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Investing in a low growth environment.

The Investment Report.



Emerging Markets Debt

The headwinds are turning

The performance of the world economy in the aftermath of the 2008 Global Financial Crisis has been characterised by an unusually slow and uneven recovery, notably in the United States (Chart 1). This weak performance has come in spite of extraordinarily loose central bank monetary policies and an unprecedented amount of Quantitative Easing. Several explanations have been put forward for the unevenness of the recovery: “a debt overhang” (Harvard Economics Professor Kenneth Rogoff), “global savings glut” (former Federal Reserve Chairman Ben Bernanke) or “liquidity trap” (City University of New York Professor Paul Krugman). Most recently, the US Federal Reserve seem to have adopted a central view close to Harvard Professor Larry Summers’ “secular stagnation theory”, which implies that neutral rates (r^*) post-crisis are likely to be much lower than they were in the past. This suggests that absent a generous fiscal easing, which remains politically difficult to achieve, rates and global yields are likely to remain extremely low for an extended period of time, and possibly move lower.

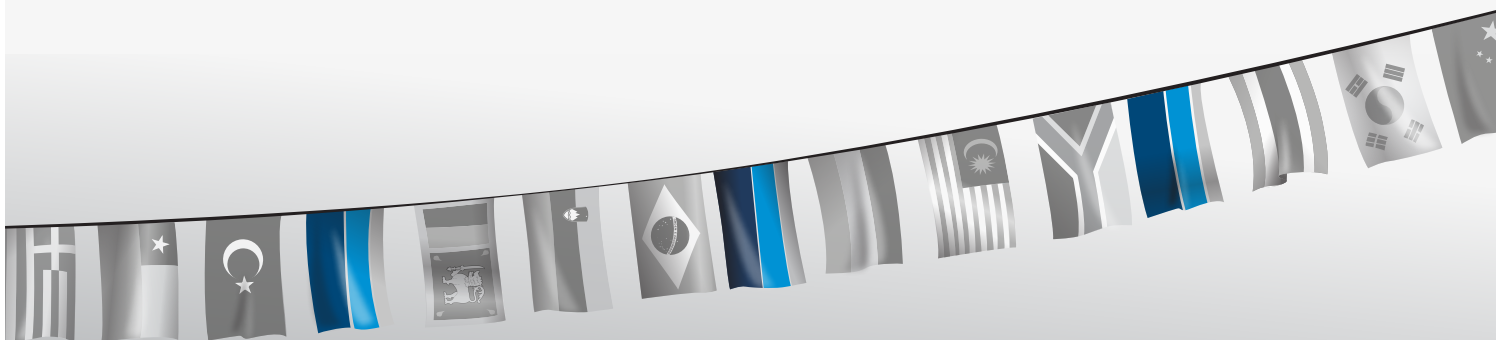
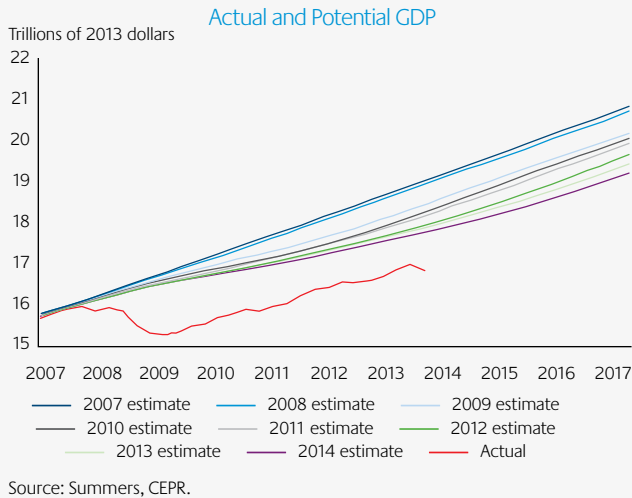
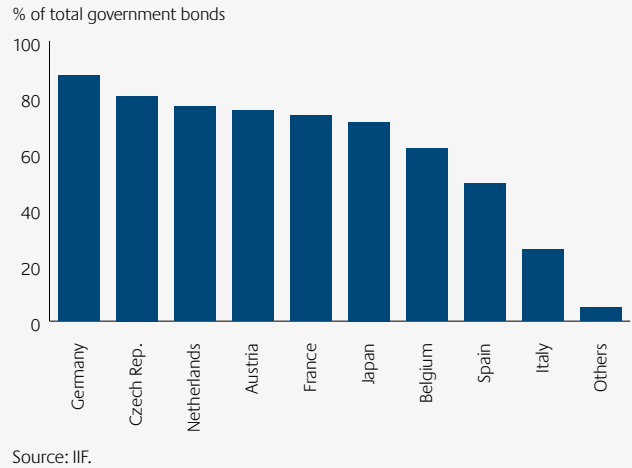


