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MONTHLY COMMENTARY

Emerging Markets Update

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It's certainly been an interesting year. Q1 represented the strongest first quarter ever for the EMBI Global Diversified, as several headwinds that hurt the asset class in 2018 started to turn: 1) a dovish tilt from the Fed, 2) signs of improved growth in China and 3) at the time, improved sentiment around the U.S./China trade negotiations. Over the last few weeks, of course, sentiment has deteriorated as trade tensions have escalated, posing a threat to global growth. While we haven't materially changed our constructive view on EMD, and the market moves since last week have in fact been relatively muted, we are in a period of uncertainty until we get more clarity on the direction of U.S./China trade negotiations.

As such, it is important to put things into context. Emerging markets are an important and growing segment of the global economy, representing close to 60% of global GDP and nearly 70% of global growth in 2019. The spread differential between real rates in EM versus DM is still close to the high end of the recent range and the January pivot of the Fed eliminates the pressure EM central banks might otherwise have felt to raise rates in order to maintain that differential. Moreover, EM real rates are significantly higher today than they were at the start of the 2013 taper tantrum. On the inflation front, EM inflation is near recent lows and continued slack in the major EM economies ensures that, while further downside surprises are unlikely, an upsurge in EM inflation is equally remote over the near to intermediate term. Moreover, absent a no deal scenario in the U.S./China trade dispute, we still expect the spread between EM and DM growth to widen marginally in 2019, owing principally to lower growth in the developed world. This has traditionally been positive for active and passive flows into EM.

In the short term, the key impact of the trade dispute is likely to come from a reduction in global trade and persistent uncertainty, leading to a deferral of investment and encouraging precautionary savings. This will impact both the U.S. and China.

In the event of an extended trade war, there are some obvious EM losers – Taiwan, Korea and Japan – all deeply embedded in the global supply chain (we would note that Taiwan and Korea are not included in the EM sovereign indices). But there are potential winners as well. Vietnam, Cambodia and Laos could benefit from a shift of productive capacity out of China. Both Brazil and Argentina would be obvious alternative sources for China's agricultural imports from the U.S., and Mexico could benefit from trade diversion, especially in low value added products.

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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.

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Growth in China began to slow in the second quarter of 2018, a result of its crackdown on the shadow banking system. The negative impact on growth was exacerbated later in the year by sentiment concerns around the impact of trade tensions between the U.S. and China. In the last six months, China has introduced a number of stimulative measures (both monetary and fiscal) equivalent to 1.5-1.75% of GDP and recent data indicate that these are having a positive impact. YTD services appear to be holding up and manufacturing is recovering. Real estate and infrastructure seem to have troughed, but overall activity data is still weak.

In the extended trade negotiation scenario, we would expect Chinese policy makers to pick up the pace of easing, targeting higher broad credit growth and expending fiscal stimulus by perhaps as much as an additional 50 basis points (bps) of GDP. Specific measures could include more public spending on infrastructure, specific pro-consumer spending measures, and further monetary stimulus via RRR cuts. In the absence of a trade deal, we would expect additional fiscal stimulus of another 100 bps or so and additional public bank lending.

It is not only the fundamental story that is underwriting continued interest in the asset class, but also valuations that help compensate for the risks. With 40% of global fixed income at yields of 2% or lower, along with over $10 trillion dollars of government debt with negative yields, more and more institutional investors are looking to make standalone allocations to the asset class.

Moreover, EM valuations are cheap to their long term averages with the EMBI GD spread at approximately 360 bps versus a long term average of 350 bps. There are very few asset classes in global fixed income that are near their long term averages, arguably most in fact are trading closer to the tighter end of their historical ranges.

Finally, the move since this recent U.S./China trade news has been relatively muted. Spreads on the EMBI have widened about 10 bps and then retraced about halfway. Local currency debt is down around 60 bps. We would watch for the following to add EMD risk:

1. From a macro perspective, the state of trade talks between the United States and China, and the state of global economy, primarily growth numbers in China and Europe.
2. On the external debt side, we would use any more meaningful weakness to add to the exposure if there are signs that U.S. and China remain committed to finding a solution. This is a necessary component, in our view, for risk assets to perform well into second half of the year. Barring any meaningful change in fundamentals, we would look to add exposure if the EMBI spread widened to 375 bps, and more at 400 bps in stages.
3. As for local currency, the DXY has been quite resilient. In the short term, we believe EMFX performance will be driven by trade-related headlines. We ultimately believe that the dollar will turn, due to a combination of slowing U.S. growth and rising deficits which have historically put pressure on the dollar. In addition, if China stabilizes, we see scope for Europe to recover, which would pave the way for EM currencies to trade better relative to the dollar. In other words, it is difficult to see a rally in EMFX versus the dollar without any meaningful stabilization in China and improvement in European economic growth. As a consequence, we have been focused primarily on hard currency debt in our total return strategy. ■

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