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INSIGHT

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September Emerging Markets Update

ANISHA GOODLY | OCTOBER 11, 2018

Tighter financial conditions, a stronger dollar, trade fears and various EM domestic challenges (Argentina, Turkey, South Africa) have weighed on Emerging Markets debt this year, with dollar-denominated sovereign debt down -3.04% and local currency debt down 8.15%. The tone, however, has started to moderately improve, partially on the back of proactive measures by several EM central banks to hike rates and stimulus in China to address the impact of trade tariffs. These measures, combined with cheaper valuations, both absolute and relative to Developed Markets (DM), have also started to encourage investor inflows.

There has been a lot of debate as to whether the recent rally represents a brief reprieve or whether the worst for EMD is in fact over. While it is hard to time, it does feel like we are in the later stages of the overall downtrade. That said, we expect volatility to continue given uncertainty around trade policy. From a fundamental perspective, our outlook for the global economy remains reasonably constructive. While we are no longer in a synchronous global growth environment, the near-term growth outlook for EM is relatively close to trend with solid G3 (especially U.S.) economic growth over the next several quarters and higher energy prices providing support to many EM economies. These trends are to some extent counteracted by tightening G3 monetary policy and global trade wars instigated by U.S. protectionism. China is providing meaningful policy stimulus to compensate for the impact of rising/expanding U.S. trade tariffs, likely resulting in only an incremental Chinese slowdown from 2018 to 2019. In addition, following a meaningful hit to European business sentiment in early 2018 – mainly from U.S. tariff threats – the European growth outlook is broadly stable around trend. The ECB has begun removing policy accommodation, with QE tapering to zero at the end of 2018. While Brexit and Italy uncertainties are a source of some drag, European fiscal policy is turning more expansionary and overall domestic demand is holding up well.

Overall, we see EM growth in 2019 in line with 2018. That said, the EM outlook is less uniform than before with some large EM economies slowing into 2019 (e.g. Turkey and Argentina), others accelerating (e.g. Brazil and South Africa), while many look to be relatively unchanged (e.g. China, India, Indonesia, Russia, Central Europe). Most EM central banks are in tightening mode, in large part in response to the Fed's tightening cycle. For many, however, it remains a gradual process which is unlikely to significantly impair growth prospects. The spread between Emerging Markets (EM) growth over Developed Markets (DM) growth is likely to remain stable over the next

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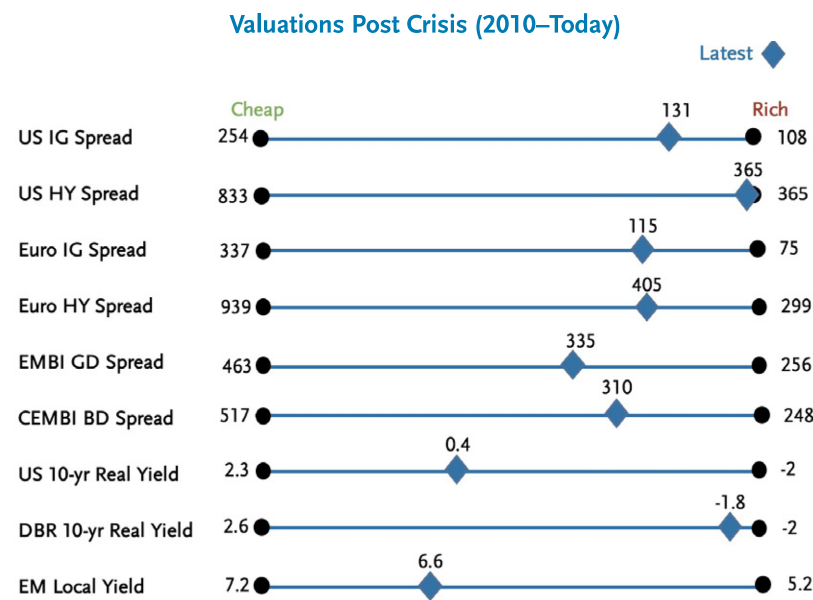
year, in our view, around two times the pace of DM growth. We see the potential for this spread to widen next year in the face of slower U.S. growth. This structural differential has historically benefited Emerging Markets, with the strongest capital inflows correlating with a widening differential between EM-DM growth.

The gradual shift in G3 monetary policy to across-the-board QE tightening represents a risk to the global growth outlook and to capital flows for those EM sovereigns with greater external imbalances and dependence on dollar funding (i.e., Turkey, Argentina). However, we would argue that both are idiosyncratic, and that Turkey is not the norm, and Argentina has been taking proactive measures to stabilize its economy. For the broader asset class, however, fundamental vulnerability has declined on the back of various structural reforms and currency devaluations. Average public debt/GDP for Emerging Markets is around 50%, which compares to over 100% for the developed world. In addition, the bulk of sovereign debt is denominated in local currency debt, rather than dollar-denominated debt. Furthermore, EM's dependence on cross border bank lending has declined given a deepening of EM financial institutions and local capital markets.

