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INSIGHT

MONTHLY COMMENTARY

August Emerging Markets Update

SPENCER RODRIGUEZ | 12 SEPTEMBER 2019

August proved a difficult month for Emerging Markets (EM) assets, punctuated by an escalation in trade tensions and a market unfriendly election outcome in Argentina. EMD dollar denominated assets proved reasonably resilient on the back of the strong U.S. Treasury market, with sovereign dollar debt returning 0.75% for the month and corporate dollar-denominated debt, 0.13%. EMD local currency debt, on the other hand, returned -2.64%, suffering from another safe haven surge in the dollar. These figures bring year-to-date returns to 13.50% for EM dollar-denominated sovereigns, 9.94% for EM corporates, and 6.83% for EM local currency debt. Deteriorating global sentiment drove net portfolio outflows, which totaled $4.5 billion across local, blended, and hard currency funds, with the majority ($3.7 billion) coming from local currency funds. For the year, EM debt inflows total $31.6 billion, largely concentrated in hard currency funds. New issuance in August totaled $10.7 billion, all issued by corporates.

In our view, the divergence in performance between hard and local currency assets is likely to continue under current market conditions. While rates in the U.S. have declined faster than in other developed markets (DM), the dollar remains supported as U.S. Treasuries continue to be the highest yielding developed market government securities. Also, despite the trade uncertainty, the dollar benefits from U.S. growth exceptionalism, while both the European Union (EU) and China continue on decelerating growth paths. Until evidence emerges of stabilization in growth in the EU and China, we believe returns on Emerging Markets local currency debt will continue to be constrained by dollar strength.

The world continues to adjust to the new reality of increased trade friction, a significant reversal from the more than two decades of systematic dismantling of trade restrictions. The ongoing and, at present, escalating dispute between the U.S. and China provide the most glaring example of this new reality, but trade and trade access are also at the core of UK's protracted and hereto unsuccessful exit from the European Union. What's more, trade barriers are becoming more readily weaponized in bouts of diplomatic marksmanship more broadly, including recently between South Korea and Japan.

Uncertainty around trade continues to negatively impact the willingness of businesses to undertake capital expenditure projects, which in turn has led to a broad deterioration in the global growth outlook. Most notable developments are ongoing growth disappointments in the Eurozone, which is also dealing with the uncertainty of Brexit, and a meaningful growth disappointment in India. In light

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of these growth pressures, policymakers have undertaken a number of easing measures. The Fed eased in July and is expected to continue to pursue a more accommodative monetary policy over the next twelve months. China has also introduced additional measures to boost consumption and the EU is expected to introduce further easing measures at their September meeting. These policies should at least soften the impact of a global slowdown and at best could spur a modest recovery. EM fixed income should benefit in the case of a moderate slowdown or stabilization in global growth, but would be vulnerable in the extremes—with a severe slowdown/recession driving a flight to quality and a sharp global growth recovery leading to inflation and higher rates. Neither extreme scenario is our base case for the balance of 2019.

Given the attractive returns on EMD in a world where 60% of fixed income yields less than 2% (including $17 trillion with negative yields), year-to-date inflows to the asset class have exceeded $31 billion, a trend we believe will continue over the near to intermediate term given the structural institutional underweight to the asset class. Moreover, October is one of the largest months for EMD debt service payments, which are typically reinvested into the asset class. A clear upside risk to the market is some form of a trade breakthrough, although at present this seems like a low probability event, with the possibility for small victories but no final resolution in the foreseeable future.

We maintain our preference for hard currency over local currency and for countries with high yield and idiosyncratic growth drivers, such as Brazil and Ukraine. The high yield segment of the market has lagged the recent U.S. Treasury rally and we believe our high yield positions will benefit from a catch-up trade. We also hold a number of investment grade sovereigns, including new index entrants from the Middle East, which trade at a premium to developed market investment grade names and should continue to benefit from low DM yields. Finally, we like high yield markets where growth is being supported via central bank action, such as Indonesia.

The surprise primary election results and subsequent sell-off in Argentina provides an important case study for the asset class, which has developed in sophistication over the years. The impact was almost entirely confined to Argentine assets and contagion risk dissipated within two trade sessions. This episode demonstrates both the depth of the market and the growing importance of differentiation within the asset class as it matures.

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