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INSIGHT

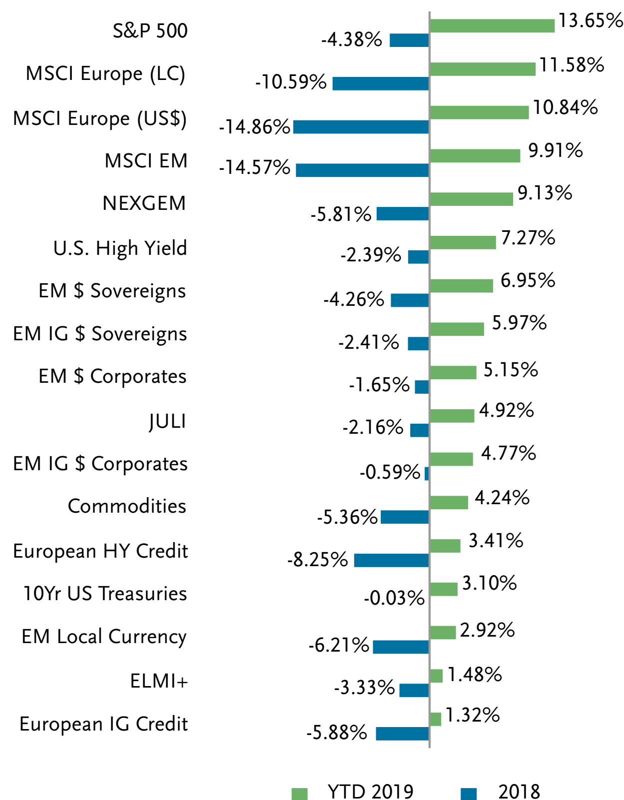
MONTHLY COMMENTARY

March Emerging Markets Update

ANISHA GOODLY | 9 APRIL 2019

Emerging Markets (EM) debt had a strong start to the year across both hard currency and local currency debt, as several of the headwinds that impacted the asset class negatively in 2018 started to turn. EM hard currency debt has entirely erased last year's losses, with EM local currency debt recouping about half. This turn has been driven by a number of factors, including: 1) improving prospects for a U.S./China trade deal, 2) early signs of China stabilizing as they push through various stimulus measures and, 3) accommodative monetary policy from both the Fed and European Central Bank (ECB).

Total Returns Across Asset Classes



Source: TCW, Bloomberg; Data as of March 31, 2019

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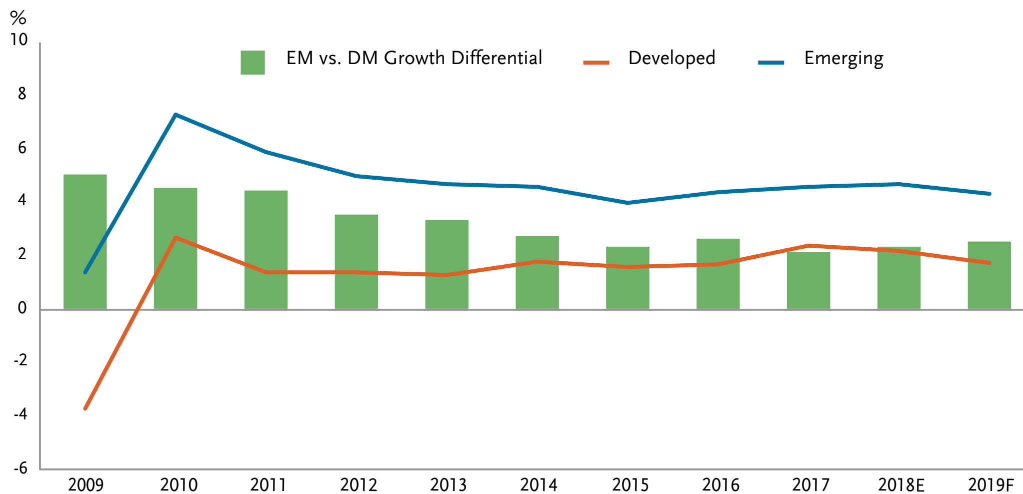
Ms. Goodly is the Portfolio Specialist for the TCW Emerging Markets and International Equities Groups. In this role, she serves as the primary liaison between TCW's Emerging Markets investment team and TCW's client relations and marketing professionals and is responsible for communicating investment 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 and is an Ambassador for Girls Who Invest. Ms. Goodly graduated with a BA in Economics from Stanford University.

