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INSIGHT

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April Emerging Markets Debt Update

ANISHA GOODLY | MAY 16, 2018

The markets have been volatile for a mix of reasons – the quick move higher in rates, dollar strength, and fears of a global trade war to name a few. As of May 15, 2018, Emerging Markets (EM) dollar-denominated debt is down around 4.5% year-to-date (YTD), primarily due to higher rates and then subsequently wider spreads as volatility picked up on trade fears and geopolitical risk. EM local currency debt is down 2.9% YTD, after returning almost 4.5% during the first quarter.

Amidst this volatility, we would note that the improving fundamental story for Emerging Markets has not changed, in our view. While there are certainly some lower-rated countries that are more susceptible in this higher rate environment, that is not the norm in an asset class with close to 70 countries. Emerging Markets continues to benefit from higher global growth, as well as a widening of the differential between EM and Developed Markets growth. This differential is expected to continue to widen in 2019, and historically, when this has occurred, EM has outperformed developed markets. In addition, the vulnerability of the asset class has declined since the time of the 2013 taper tantrum. At the time of the taper tantrum, EM growth was falling, current account deficits and inflation were high, and real rates were low. Since then, we have seen growth improve after some important structural reforms and deleveraging, with large index countries such as Brazil and Russia emerging from recessions. Inflation is now in the low single digits, and appears relatively contained given negative output gaps. In addition, after a significant adjustment period from 2013-2015, Emerging Markets is now in the early to mid-stage of its business cycle, whereas arguably the U.S. is in the later stages after a 10 year expansion.

The uncertain trade environment is, in our view, likely going to contribute to higher volatility in the near term and we would also acknowledge the risk of potential policy errors. Rising policy uncertainty over trade and investment barriers is likely to dampen business sentiment and capex, though we expect this to hit businesses in the U.S. harder than in China, given 1) current strong growth tailwinds in China, 2) China's limited dependence on external demand, with only 3.5% of output consumed in the U.S. and 3) China's ample fiscal power to support growth, as well as its ability to ease financial conditions or property policies. We do not, however, believe that China will retaliate by depreciating the CNY or selling U.S. Treasuries -- both highly unlikely given their desire to maintain financial stability and be seen as the more responsible actor in global markets.

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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.

That said, EMBI (sovereign-dollar denominated) spreads have widened as much as 80 bps from this year's lows to the wides of 340 bps in early May, from which we have seen only a modest amount of retracement. As such, average yields between the EM dollar debt and EM local currency debt have converged to approximately 6.30%, and to us, the return potential going into the end of the year appears more balanced at current levels. We do, however, believe that local currency debt presents greater individual opportunities for higher returns, particularly in light of the potential to capture currency gains. EM currencies are down about 30% on average since the time of the taper tantrum, despite improving fundamentals. And while there certainly may be periods of counter trend dollar rallies, we do not see the case for a sustained and continued dollar rally, especially considering the fact that EM growth is outpacing U.S. growth and periods of twin deficits in the U.S. are usually associated with dollar weakness.

To us, this move has created some real value in the market and we have had a number of both hard and local currency institutional investors add exposure during this downtrade. Current levels appear to represent an interesting entry point, particularly in light of the continuation of strong EM fundamentals. We have been selectively adding risk, particularly via 1) new issues (the market is forcing higher premiums, which is subsequently repricing the market) and 2) credits that we believe were too severely punished in the downtrade. At the same time, we are generally reducing duration as curves have flattened – shorter duration 5 and 10yr bonds are offering some healthy carry on the back of the move in U.S. rates.

It does feel to us that we are likely closer to the end of the downtrade than the beginning. Having said that, this could go on a bit longer given concerns around trade policy and this counter trend rally in the dollar, and so we would recommend scaling into the asset class.

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