Q2 2019

Outlook

Aberdeen Standard Investments

Emerging Market Debt

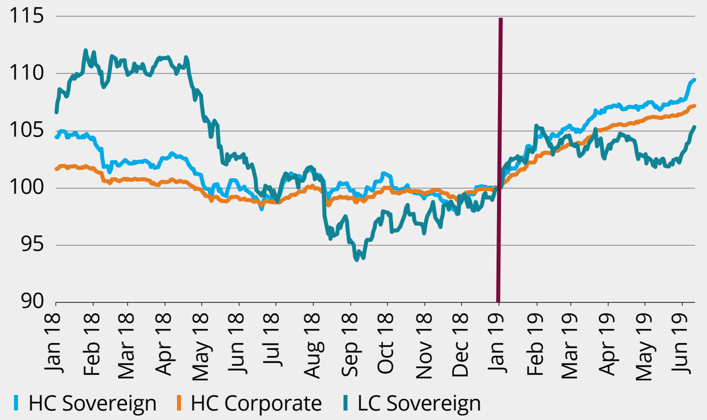
What are the drivers?

- The fundamentals of emerging markets (EM), in aggregate, are expected to remain strong over the medium-term. According to the IMF's recently-published World Economic Outlook, growth in the developing world is forecasted to accelerate from 4.35% y/y in 2019 to an average of 4.85% from 2020 until 2024. The developed world, on the other hand, will slow from 1.80% y/y in 2019 to an average of 1.63% over the same period. If this comes to pass, it will be a reversal of the years following the Global Financial Crisis, when the growth differential between developed markets (DM) and EM shrank to just 200bps in 2015. It may be the case that the IMF's numbers are already stale, as EM economies will have to face the headwind of global trade tensions for the remainder of the year.
- Inflation remains below many central banks' targets, allowing many of them to adopt an easing bias in order to and boost growth. This has also been helped by lower developed-market rates. The likes of Indonesia, India, Malaysia, the Philippines, Thailand, South Africa, Chile, Brazil, Mexico and Peru have scope to cut policy interest rates, while some countries, such as those in Eastern Europe, will likely delay hikes.
- Looser developed market monetary policy will help emerging market central banks. While the U.S. Federal Reserve (Fed) has room to cut, having somewhat normalized its interest-rate policy over the last four years, others in DM have far less scope to maneuver.
- Softer oil prices will weigh on oil exporters, but the disinflationary impact will be positive for local bond markets. Although it's tough to ignore the correlation between oil prices and emerging market debt (EMD) asset prices, 70% of countries in the EM universe will benefit from lower hydrocarbon prices, as they are net fuel importers. If oil prices were to collapse under U.S.$50 per barrel, the reaction should be less pronounced than in 2014/15. This is because many of the vulnerabilities (e.g., current account deficits, low FX reserves, rigid budgets) have been addressed. Additionally, most exposed countries have signed up to funded IMF programs, reducing their reliance on external capital markets.
- President Trump has found his key policy tools: trade tariffs and economic sanctions. The re-emergence of further trade tensions between the U.S. and China caught both our firm and the market by surprise, as both administrations had given positive signals in the first few months of the year. Because Trump surprised the market by threatening Mexico with tariffs just as the USMCA being signed, these risks should not be discounted as mere one-offs.
- Geopolitical risk remains high given ongoing tensions in the Middle East (U.S./Iran, Israel/Iran, U.S./Russia/Syria, Qatar/GCC, ISIS, Libya, etc.). There are also tensions with Venezuela, Cuba, North Korea and South China Sea, among others. Sanction risk remains high with Iran, Venezuela and North Korea. We expect further economic sanctions to be placed on Russia in the second half of the year as this is a bipartisan issue.
- There have been some important elections in EM in 2019, but most have passed without incident (Nigeria, South Africa, Ukraine, Nigeria etc.). Argentina and Turkey remain sources of idiosyncratic political risk with negative effects on their respective asset markets. October's presidential election in Argentina is too close to call at this point, while the re-run of the Istanbul municipal election (which the AK party lost in April) at the end of June provides another potential spark point.
- The key risks to the asset class remain: continued dollar strength, persistence of U.S. exceptionalism, a deeper China slowdown and a further escalation in trade wars.