March Emerging Markets Update

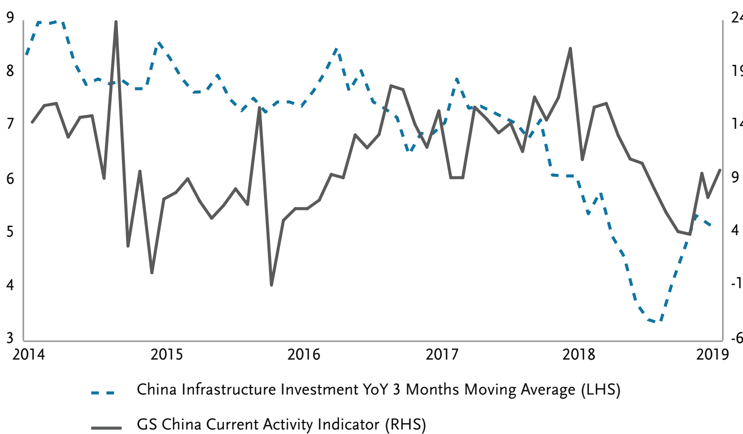
More recently in March, markets were volatile on the back of potential weaker global growth. This has remained a key risk to global markets, as the U.S. economy is slowing and European growth remains weak. At this point, the extent of the slowdown in the U.S. remains unclear. We should have more clarity over the next several months whether the U.S. economy is slowing to trend (as we believe) or heading into a recession. U.S./China trade negotiations continue, and we ultimately believe a deal will be completed that reduces the risks of higher tariffs (even if tensions over technology continue). But more importantly, there are early signs of green shoots in China; its strong March PMI print showed broad-based improvement across a number of sectors. If this trend is confirmed over the next quarter or so, in line with our view, it should help stabilize growth both in China and by extension, in Europe. In addition, ECB policy stimulus should help European growth in coming quarters. As such, we see improving prospects for global growth bottoming out. In addition, we believe that the EM/DM growth differential should widen this year, providing support to the asset class.

EM/DM Growth Differential Widening



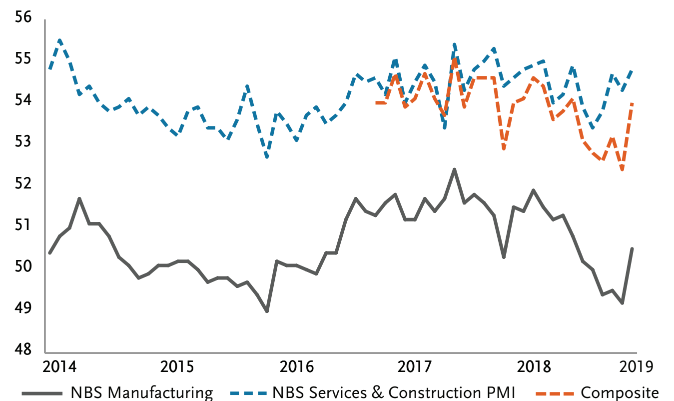
Source: TCW Emerging Markets Research, Data as of March 31, 2019

China: Overall Activity and Infrastructure Investment Appear to Have Troughed



Source: Bloomberg, Goldman Sachs, Data as of March 1, 2019

China: Services Holding Up and Manufacturing Recovering



Source: China Federation of Logistics and Purchasing; Data as of March 31, 2019

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March Emerging Markets Update

