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Global Perspective

Have emerging markets outgrown tantrums?

Asset Management

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Salman Ahmed
Chief Investment Strategist

Charles St-Arnaud
Senior Investment Strategist

We continue to think that emerging market assets – especially equities and local currency debt – offer attractive opportunities to investors who are prepared to ride out short-term volatility. We believe emerging market investments are never likely to offer a smooth return profile; as markets react to - and then bounce back from – systemic and idiosyncratic shocks the ride can be bumpy over the short term. Yet we also believe emerging markets may have reached a milestone, moving past a difficult stage in their development.

Investors may remember the “taper tantrum” of 2013. Market participants started to anticipate a reduction in the pace of the US Federal Reserve’s bond purchase programme and fixed income investors became worried over their exposure to higher yields. As money flowed out of the US bond market in anticipation of higher rates, emerging market debt flows followed suit, as the asset class has tended to track US Treasuries. Today, with signals from North American and European central banks that monetary policy is likely to tighten, should emerging market debt investors be bracing themselves for a similar hurricane?

We would argue the current situation is different from 2013, when emerging market economies were much more closely linked to the health of the US economy and the underlying fundamentals of developing countries, and valuations were higher.

In early 2016, we expressed our conviction that the emerging world had passed the trough in its economic growth and financial fragility, and that market valuations were attractive. We stand by that conviction, but we also acknowledge a new and evolving set of risks that underline the importance of a low-turnover and quality-driven approach to investing in the asset class.

Key central banks turn hawkish

Four years ago, hawkish noises from the Federal Reserve sent US Treasury yields up sharply, rising by almost 100 basis points in the space of six weeks, in the case of the 10-year note.[1] This reduced the attractiveness of emerging market debt and also shone a light on the challenges that some emerging markets could face when trying to finance their current account deficits in a strong-dollar and higher US yields environment. Since then, however, the situation has changed.

[1] Source: Bloomberg. Past performance is not a guarantee of future results.

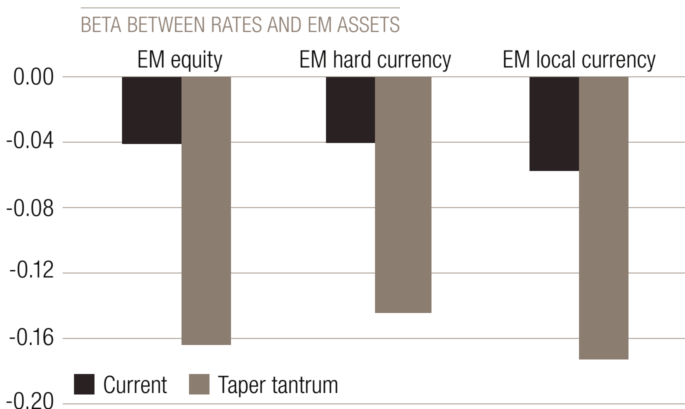
Over recent weeks in developed markets, one central bank after another has signalled that it is planning to tighten monetary policy, leading to volatility in long-term yields and lower bond prices:

- The US Federal Reserve is set on continuing to remove its stimulus measures, referring to a “new central bank paradigm.” This suggests that the Fed could be becoming less concerned by the absence of inflation, which would usually mean maintaining a loose policy stance, to focus instead on worries around asset valuations.
- The European Central Bank says it no longer perceives a risk of deflation and this paves the way for some tapering in the pace of its asset purchase programme later this year. Despite this, monetary policy in the Eurozone is set to remain very accommodative, in our view.
- The Bank of England is signalling that its policy may need to tighten in the coming months, although last month’s drop in inflation may slow this process.
- The Bank of Canada has already hiked rates as economic data has improved, amid concerns about financial stability.

However, emerging market assets have been more lightly impacted by these developments than the past relationship would have suggested, and have so far avoided important sell-offs (see Figure 1).

FIG. 1 EMERGING MARKET ASSETS LESS AFFECTED BY HIGHER YIELDS

BETA BETWEEN RATES AND EM ASSETS

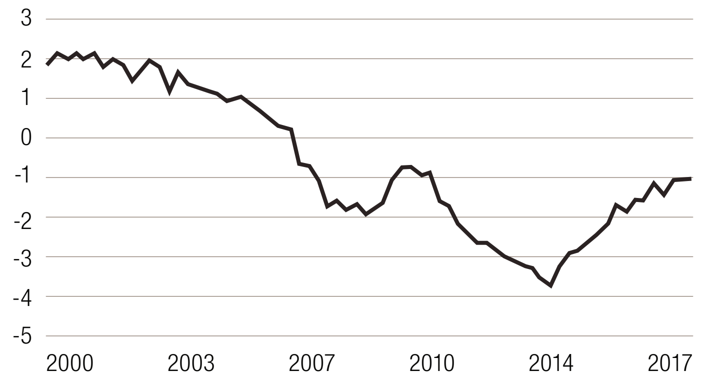


Note: the chart shows the 13-week rolling beta between an average of the change in yields for 10-year US Treasury note and Bunds, and changes in emerging market assets. Equities are a represented by the EM MSCI, EM hard currencies by the JP Morgan EMBI and local currency by JPM GBI index.
Source: Bloomberg and Lombard Odier IM. For illustrative purposes only.