What is changing?

Emerging market debt returns have been positive, but the magnitude of performance has been mixed, depending on whether investors have held hard-currency (sovereign or corporate) debt or local-currency debt in U.S. dollar terms. Hard-currency sovereign bonds have returned close to 10% year-to-date, with corporate debt at just over 7% and local currency the laggard at slightly more than 5%, helped by a surge in emerging market currencies in June. Valuations in hard-currency sovereign are arguably more "fair" rather than "cheap." The aggregate spread over U.S. Treasuries is about 350bps, which is close to the average over the past five years, although this does not take into account the changing composition of the index. The addition of investment-grade Gulf Cooperation council (GCC) countries, such as Kuwait, Abu Dhabi, Saudi Arabia and Qatar, has positively influenced EM spreads since their tapered inclusion into the benchmark index since January 2019.

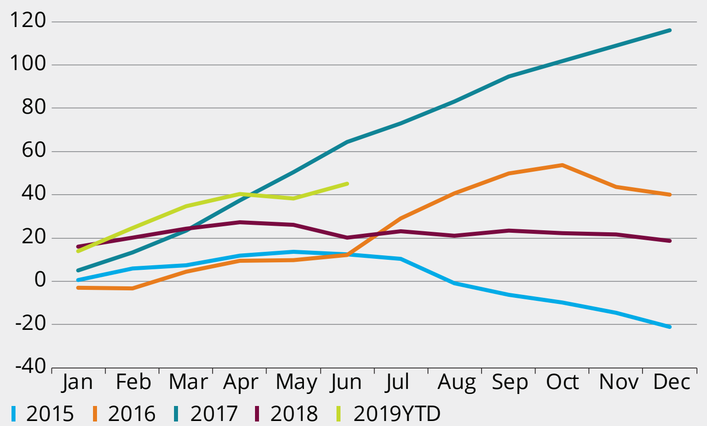
Disparate returns across Emerging market debt so far in 2019



Source: Aberdeen Standard Investments, JP Morgan, June 2019

Flows into the asset class have slowed since April, after nearly $35 billion was allocated to emerging market debt in the first quarter of the year. These flows were primarily directed into hard-currency debt ($28 billion), while local-currency funds ($7 billion) lagged behind. Retail flows ($28 billion) were the key driver, while institutional mandates ($10 billion) were also quite strong compared to a quarterly $7.2 billion in 2018. Interesting spread valuations at the beginning of the year in hard-currency bonds, as well as uncertainty on the direction of the U.S. dollar, may have been the key drivers of investor flows. JP Morgan's latest estimate of full-year flows is $30-40 billion, which suggests that investor activity will not provide a key support to markets in the second half of 2019.

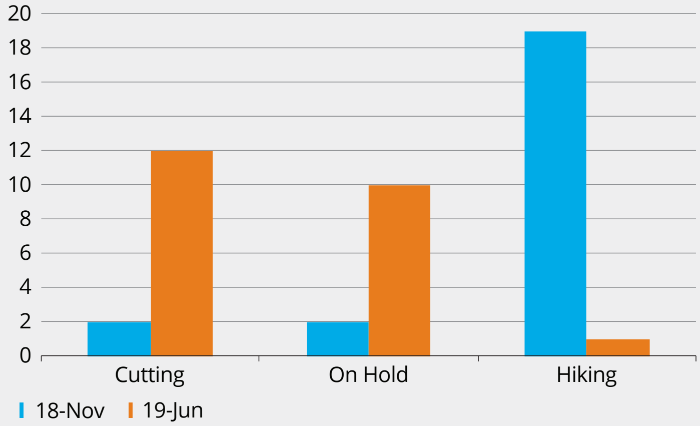
Emerging market debt flows moderating after strong Q1 2019



Source: Aberdeen Standard Investments, JP Morgan, June 2019

Monetary policy seems to be turning more accommodative as slower underlying growth in the U.S. has pushed the market to price in 50bps of Fed rate cuts, compared to 50bps of hikes just six month ago. Emerging market central banks will use the latest maneuvers in the developed world to begin a cutting cycle in order to boost growth. In Asia, cuts are priced in in Indonesia, Malaysia, Thailand and the Philippines. In CEEMEA, South Africa, Russia and Turkey can ease, and in Latin America, Mexico and Brazil are also pricing cuts, while Chile unexpectedly eased policy in early June.

