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June Emerging Markets Debt Update

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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.

The external backdrop remained challenging in the second quarter, with Emerging Markets (EM) sovereign dollar-debt returning -3.54%, corporate debt, -2.87%, and local currency debt faring the worst, returning -10.40%. While the initial leg of the sell-off was driven more by higher U.S. rates and a stronger dollar, more recently the market has been under pressure due to growth concerns and heightened trade tensions.

Our base case for Emerging Markets has been underpinned by a synchronized global growth recovery, which has been called into question amidst weaker-than-expected growth data in Europe and several Emerging Markets countries against stronger U.S. growth. While we still believe that the differential between EM and Developed Markets (DM) growth will widen over the next 12-18 months, current above-trend growth in the U.S. and slowing EM growth, particularly in Latin America, has narrowed the extent of this divergence.

We believe key for a recovery in returns in 2H18 is a rebound in growth outside the U.S. While it is too early to make a definitive call, we are starting to see signs of stabilization in non-U.S. growth. In addition, an uptick in Developed Markets wage inflation should translate into increased capex, which positively impacts EM via the trade channel. Another positive dynamic in EM is the abatement of election-induced uncertainty, except for Brazil. In addition, outside of the Fed, we believe that DM central banks are likely to remain dovish, in response to the weaker data during the first half. Similarly, China is acting in a countercyclical fashion, providing a targeted activity stimulus.

The key risk to this narrative is the rising trade tension. While we believe the direct impact for EM from the announced measures is limited, an escalation of a trade war and a potential business confidence shock could derail the growth recovery.

We would further note the following:

- Vulnerability around the asset class has declined, particularly when compared to the taper tantrum period. Current account deficits and inflation levels are lower, and fiscal deficits have been improving. In addition, we believe EM economies are in the early to mid-stage of their business cycle, as opposed to the U.S., which is arguably in the later stages.

- Emerging Markets, in our view, can handle gradual U.S. rate hikes in the context of improving growth (consider 2017 as an example). Rate volatility, however, tends to spook markets, and the risk is that U.S. inflation picks up materially and unexpectedly, forcing the Fed to hike at a faster pace. Rising U.S. rates will present challenges for those EMs that have a large stock of USD-denominated debt and are dependent on foreign financing (e.g. Turkey). But overall, our view is that EM balance sheets are healthy, with many economies in a much better position to handle higher U.S. rates than they were during the 2013 taper tantrum period, due to bigger reserve cushions and undervalued exchange rates.
- We believe tail risks around China have declined compared to several years ago due to more balanced capital flows, well-executed currency management, and the growth in services and other emerging sectors. The short-term economic impact of trade tariffs is limited for China, as only 3.5% of Chinese output is consumed in the U.S. Nonetheless, rising policy uncertainty over trade and investment barriers is likely to dampen business sentiment and capex both in China and the U.S. China will likely retaliate proportionally against the U.S. trade and investment restrictions, and depending on the U.S. reaction, risks are rising that this could go beyond the initial $50 billion of exports. China, in our view, has tools to withstand this, and notably, recently announced measures to provide counter cyclical support to the economy and lessen the impact of tariffs including cuts in tariffs on other countries' exports, income taxes and banks' reserve requirements. We do not believe that China will retaliate against U.S. trade measures by actively depreciating their currency, as it could be destabilizing to their own financial markets. That said, China is unlikely to resist a market-led CNY depreciation, though they will likely step in to limit the pace of depreciation and keep markets orderly.
- Outside of a few emerging markets that are highly dependent on exports to the U.S., such as Mexico and Vietnam, we do not believe that rising protectionism by itself is enough to derail the EM growth story, although it is likely to have a negative impact on sentiment. Above-trend growth in the U.S. (turbo-charged by fiscal stimulus) and continued solid growth in China provide an important foundation for emerging markets growth over the balance of the year.
- Recent European economic surprises data has turned positive. This could signal a return to synchronous global growth, although as mentioned, it is too early to make this call. If further data supports this conclusion, we believe the strength of the U.S. dollar will taper off as investors shift their focus from cyclical factors to the structural issues facing the U.S. economy. This, in turn, would alleviate pressure on EMFX and provide further support to the EM growth story.
- Idiosyncratic EM risks have declined as a number of elections have now occurred (Turkey, Mexico). Brazil remains as a source of uncertainty with elections in the fall and no clear leading candidate.

We have had a significant repricing in both the dollar-denominated and local currency markets. Emerging Markets dollar-denominated debt spreads are 110 basis points (bps) wider from the tights of late January, ending the quarter at approximately 370bps. 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 Emerging Markets and Developed Markets credit. Now, it appears to us that not only is EM 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. In fact, 16% of global fixed income still trades at negative interest rates. And, while there is no science to this, historically, the 400bps spread level on the EMBI has been a strong signal to add.

In addition, EM currencies are down 35% versus the dollar on average since the time of the taper tantrum and the local currency index is down close to 11% from its strongest point this year alone. We question the sustainability of the recent U.S. dollar strength. In our view, the large U.S. tax cuts are likely to exacerbate concerns about the return of a "twin deficits" problem in the U.S. (i.e. large fiscal deficit combined with a large current account deficit) which has historically been a negative for the dollar. In addition, technical positioning exacerbated the 2Q move higher in the U.S. dollar, as market participants entered the year very short the dollar versus other currencies. We would argue that a good amount of these positions have been cleared out, resulting in more balanced dollar positioning.

Yields between dollar-denominated debt and local currency debt have converged to approximately 6.5%, making the return story relatively balanced for the remainder of the year,

in our view. We believe that there are some pretty interesting opportunities in local currency debt, but this segment of the market will likely be more volatile in the near term amidst concerns about trade policy and the potential for continued dollar strength.

We believe that the main risks to our thesis, which do not represent our base case, are as follows: 1) a global trade war, with the U.S. becoming much more aggressive in its protectionist efforts versus China, Europe and others, and/or a serious consideration of leaving the World Trade Organization, 2) an unexpected pickup in U.S. inflation, which is not inconceivable amidst low unemployment, high oil prices and a large fiscal stimulus, and 3) a further increase in U.S. growth relative to the rest of the world (which appears a little more challenging given where the U.S. is in its business cycle, in addition to the fact that the stronger dollar has put pressure on corporate profitability). In these scenarios, we would envision a continued rise in the dollar and higher U.S. rates. This would put downward pressure on EM growth and upward pressure on inflation. Finally, this is the first time that the financial markets are going through the withdrawal of QE. As such, it is difficult to predict with precision the impact on risk markets. We view EM balance sheets as healthy – fiscal deficits have fallen over the last several years and, as mentioned, the bulk of funding is issued locally – but it is something we are watching closely.

We are seeing institutional investors add exposure via both hard and local currency debt to take advantage of this downtrade. We believe that the next few months will be volatile, but could present an interesting opportunity to add risk. But in any case, investors seeking to add exposure should consider scaling in, rather than in a single trade, as volatility is likely to continue for a while. In a market with close to 70 countries, security selection and country differentiation remain key in this environment. ■

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