Improving fundamentals

There are important reasons behind this resilience. Since 2013, current account deficits in some key emerging market economies have consistently improved, partly thanks to the correction in foreign exchange rates that occurred following the taper tantrum, and partly due to the improvement in the trade balance as a number of emerging market countries underwent significant economic change. Figure 2 shows the progress achieved in the key countries of Russia, Brazil, India, Turkey and South Africa. Moreover, structural improvements have made these countries less reliant on global growth and the commodity cycle, and increased the relative importance of domestic demand trends in these economies.

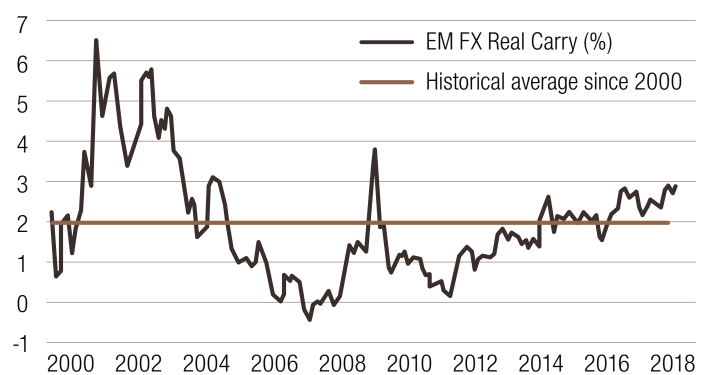
FIG. 2 AVERAGE CURRENT ACCOUNT BALANCE AS % OF GDP FOR RUSSIA, BRAZIL, INDIA, TURKEY AND SOUTH AFRICA



Note: Bloomberg, Lombard Odier IM. For illustrative purposes only.

In the fixed income space, emerging markets also now enjoy a bigger cushion in the real yield spread. Emerging market real yields have increased since the taper tantrum while US real yields have barely changed. Emerging market real yields are approximately 200bps higher than in 2013 (see Figure 3), this makes them more attractive and offers some compensation for any increased volatility and shocks, in our view.

FIG. 3 EM REAL RATES STILL AT THE TOP END OF THE RANGE



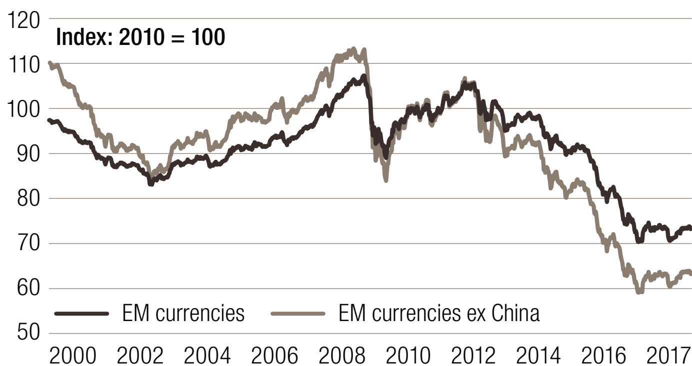
For illustrative purposes only. Yields are subject to change and can vary over time.
Source: GS Research, Haver, Bloomberg. FX Real Carry derived from 12M forwards minus 1yr consensus inflation expectations.

Valuations remain attractive

Emerging market asset valuations have also become more attractive, thanks to the appreciation in the US dollar since 2013. We believe emerging market currencies likely have some way to appreciate before they hit fair value (Figure 4) and a softer environment has certainly helped. In addition, we expect improving fundamentals in emerging markets to support economic growth and create resilience to external shocks in the medium term. The resulting improvement in the current account balance means these countries are less dependent on foreign financing, reducing the risk of collapse of the local currency, in our view.

