TCW

INSIGHT

MONTHLY COMMENTARY

December Emerging Markets Debt Update

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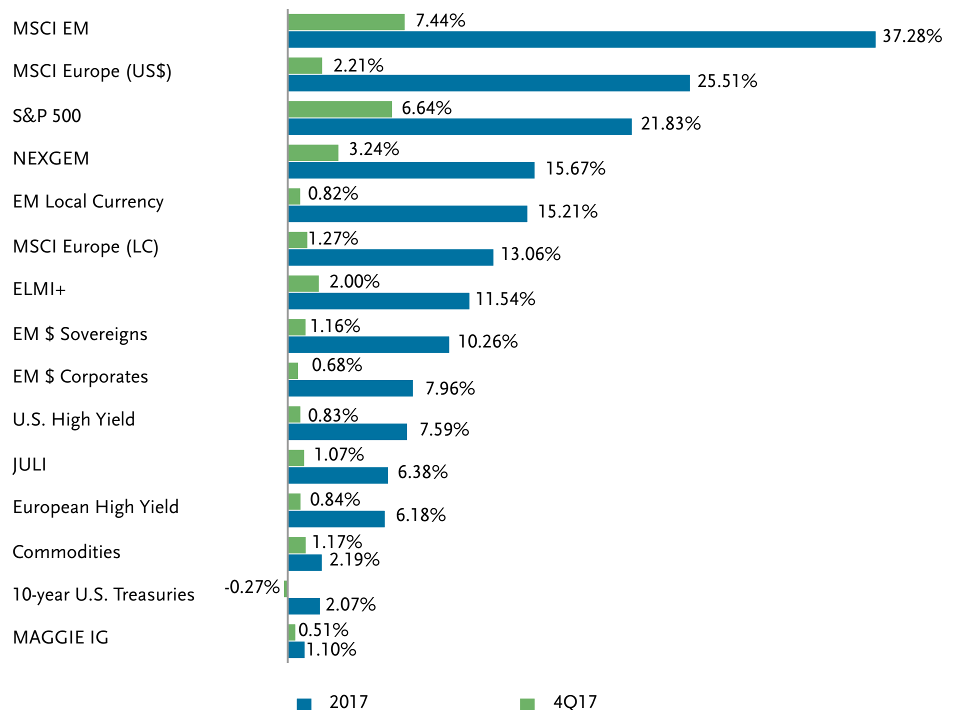
JANUARY 5, 2018

The year was characterized by synchronized global growth and low inflation, both of which benefited Emerging Markets debt (EMD). The asset class was able to withstand higher U.S. rates as the Fed moved slowly and in line with prior guidance and the ECB and BOJ remained accommodative. Emerging Markets local currency debt outperformed dollar debt, returning 15.21%, followed by dollar-denominated sovereigns, 10.26%, and dollar-denominated corporates, 7.96%.



Source: Bloomberg; JP Morgan; Data as of December 31, 2017

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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.

Given the rally, we are often asked whether the Emerging Markets (EM) trade is over, particularly in light of developments in the U.S. (rising rates, tax reform, and foreign policy uncertainty) and slowing Chinese growth. We believe EM can continue to weather these various market risks and benefit from continued inflows in light of improving fundamentals, attractive relative value versus developed markets and supportive technicals. Our view is predicated upon the following:

- The synchronous global growth story continues, directly benefiting EM through improved trade and a stronger commodity-price environment. In addition, growth has been broad-based, rather than concentrated in a small number of countries. Growth potential for EM sovereigns is also significantly ahead of developed markets with the spread between EM and developed market (DM) growth likely to increase for the second year in a row.
- Growth in China surprised on the upside during the first half of 2017, and while second half data indicates slowing, the tail risks appear to have subsided as capital outflows have stabilized and exports have increased. Furthermore, authorities continue to focus on reducing risks in the financial system, with an emphasis on increasing borrowing rates and reducing shadow-bank lending. We expect full year 2017 growth to be approximately 6.8% and estimate growth in 2018 to slow to 6.3%.
- At the time of the 2013 taper tantrum, EM growth was slowing and much more vulnerable to Fed normalization. From 2013-2015, however, EM went through a notable adjustment period, implementing important structural reforms and reducing current account deficits. EM growth is increasing and the widening spread between EM and DM growth typically has had positive implications for both foreign direct investment and passive investment flows.
- Real yield differentials between EM and DM are closer to the wide end of the range over the last five years. While we believe that this spread will continue to compress in 2018, it should remain wide enough to continue to support inflows, even as the Fed continues its slow and well-telegraphed pace of rate hikes.
- In addition, inflation has fallen to low single digits on average, and fiscal conditions – for the most part – have improved. And while we expect inflation to moderately increase in 2018, we do not anticipate that it will be a significant headwind in light of negative output gaps in most major EMs.
- EM is in the late early-to-mid stage of its current business cycle, which differs from the U.S., which is arguably late stage. EM corporates continue to demonstrate robust earnings growth (although at a slower pace than in 2017), and there are clear signs of continued deleveraging. Corporates are also increasing capital expenditures, which suggests comfort with the growth outlook and demand prospects. While 2017 was a record year for gross issuance, the bulk of this represented refinancings, tenders and buybacks with net new issuance a restrained $141 billion. In addition, the EM market tends not to fund lower rated CCC credits. In fact, CCC issuance is nearly 0% of supply in 2017, which compares to 33% for U.S. high yield.
- EM fixed income now represents approximately 16% of global fixed income. Despite approximately $110bn of inflows in 2017, most investors remain underweight. We expect technicals to remain supportive in light of this underweight, and continue to see investor interest to add exposure to the asset class.

As for valuations, with average yields of 5-6% (with the potential to capture more in select markets), valuations remain attractive versus developed markets, particularly considering that close to 60% of global fixed income trades below 2%. We remain constructive on EM dollar-denominated debt, given cyclical and structural tailwinds. We certainly have to acknowledge that spreads have tightened significantly as inflows have increased. EM sovereign spreads tightened around 60 basis points (bps) in 2017 and are around 90 bps inside long term averages. That said, the pickup over developed markets debt remains attractive. EM sovereigns benefit from minimal supply, and EM corporates currently trade 40-60bps above similarly rated U.S. credits. We believe that carry will represent the bulk of returns in 2018, supported by spread tightening in select higher growth markets and offset by higher U.S. rates.

We continue to see EM local currency debt as providing the greatest return potential in EMD over the next 12 months. Approximately 65% of the local currency index is rated investment grade, and the pickup in growth has helped stabilize ratings downgrades. In addition, average yields in local currency debt are around 6%, with the potential to pick up higher carry in select markets. Plus, a variety of short and long-term currency valuation metrics indicate that EMFX is undervalued relative to the dollar. We see potential for currency gains, as EM currencies are still down over 25% on average since mid-2013. The dollar appears to be peaking, and

while there certainly may be periods of dollar strength, we do not see the case for a sustained and continued dollar rally, especially considering the fact that EM growth is outpacing U.S. growth. And keep in mind that even a moderate FX catch-up of 10% over the next year would serve as a powerful 'kicker' on top of high carry. We would look for opportunities to buy on weakness.

Our base case for 2018 is predicated on a synchronous global recovery, modest upside in inflation and a gradual removal of monetary accommodation. We see the risks as follows:

- **Inflation/Rising U.S. Rates:** As mentioned, inflation in EM remains benign and is expected to slightly increase next year from low levels. However, any meaningful and/or unexpected pickup in U.S. inflation that forces the Fed to hike more aggressively will likely weigh on fixed income markets (not just EMD).
- **Idiosyncratic Risk:** There are over 10 elections in Emerging Markets next year, including in larger countries such as Brazil, Mexico and South Africa, which could both contribute to heightened volatility and present some economic growth downside depending on outcomes.
- **U.S. Policy:** Changes in U.S. policy could present both growth and geopolitical risk. ■

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