EM Policy Rate Forecast turning more accommodative



Source: Aberdeen Standard Investments, JP Morgan, June 2019

In terms of issuance in hard-currency debt, the latest JP Morgan estimate of gross issuance has increased to $138 billion (from $110 billion at the beginning of the year), which is lower than any of the previous three years. The composition of sovereign issuance has changed markedly over the past few years as the emergence of high-grade Middle East and high-yield Sub-Saharan African countries have come to dominate syndicate desks. This has been at the expense of the traditional issuers, such as Brazil, Mexico, Russia and Indonesia.

Low forecast for gross issuance relative to recent history

	2016	2017	2018	2019 YTD	2019F
Gross Issuance	145.8	178.3	149.9	75.3	137.9
New Issuance	130.1	156	140.2	72.3	134.8
Taps	15.6	22.4	9.7	3	3
Estimated Cash flows	71.7	89.7	88	54.1	101.5
Amortizations	30.7	43.3	36.1	28.8	47.1
Coupons	41	46.5	52	25.3	54.4
Buybacks	9.8	8.1	9.6	0.9	10
Net issuance	105.3	126.9	104.2	45.7	80.8
Net financing	64.3	80.5	52.3	20.3	26.3

Source: Aberdeen Standard Investments, JP Morgan, June 2019
Projections are offered as opinion and are not reflective of potential performance. Projections are not guaranteed and actual events or results may differ materially.

For China, the trade war with the U.S. has domestically become more of a nationalistic issue. Previously China had suppressed any news that tried to incite anti-U.S. sentiment. Now it seems that these efforts have been relaxed and some media have pivoted to a harder line against U.S. "aggression." China's complaints in recent negotiations have been focused on a few points that Chinese leadership has deemed unacceptable. These include:

- The U.S. refusing to remove all tariffs raised in the agreement;
- The U.S. wanting China to commit to a pre-agreed amount of imports per year (which would be monitored by the U.S. and not a third party);
- The U.S. wanting China to commit to explicit IP (Intellectual property) and other legal changes in the trade agreement while China prefers a non-committal agreement based on a higher level framework with a third party monitoring.

While it is unclear where Trump's true motivations lie in regard to this issue, the view from our Shanghai colleagues is that there is determination from China to fight a longer trade war. There is a chance that domestic reforms will be delayed as a result. As ASIRI notes in their latest quarterly outlook, policy measures to boost the Chinese economy were beginning to show results, and it will be interesting to see how much of a slowdown in growth the authorities will tolerate (especially given social pressures). Recent economic data has been weak out of China, including trade data in which imports contracted in May, despite exports rebounding on likely front-loading following the breakdown of trade negotiations. The official manufacturing PMI fell to 49.4 in May from 50.1 in April. This was driven by weaker demand indicators and also weaker employment data. Other activity indicators, such as industrial production and retail sales growth have also undershot market expectations. There is a risk that further Chinese stimulus fails to boost the economy due to the external environment. It is unclear what this means for the market at this time, although we did see an immediate reaction from the Chinese yuan. CNY depreciated against the USD from 6.73 at the end of April to 6.90 in mid-May, where it has range-traded ever since.

In 2018, Argentina and Turkey were the "bad boys" of emerging markets, as poor policymaking coupled with a weak market meant that asset prices for these countries fell significantly during the year. Unfortunately, the market views both credits as needing a significant risk premium mostly due to election-related events.