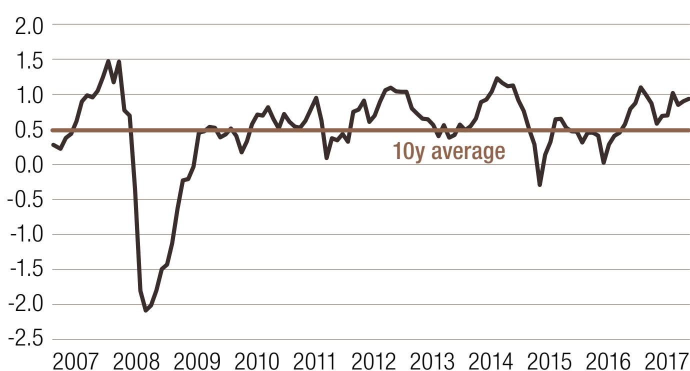
We see as much as a 15% to 20% upside in some local currencies before fair value is reached, in part supporting our current view that local currency bonds will outperform hard currency debt, where spreads are looking very tight. Moreover, with the spread between yields available on local currency bonds and bonds denominated in US Dollars approaching the top of their decade-long range, we believe this provides further support for our preference for investing in local currency emerging market bonds against a backdrop of under-valued currencies (Figure 5).

FIG. 4 EM CURRENCIES VERSUS USD



Note: GDP-weighted average of 25 emerging countries' exchange rate versus USD.
Source: Bloomberg, Lombard Odier IM. For illustrative purposes only. Past performance is not a guarantee of future results.

FIG. 5 EMERGING LOCAL CURRENCY SPREAD OVER HARD CURRENCY

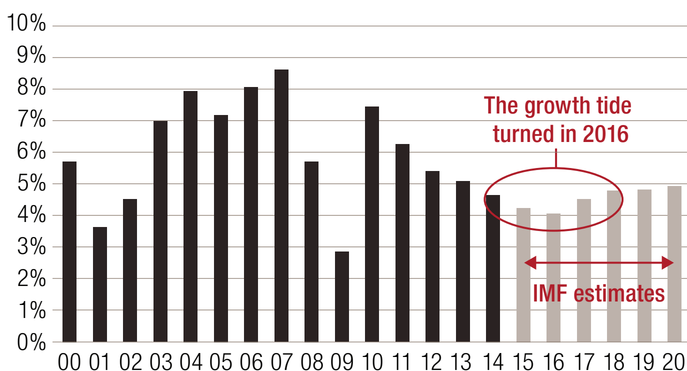


Source: Bloomberg. Past performance is not a guarantee of future results.

Growth is recovering, inflation remains benign

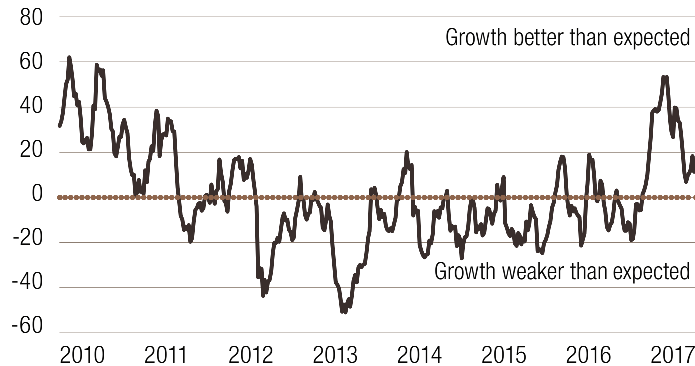
There are other signs of improved fundamentals for emerging market economies. Economic growth appears to have bottomed out in 2016 (see Figure 6), and the Citi Economic Surprise Index for emerging markets shows expectations being beaten consistently in recent months (see Figure 7). The International Monetary Fund recently raised its GDP growth forecasts for the emerging world for the first time in years and purchasing managers' indices (PMI) suggest growing confidence among emerging market businesses.

FIG. 6 WE REMAIN IN THE EARLY STAGES OF THE EMERGING-MARKETS GROWTH RECOVERY – EMERGING MARKET AND DEVELOPING ECONOMIES GDP GROWTH (% YOY)



Source: IMF. World Economic Outlook.

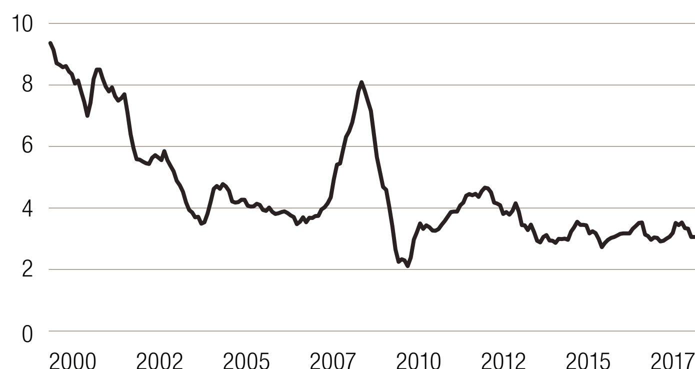
FIG. 7 EM GROWTH SURPRISE INDEX



Source: Citi. For illustrative purposes only.