Chart 1: Long-term US economic projections have been consistently revised lower



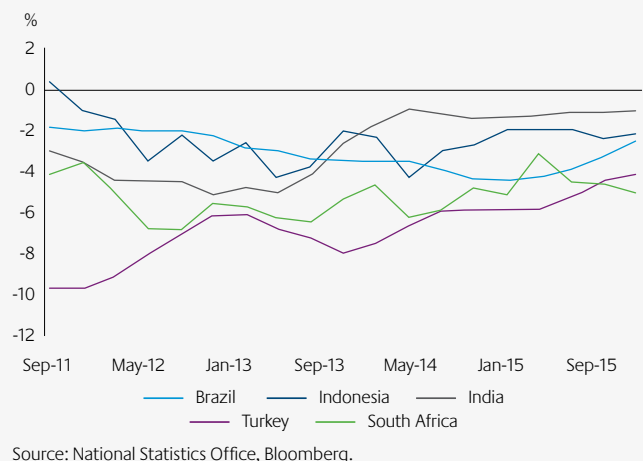
In the case of emerging markets (EM), the growth recovery has also been uncharacteristically slow, especially since 2012. The strong US dollar (USD) combined with tepid global growth has weighed on commodity producers who still represent a major share of the EM universe. In addition, manufacturing exporters, who should have benefited from the commodities repricing, have faced a slowdown in global trade. The structural transition in China from an investment-led to a consumption driven growth model has automatically caused weaker growth in its national economy (and global impacts). Finally, some countries (Brazil and Russia notably) suffered from one-off political shocks which led to very poor growth over that period. As a result, global investors initially retrenched from the asset class due to a weakening in credit metrics. However, it is important to note that unlike previous episodes of global tightening and commodity shocks, EM neither experienced a 'crisis' nor witnessed large scale capitulation from institutional investors. This demonstrates a level of maturity for the asset class which has now become a core part of the fixed income universe.

Chart 2: Negative yielding bonds now constitute a major share of the global sovereign bond universe



Since the start of the year, it appears that many of those growth headwinds have started to fade. The most striking fundamental improvement for EM has been the correction in the large trade deficits and current account imbalances (Chart 3) that were present in previous years and led to the moniker of 'Fragile-Five' in the case of Brazil, South Africa, Turkey, India and Indonesia. The current aggregate external position in EM (ex-China) is at its strongest surplus since 2009. Capital outflows from China have stabilised for more than six months following the introduction of a managed floating currency basket regime and the moderate depreciation of the renminbi has put the Chinese economy on a better footing (although many other risks related to excessive leverage remain to be addressed). Global foreign exchange (FX) reserves in EM have stabilised and real rate differentials with developed markets have widened, offering a further buffer against volatility in global liquidity. EM currencies have arguably undershot their fair value from a purchasing power perspective and continue to provide a competitiveness advantage.

