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INSIGHT

MONTHLY COMMENTARY

October Emerging Markets Update

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Early 2018 was characterized by synchronous global growth, an environment that has historically benefited Emerging Markets. However, as the year progressed, the synchronous growth story was called into question amidst weaker-than-expected growth data in Europe and several Emerging Markets countries against stronger U.S. growth. The weaker growth story, along with tighter financial conditions, a stronger dollar, trade fears and various EM domestic challenges put further pressure on Emerging Markets debt.

Looking ahead, the overall EM outlook appears to be less uniform than before with some large EM economies slowing into 2019 (e.g, China, Turkey and Argentina), others accelerating (e.g., Brazil and South Africa), while many look to be relatively unchanged (e.g., India, Indonesia, Russia). That will present differentiated opportunities, in our view.

We believe that a recovery for Emerging Markets is centered around stabilization in China. While we have lowered our growth forecast for 2019, and expect a continuation of trade tensions in the near-term, we do not envision a hard landing in China. We believe we will start to see the impact of various stimulus measures during the first half of 2018 with full year growth likely to be in the 5.75-6.25% range. Consolidating our forecasts for growth in individual EM countries, we expect overall EM growth in 2019 to be comparable to 2018. This compares with our expectation that DM growth in 2019 will come in slightly below the 2018 level as the impact of fiscal stimulus in the U.S. begins to fade. This structural differential has historically benefited Emerging Markets, with the strongest capital inflows correlating with a widening differential between EM-DM growth.

We have had a significant repricing in both the dollar-denominated and local currency markets. Emerging Markets dollar-denominated debt spreads are over 110 bps wider from the tights of late January 2018. At the beginning of the year, we felt that credit spreads globally were tight, and that there was more of a relative value story between EM and Developed Markets (DM) credit. Now, it appears that not only is EM still cheap to DM, but EM is also moderately cheap relative to its own history, one of very few asset classes about which this can be said.

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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.

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In addition, 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). Given the divide in Congress, we see less of a chance of additional and broader U.S. fiscal stimulus next year, and therefore a higher probability of our base case of U.S. growth slowing next year, and less upward pressure on U.S. rates and the dollar.

Emerging Markets debt represents 16% of global fixed income. Notably, throughout the year we have continued to see investor interest to add exposure, taking advantage of the recent downtrade to reduce underweights to the asset class. ■

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