In Turkey, the re-run of the Istanbul mayoral election at the end of June has ensured that unsustainable heterodox policies and price controls will remain in place for longer than previously expected. The economic team's drive to ensure growth via state-directed lending is already causing imbalances in the economy, while geopolitical considerations (Russian S400 missile system, Syria, Venezuela, etc.) add more noise and a strong sanction threat. A return to more orthodox policies focused on structural, not cyclical, adjustment could lead to valuations getting closer to BB rather than the current B credit rating peer group, although we do not think this is likely.

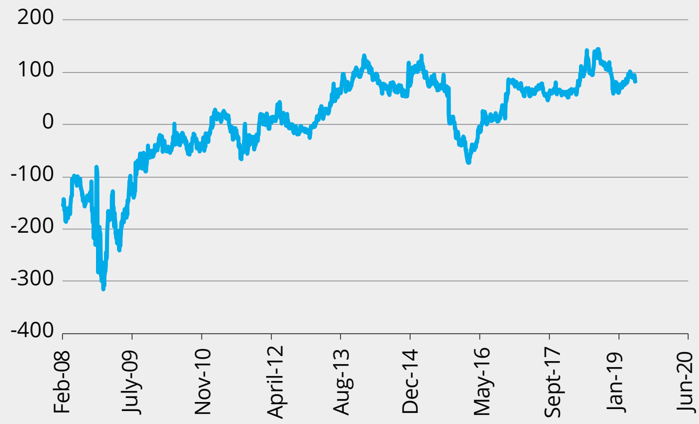
In Argentina, a lack of clarity on who might win October's presidential election means that markets are close to pricing in a worst-case scenario, which might see former President Cristina Fernandez de Kirchner return to the Casa Rosada (although in the less powerful position of Vice President). Already there are signs that incumbent President Macri is doing better in the polls. Markets will trade any political news while focusing closely on the stability of the peso and inflation to see whether the economy will improve in time for the election.

In Brazil, pension reform is likely to be passed by year end despite the problems that new President Bolsonaro is facing in Congress. Markets are beginning to price in cuts this year and in 2020 as pension reform removes a key risk from the Brazilian fiscal accounts, while growth expectations have steadily declined as well. In Mexico, problems at Pemex, the state-owned oil company, have begun to affect the creditworthiness of the sovereign. Fitch downgraded both entities to BBB and BB+ respectively, bringing Pemex its first sub-investment grade rating – all eyes now turn to Moody's where a negative outlook puts the risk of a downgrade firmly in the period up to the end of the year, which would prompt forced selling from investment grade accounts. South Africa has come through its own elections relatively unscathed as the ANC's majority was within the market expectations. Unfortunately, a growth problem leading to fiscal and debt issues, coupled with the likely need for a government bailout of Eskom, the state-owned utilities company, means that pressure on the South African rand is expected to continue as investors rotate risk to other more favored names. These might include frontier markets Egypt, Ukraine and Ecuador, where high yields paired with a policy anchor in the IMF provide some comfort to the market.

What is priced-in?

On a ten-year view, hard-currency sovereign debt remains somewhat attractive, despite the fall in relative spreads since September 2018. As explained in our Q1 2019 EMD Quarterly Outlook, one of the indicators that we monitor is the spread of the emerging market hard-currency sovereign debt against U.S. credit, which we adjust by credit ratings for a better match. At a current spread of 80bps, this is also the average for 2019, but far above the 10-year average of 20bps. It is worth remembering that the EM spread still reflects the inclusion of Venezuela/PDVSA bonds. While these bonds only comprise slightly more than 1% of the index, because of their putative yield, they push the index spread up by 42 bps. JP Morgan is contemplating the removal of Venezuela/PDVSA from the benchmark index, which would, have an immediate effect on relative valuations.