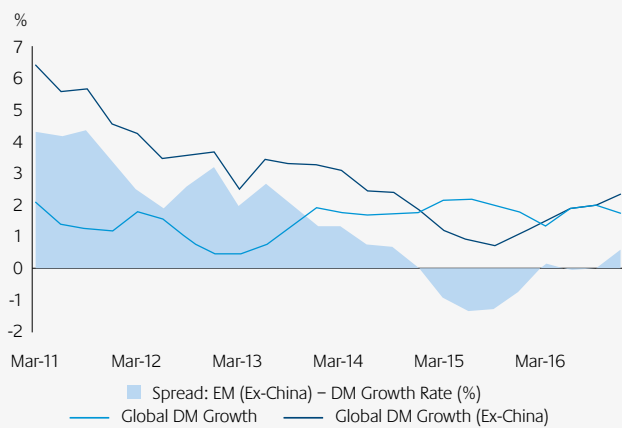
Chart 3: Current account imbalances have corrected





A direct result of this mediocre global growth and inflation dynamic, combined with the extraordinary monetary stimulus, has been the increased share of negative yielding bonds, from a peculiarity when first introduced by Denmark in 2012, to a global feature with now almost 30% of the outstanding stock of government bonds trading with negative yields (Chart 2). Many income-seeking asset managers do not have the ability to hold those ‘assets’ and have been forced to seek higher yields. Within fixed income, EM have been a prime target of those inflows (Chart 5), particularly as the disappointment in economic data and rise in political risks seen in developed markets is coinciding with an acceleration in growth in EM (Chart 4) due to the improvement in fundamentals that we highlighted above.

Chart 4: EM growth has accelerated past DM over the past year



Source: National Statistics Office, Bloomberg, Economist forecasts, World Bank.

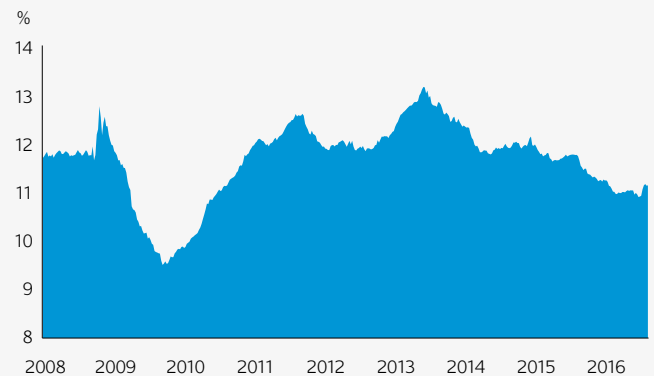
Investing in EM fixed income can be done through three main channels: hard currency sovereign bonds (mostly USD-denominated), hard currency corporate bonds and local currency sovereign bonds (denominated in local FX).

Our base case is that over the next stage of the ongoing low global growth environment, EM will continue to experience stronger growth than developed markets. This is likely to lead to a positive reassessment of the credit worthiness of those countries and contribute to a compression of risk premia. In addition, EM currencies, which offer cheap valuations at present would likely reprice favourably.

Going forward, we expect inflows to continue, due to the relative under-investment by global managers in the EM universe over the past several years (Chart 5). One note of caution is that an unusually large share of the most recent inflows has been executed through exchange-traded funds which are liquid and readily available so can be more prone to reversals due to short-term changes in sentiment. The main catalyst for such a reversal would be a further rise in populist political movements in core developed markets. This could lead to expectations of a further deceleration in global trade caused by protectionist measures against mercantilist Asian exporters

(US presidential candidate Donald Trump for one supports such measures), and possibly a reduction in worker remittances to Eastern Europe and Latin America. Another potential trigger for a reversal would be that rate differentials start to favour developed markets again.

Chart 5: The share of portfolio allocations to EM has stabilised



Source: IIF, EPFR.

Chart 6: EM credit spreads have room to compress



Source: Bloomberg.

Conclusion

After several years of disappointment, growth in EM countries, particularly relative to developed market growth, is starting to pick up. Commodity prices appear to have stabilised and current accounts in some countries are improving, including in countries that are most dependent on external financing.

The need to avoid low and negative yields has encouraged global asset managers to increase their EM allocation as a share of total assets in recent months. We expect this effect to persist in a low growth environment, leading to further compression in credit spreads and the revaluation of EM currencies.



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