In addition, despite the shock of the foreign exchange devaluations of 2013, inflation has remained low in most countries (see Figure 8), partly as a result of weaker oil prices which have allowed monetary conditions to remain accommodative. Brazil in particular has seen inflation fall below the central bank's target, allowing it to cut rates from 14.5% to 10.25% since October last year.

FIG. 8 AVERAGE EM INFLATION RATE (%)



Note: Average inflation rate of Brazil, Chile, China, Taiwan, Colombia, Czech Republik, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Russia, Singapore, South Africa, Thailand and Turkey.
Source: Bloomberg, Lombard Odier IM. For illustrative purposes only.

New risks

Although we believe the broad outlook is positive, there are new and important risks in emerging market debt that investors must take into consideration. We believe that the biggest risk is from the largest player in the market: China. Credit conditions there are tightening with President Xi Jinping explicitly prioritising financial stability after a period of looser policy, especially after the Communist Party Congress later this Autumn.

China has seen debt grow exponentially across key sectors of the economy, especially since 2008-9. This heavy debt burden makes it vulnerable to financial and economic shocks, which would carry serious negative consequences for the rest of the world, given China's important role in the global economy.

We are optimistic, however, that a balance of payments crisis can be averted as the debt overhang unwinds (see our paper "China's misunderstood debt challenges"). That said, there are signs of a gentle tightening in credit conditions already underway.

Important information: Please see important information at the end of this document.

A number of factors contribute to this optimism. Unlike most global economies, China runs a relatively closed capital account with powerful controls, mitigating the risks of broad-based domestic capital flight. Already this year the People's Bank of China has shown that it is not averse to using these controls, as it temporarily halted some Western banks from trading.

The inclusion of Chinese A-shares – those listed in Shanghai as opposed to Hong Kong or the US – in major global benchmark indices and the opening of Bond Connect is facilitating capital inflows into a country where foreign ownership remains very low (e.g. around 5% of China debt is held by foreigners).

In addition to China, the continued shift towards a hawkish stance by key central banks is another risk factor for emerging markets. Here, Yellen's shift in focus towards the weakness in inflation has been welcomed by the markets, and in the case of the European Central Bank, we think the perceived hawkishness by Mr. Draghi was misinterpreted by the market. That said, faster-than-expected monetary tightening remains an important risk factor to watch as balance sheet normalisation by the Fed and some gentle tapering by the ECB comes on the table later in the year.

Lastly, concerns over trade protectionism, which was a key source of concern for investors at the start of the year post Trump's victory, could return as the North Korea situation creates tension between the two economic powers – this is another risk factor we are watching carefully.

The importance of low turnover and quality in a fractured liquidity environment

When it comes to fixed income investing, recent developments echo our broader view of emerging market debt, which is that it is important to focus on a low-turnover and quality-driven approach to portfolio construction, rather than following benchmark indices. As is widely acknowledged, an index-based strategy will naturally concentrate the portfolio in the most indebted countries, rather than the strongest. The flaws of this technique were highlighted in mid-May, when the Brazilian real plunged by 9% and Brazilian stocks lost a tenth of their value after President Michel Temer was implicated in the ongoing corruption implications plaguing Brazil's political elite.[2]

The sell-off in Brazil was exaggerated by the problem of fractured liquidity – as the pressure on the primary dealer model, which is reflected in low inventories, led to a near shut-down of the cash bond market. Regular readers will know we have been warning of fractured liquidity in fixed income markets for some time (see A new paradigm in fixed income), and this reinforces the case for investing with a focus on fundamentals, in our view. In a high-quality, low-turnover portfolio one is less likely to be holding poor quality assets that may prove impossible to sell, and more likely to maintain high quality assets through bouts of severe market volatility, which can be exacerbated by damaged liquidity conditions.

Proceed with prudence

These are important caveats as we make the case for emerging market local currency debt as a long-term value opportunity. Fundamentals have improved quite broadly and valuations have adjusted meaningfully since 2013. Note the calm with which these markets navigated the Fed hikes in 2015 and 2016 and volatility in oil prices (where were driven by supply side issues). We are confident they have grown out of the tantrum phase. Not all countries have progressed at the same rate on all measures, however. Not all are at the same stage in their economic cycles and not all have solved the governance issues of the past. We believe the attractive positioning of the asset class is very real – but given fractured liquidity and heterogeneity in emerging markets, adopting a low turnover, quality-driven approach remains key to us.

[2] Source: Bloomberg. Past performance is not a guarantee of future results.

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