INSIGHT

MONTHLY COMMENTARY

March Emerging Markets Debt Update

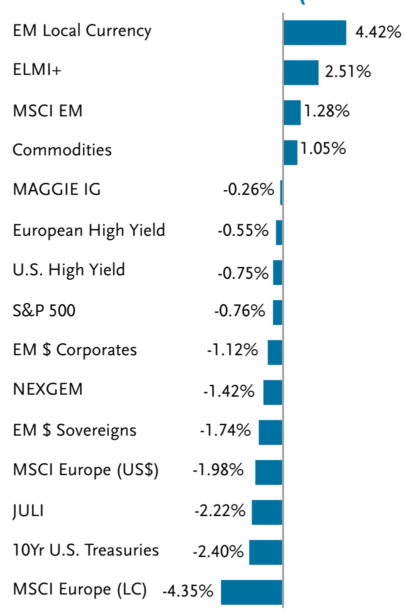
ANISHA GOODLY | APRIL 4, 2018

In our fourth quarter outlook and commentary, we noted that our constructive view on Emerging Markets was predicated upon synchronous global growth and improving EM fundamentals, and further supported by a benign Fed, muted inflation dynamics, stability in China, attractive valuations and supportive technicals. We noted that several of the major risks to our thesis included an unexpected rise in U.S. inflation, as well as changes in U.S. policy, whether trade related or geopolitical.

The strong start to the year reinforced our constructive thesis, but as we have seen, several of the tail risks have come to the forefront. The markets have been volatile due to varying factors, ranging from U.S. inflation concerns to headlines about North Korea to fears of a global trade war. During the quarter, 10-year U.S. Treasury yields sold off more than 50bps on inflation fears, before partially rallying back on U.S. growth concerns. U.S. equities ended marginally lower for the quarter, but down almost 8% from their January high, particularly on trade fears and more recently, due to a repricing of the tech sector.

Against this backdrop, Emerging Markets dollar-denominated debt has been relatively resilient; while posting negative returns (-1.12% for corporates and -1.74% for sovereigns), the asset class notably outperformed 'safe haven' U.S. Treasuries. But, as we anticipated at the beginning of the year, EM local currency debt was the clear outperformer, returning close to 4.5% on the back of dollar weakness.

Total Returns Across Asset Classes (Year-to-Date 2018)



Source: TCW, Bloomberg; Data as of March 31, 2018

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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.

At the time of this writing, uncertainty persists on the back of trade fears. While the breadth and extent of U.S. trade sanctions remain unclear, actual measures have tended to be scaled back from initial announcements. The impact of the measures announced thus far on Emerging Markets should be limited. U.S. imports represent about 15% of global trade, suggesting that the other 85% is largely insulated from U.S. protectionism. In fact, it is possible that these tariffs will have a negative impact on U.S. growth. For example, U.S. steel and aluminum industries are near full capacity so tariffs would effectively hurt domestic importers of these products, and ultimately consumers who will have to pay more for products made from these materials.

Looking ahead, we do expect continued noise as we head into the U.S. midterm elections. China is likely to continue to retaliate to U.S. tariffs on its exports by imposing trade sanctions of its own on specific U.S. products that will cause political pain in electoral swing states (Iowa and Florida, for example).

While we do not discount the risks of a global trade war, we do not believe that the recent news signals a fundamental change in the direction of Emerging Markets. The asset class continues to benefit from a global expansion and a widening of the EM/DM growth differential. Furthermore, the expansion within EM has been broad-based, and domestic demand is improving. Growth tailwinds in China – an important driver of EM growth – are too strong, in our view, to be materially derailed by sanctions. Most analyses to date estimate that the direct impact of 25% U.S. tariffs on China is small – between 0.2% and 0.4%. In addition, China has ample fiscal power to support growth, and could also ease credit and property policies if needed. Moreover, EM countries are moving forward to remove trade barriers. For example, the TPP was signed, without the U.S., in March.

Importantly, Emerging Markets are in the early to middle stages of their business cycle, after undergoing significant adjustments from 2013-2015. EM inflation, already in the low single digits, is likely to remain muted, particularly in the face of negative output gaps and below-trend growth. And while DM financial conditions are tightening, we do not see this as derailing the EM story so long as the Fed and other DM central banks continue at a slow and well telegraphed pace. Indeed, a continuation of the recent sell-off in U.S. stocks could tilt the Fed to be even more measured with rate hikes and lead to further inflows into fixed income.

As for valuations, the combination of the rate backup and a widening in spreads has led to average yields of close to 6% in sovereign dollar-denominated debt. We believe this continues to look attractive relative to developed markets debt, particularly considering the aforementioned improvement in EM fundamentals. Within EM, we believe the story now appears more balanced between dollar-denominated and local currency debt. Yields between the two have converged, and thus the return potential between the two for the balance of the year appears to be closer on a risk adjusted basis, particularly in light of the significant outperformance of local currency debt in the first quarter. We do, however, believe that local currency debt continues to present selective opportunities for higher returns, particularly in light of the potential to capture currency gains. The dollar appears to have peaked in 2017 and, while there certainly may be periods of dollar strength from time to time, 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 periods of twin deficits in the U.S. are usually associated with dollar weakness.

We see several important risks, including the following:

- A significant pickup in anti-trade/nationalism could present downside risks to the markets. While a global trade war is not our base case, there is a risk that the aggressive use of non-traditional, and non-WTO approved trade measures, will negatively impact growth. An unwinding of the growth story would be negative for risk assets, including EM. Business sentiment could also fall due to increased policy uncertainty. Certainly EM economies are starting from a position of strength, given reduced current account deficits, higher FX reserves and stronger relative growth dynamics, but in general, trade wars are not good for anyone.
- Inflation in EM remains benign and, while it is expected to increase slightly this year, it is starting from historically low levels. Nonetheless, 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).

- This is an election-heavy year in the emerging markets, including some of the larger index countries (Brazil and Mexico, for example). This could contribute to heightened volatility and present some economic growth downside depending on outcomes.

We believe that volatility will continue in the near term, driven more by U.S. policy rather than by EM-specific factors. We believe that there is scope for EM to outperform developed markets given the combination of improving fundamentals and attractive valuations. We believe differentiation will continue, making country allocation and security selection decisions key to alpha generation. ■

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