless, we think 2019 could be a better year for EM. For dollar-denominated debt, we forecast EMBI spreads to be flat to somewhat tighter, with returns driven primarily by carry (6.50%) and offset partially by higher U.S. rates. For local currency debt, our forecasts are driven by carry of 6.50%, enhanced by EMFX appreciation of 1-2%, if as suggested above, structural issues begin to exert downward pressure on the USD later in the year.

1. As of January 9, 2019; 2. Federal Reserve; 3. Chinese President Xi Jinping; 4. International Monetary Fund

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From a technical perspective, investors remain underweight despite the fact that institutional/strategic investors with zero to minimal allocations to EMD took advantage of the 2018 downtrade to add exposure (keep in mind that EM debt now comprises close to 20% of global fixed income). This is in the context of minimal net new issuance for 2019: $2bn for sovereigns and $22bn for corporates.

We see the primary risk factors – which do not represent our base case – as follows:

1. A notable slowdown in China, in the low 5% area, below what we are expecting, with a more material downturn in property adding to deleveraging and trade headwinds, as well as reducing local government funds to finance infrastructure investment. Lower rated corporate borrowers could come under stress as they seek to refinance large amortizations in both domestic and external markets.
2. A dysfunctional political environment in the U.S. or a recession in the U.S. later in the year. In either of these scenarios, we would envision an extended U.S. equity sell-off that would weigh on risk assets more broadly.
3. A stagflation scenario, where the Fed gets behind the curve through accelerated rate hikes. Investment flows and liquidity would be at risk. ■

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