Looking across regions, stabilization in Chinese growth will provide an important source of support, in our view, for Asia and among commodity-dependent economies, helping offset falling external demand elsewhere. While growth in Latin America has moderated, Brazil and Argentina are two notable exceptions to this trend, due to a turn in the domestic cycles as both countries recover from recessions, but the pace of recovery there will also be tempered by the weaker external environment. A slight but measured upward bias in commodity prices should be supportive of the region as a whole. In Emerging Europe, the picture is mixed, with Russia and most of the FSU countries growing around trend assuming no large swings in energy prices, and a prolonged economic recession in Turkey. CEE economies have slowed modestly from 2018 to 2019, but growth in the newer member states of the EU (e.g. Poland, Hungary, etc.) remains 2-3x the pace of growth in the Eurozone. The pace of slowing in these economies is cushioned by structural factors such as EU cohesion funds that support economic activity and exchange rates.

The overall weaker global growth data, combined with the lack of inflationary pressure, should keep global rates low for an extended period and support capital flows into EM. The Fed and ECB have responded quickly to the slower growth environment and trade uncertainties by halting plans for additional tightening, and the ECB has recently indicated plans to provide new liquidity mechanisms. Furthermore, the dovish tilt from developed central banks has allowed EM central banks to turn more dovish as well.

The other main question is when the dollar turns. Our base case is for the dollar to be under pressure as the U.S. slows and growth in China and Europe stabilizes, which we believe there will be signs of as we approach the second half of the year. Furthermore, with slower U.S. growth the market should start to focus more on the structural issues facing the U.S. economy – a rising U.S. current account and fiscal deficit – which would also be dollar negative. As such, we continue to believe that the second half of 2019 could present opportunities to increase EM local currency exposure.

As mentioned, the key risk is if global growth turns meaningfully lower. While the asset class is not immune to global risk aversion or negative performance, we would note that the EMBI (EMD dollar-denominated sovereign index) is a BB+ rated index, with approximately half of the index rated investment grade. Furthermore, when looking at the corporate sector, EM corporates tend to have better balance sheets and higher quality new issuance than developed market counterparts. For example, CCC issuance in U.S. High Yield (HY) was approximately 15% in 2018, which compares to 0% for Emerging Markets. That helps provide a buffer during more challenging environments. Furthermore, we see the potential for additional dislocations in the U.S. HY market, given that current fallen angel[1] candidates would comprise almost 10% of the U.S. HY market if in fact downgraded to high yield. On the other hand, fallen angel candidates in EM would represent only 3.5% of the EM HY corporate market if downgraded.

As for current valuations, EMBI spreads have tightened from wides of approximately 420 basis points (bps) at the beginning of the year to 350bps, in line with long term averages and around 10-15bps above this year's tights. For the balance of the year, we believe returns will largely be driven by carry, with potential for 25bps or so of spread tightening in the event of any upside surprise to growth.

For local currency debt, we believe EMFX sentiment will improve and outperform the dollar if there is a positive shift in global growth sentiment, especially as being short the dollar against other developed market currencies is a negative carry trade. In the interim, we believe EMFX moves will be driven more by idiosyncratic factors. Valuations in local currency are attractive, with average carry of 6.2%. If the dollar turns, in line with our view, we see the potential for EMFX appreciation of another 1-2%. That looks attractive to us, particularly as 40% of global fixed income yields below 2%, and around 17% trades with negative yields.

Technicals remain strong as well. The asset class has had a record start to the year, with $21.5bn in total inflows year-to-date. We continue to see interest from investors to reduce underweights, especially as EM fixed income now comprises 20% of global fixed income. Net issuance needs also remain low, with $13bn total forecasted for sovereign dollar debt and $22bn for corporate dollar debt.

We are also mindful of idiosyncratic risk in Emerging Markets, particularly as there are a number of important elections coming up (South Africa, Ukraine, India, Indonesia, Argentina). While the recent sell-off has created value, differentiating between credits remains key in an asset class of over 70 countries. ■

1 Fallen angels defined as investment grade rated bonds with a BBB- average rating and on negative watch/outlook by at least one rating agency.

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