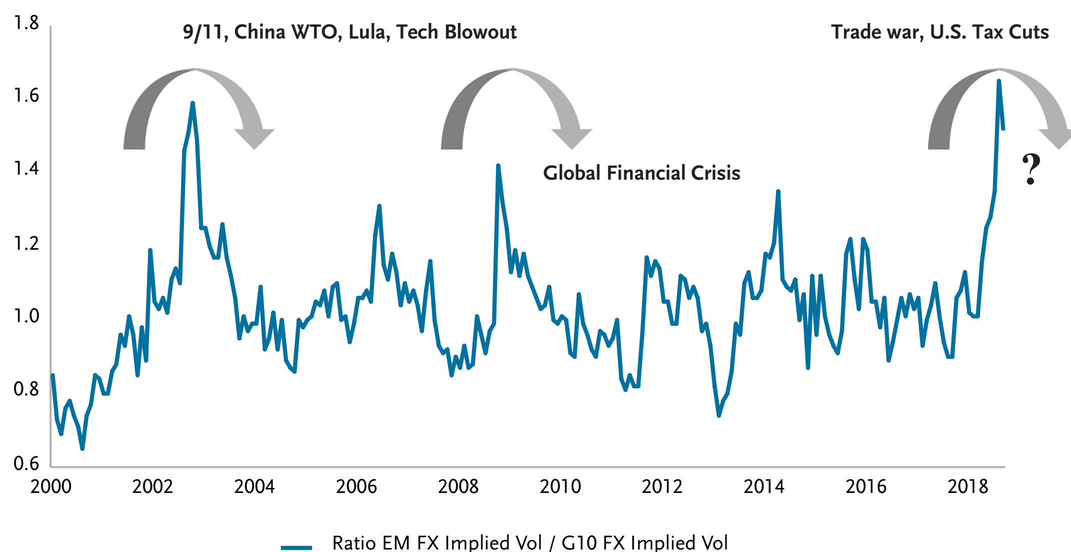
Trade tensions with China present another downside risk. That said, the short-term economic hit should be manageable, as both the U.S. and China are large economies that are much more dependent on domestic than external demand. In addition, domestic demand in China is relatively strong, driven by consumption and property investment. In our base case, U.S. tariffs on China ramp up to 25% in 2019 as we believe prospects are low for a near-term resolution. We believe China will continue to retaliate but in a measured way to encourage the U.S. to de-escalate, with an emphasis on limiting the damage to its own economy. By extension, this helps limit the damage to many other EM sovereigns. Chinese stimulus is likely to remain tempered and targeted towards moderating the slowdown, helping companies hurt by tariffs, and putting a floor on growth, rather than driving a robust recovery. And with Chinese growth above target in H1, there's no need yet for a big stimulus in our view. We certainly must acknowledge the risk that a serious escalation of tariffs has the potential to slow growth and increase inflation, which is generally not a positive factor for risk assets. While this is not our base case, despite sound fundamentals, the asset class is not immune to risk-off sentiment and a global growth slowdown, and we are monitoring these developments closely.

EM dollar-denominated spreads have traded in a 260-377bps range this year, ending the quarter at around 335bps. This puts EM spreads relatively in line with its long-term median. In this regard, Emerging Markets debt stands out when compared to developed markets fixed income, which is trading closer to the richer end of historical ranges.



Source: TCW, JP Morgan, Bloomberg

EM local currency debt has borne the brunt of the weakness this year, as typically, a pickup in U.S. growth relative to other parts of the world tends to benefit the dollar. We certainly see value at current levels. What prevents us from adding local currency risk in a significant way at this point is the uncertainty around U.S. trade policy and the resulting volatility – this year, EM currency volatility hit its highest level since 2001. However, we believe that dollar strength will begin to wane as the spread between growth in the U.S. and the rest of the world begins to narrow and the market turns its attention away from cyclical factors and starts to focus more on structural issues (rising U.S. current account and fiscal deficits). In addition, we believe that the impact of U.S. fiscal stimulus will begin to slow in 2019, and that, combined with rising rates, can weigh on U.S. growth.



Source: BNP Paribas, Data as of September 25, 2018

This has been a challenging year for asset markets globally, with only a few asset classes posting positive returns. That said, we see certain segments of the EMD market as oversold and are looking for opportunities to add risk selectively. ■

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