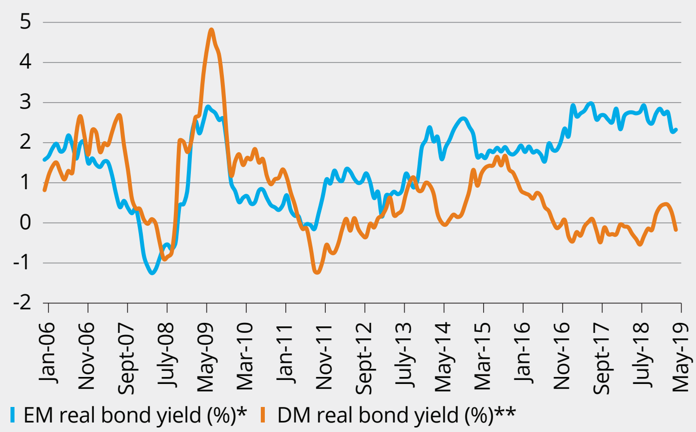
EM Sovereign hard currency spreads still attractive relative to U.S. credit



Source: Aberdeen Standard Investments, JP Morgan, June 2019

While hard-currency valuations are fair, local currency markets are far more attractive, as emerging market real yields remain elevated compared to those in the developed world. While real yields have dropped in the last month as markets begin to increasingly price in interest rate cuts, the difference between emerging and developed markets remains wide as developed real yields have once more dropped into negative territory. The return of the "lower-for-longer" yield environment benefitted EM in the years following the GFC and there is a chance that this will reassert itself once more in the current environment.

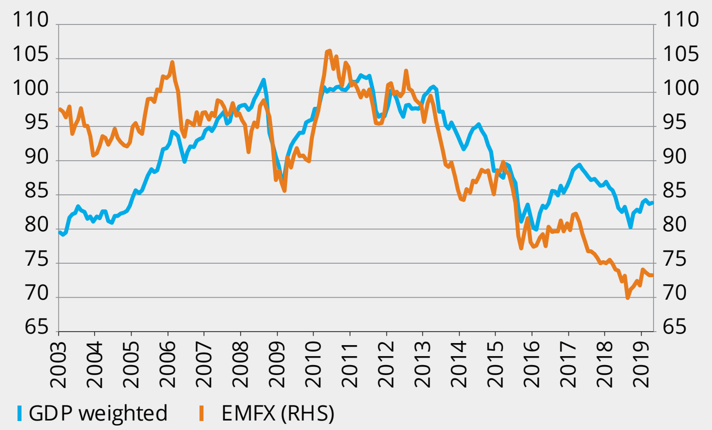
EM real yields extremely elevated compared to DM



Source: HSBC, IMF, as of March 2019.* PPP weighted average of Brazil, China, India, Indonesia, Mexico, Poland, Russia, S. Africa and Turkey. ** PPP weighted average of Germany, Japan, UK and the U.S.. For illustrative purposes only

Unfortunately, the rates markets are only one factor when investing in local-currency bonds. It has been the strength of the U.S. dollar which has been the key driver of (under)performance over the past few years. The strength of the U.S. dollar, come rain or shine, has been a surprise to us and to the market especially, since longer-term valuation measures suggest that EM currencies are undervalued in aggregate. The problem is that, depending on the extent of the Fed cuts, the U.S. dollar is the highest yielder within the developed world and thus will remain an attractive carry play. According to Deutsche Bank, the Fed would have to cut by 125-150bps in order for the U.S. dollar to lose its place at the top of the carry rankings. Whether emerging market currencies can still do well in this environment remains to be seen, but the uncertainty in regard to the U.S. dollar may mean that they remain undervalued in the short-term.

EM Currencies are undervalued in historic terms



Source: BIS (Bank for International Settlements), JPMorgan, April 2019

In corporate debt, strong fundamentals are not necessarily matched by tight valuations. Corporate bonds tend to be the most defensive segment of the asset class, helped by highcredit-quality and lower-duration characteristics. Relative to their developed market counterparts, data from BAML suggests that emerging market companies have tended to be consistently less leveraged than U.S. companies. This has been reflected in default rates, as despite the perception of higher risk in emerging markets, permanent capital impairment has been twice less likely to occur in EMD Corporates than in U.S. high yield. At every credit rating, investors receive more yield per unit of company leverage compared to corporates in the U.S., despite EM companies often having better fundamentals.

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Important information

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