Invesco Fixed Income Investment Insights

Q&A: Discussing emerging markets opportunities and challenges today

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"Global growth, firming commodity prices and moderate inflation provide a still-favourable backdrop for emerging markets."

- Rashique Rahman

Given the need for diversification and yield, client interest in emerging markets remains high. With volatility expected to continue as markets react to European elections, US trade policies, Chinese growth and the path of Fed rate hikes, investors are wondering whether now is a good time to invest in emerging markets. We recently sat down with Rashique Rahman and Mike Hyman of the Invesco Emerging Markets team to get their views on global market conditions and thoughts about investing in emerging markets today.

Q: Michael and Rashique, what are the top three issues likely to affect emerging market assets in 2017?

Michael: Global growth will be one of the key things to watch in 2017. Right now, most expectations are being revised upward, predominantly related to the US and China. These revisions may have gone too far, but overall we agree that the world is on firmer footing after years of monetary life support. Healthier growth and inflation trends would likely be a supportive backdrop for emerging markets.

Rashique: The second key issue to watch is the path of US monetary policy. Upward growth revisions suggest more Fed hikes rather than fewer, which could be a headwind for emerging markets if they lead to sharp moves in US Treasury yields or sustained US dollar strength. That said, should growth come in below market expectations, as our team suspects, 2017 could be another year where markets are overly ambitious when it comes to pricing in Fed hikes.

Michael: Lastly, the new US administration's proposed changes to both fiscal and trade policy will likely be important drivers for emerging markets assets. Fiscal expansion plans could impact expectations for monetary policy, and in turn influence US Treasury yields or the US dollar. The potential implementation of selective tariffs or a 'border tax' may adversely impact exports for a number of countries, particularly Mexico and goods exporters in Asia.

Q: You mentioned the possibility of rising rates, and most investors probably regard this as bad news. Are they right?

Rashique: Rising US interest rates are generally a headwind for fixed income, but they adversely impact asset classes to varying degrees. There are three factors to consider when investing in the emerging markets during periods of rising rates. First, rising interest rates in the context of stronger global growth and supportive financial conditions are favourable for emerging markets bonds, as spread compression can compensate for rising US rates. Second, some portions of emerging markets debt can exhibit less sensitivity to US interest rates given the large credit component relative to the interest rate component of its yield. Lastly, EM consists of both US dollar and non-dollar denominated assets. The net exposure of emerging markets countries to US dollar funding has declined as they have built up healthy cushions of foreign exchange reserves. This can provide a buffer when navigating through a period of potentially higher US interest rates, particularly if funding conditions deteriorate. The non-dollar denominated debt tends to respond to domestic interest rate trends and currency movements.

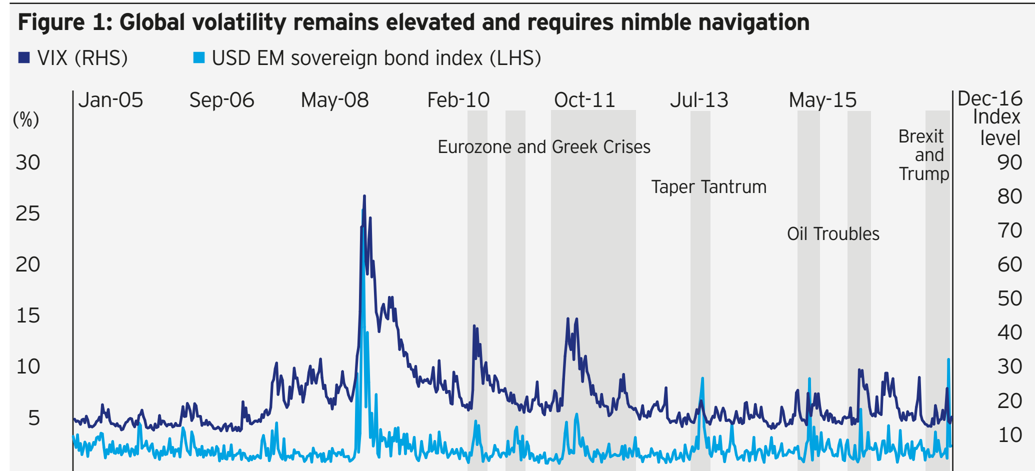
Michael: I agree. While rising interest rates may be a challenge for fixed income assets as a whole, many other factors will likely influence emerging markets debt performance. With such a diverse asset class, we believe emerging markets offer enough different levers to help navigate the increasingly complex global financial landscape.

Q: Rising rates are one possible headwind, uncertainty is another. What should investors watch out for here?

Rashique: There are a number of uncertainties, which we expect to lead to bouts of volatility (see figure 1). I am thinking of the upcoming European elections, the direction of the US dollar and US rates, and concerns over economic stability in China. We will also be closely monitoring diplomatic relations between the new US administration and the rest of the world.

Michael: We are also attuned to valuations, which can fluctuate dramatically and deviate from fundamentals during periods of volatility. Generally, we seek to reduce market exposure when valuations get rich, according to our models, and add market exposure when valuations become cheap. In other words, market disruptions may open up opportunities that were less compelling beforehand.

Figure 1: Global volatility remains elevated and requires nimble navigation



Source: Bloomberg L.P. Weekly data from Jan. 1, 2005 through Dec. 2, 2016. USD EM sovereign bond index represents the weekly volatility of the JPMorgan Emerging Markets Bond Index Global Diversified quoted on an annual basis, and VIX represents the value of the VIX Index over the same period of time.

Q: And what about the risk of a stronger US dollar?

Rashique: Generally, emerging markets countries have become more insulated from US dollar moves, as many countries have accumulated a larger stock of liquid US dollar assets against what has been a rising stock of external liabilities. That said, in an environment of a sharply stronger US dollar, we tend to reduce overall market exposure as a stronger dollar can be associated with downward pressure on emerging market currencies and upward pressure on credit spreads.

Michael: When we expect US dollar strength, we tend to buy dollars against higher-beta EM currencies and favour export-oriented corporate issuers. Exporters tend to fare better in a strong US dollar environment since they earn US dollars but pay wages in domestic currency. However, it also depends on the outlook for global growth and, more specifically commodities. We see a stronger dollar coupled with stronger commodities, which is a more benign environment for the emerging markets and one that favours commodity-producing countries, currencies and corporate credit.

Q: Tell us more about your views on oil. What do you expect for 2017, and what does this mean for emerging market bonds?

Michael: We retain a favourable view toward oil prices and commodity-oriented currencies and corporates. We believe the recent OPEC agreement to curtail supply will continue to have both a psychological and actual effect on oil prices. And we see the marginal increase in supply from much smaller producers (Nigeria and Libya, for example) as being an insignificant offset to OPEC's cutbacks. Visible reductions in output, amid stronger demand due to improving global growth, should underpin prices. Stabilization in oil prices, if sustained, should in turn support emerging markets (see figure 2).

Rashique: It is important to note that oil tends to be one of the most important factors driving emerging markets currency and credit returns. For one, many emerging markets countries and companies are oil exporters or producers, and second, investors often view oil as a proxy for global growth. When oil prices rise, exporters tend to outperform importers, but historically higher oil prices have been a positive influence for broad EM assets.

Figure 2: Oil above USD50/barrel generally supportive for EM assets

Source: Bloomberg L.P. Data from Jan. 3, 2014 through Jan. 20, 2017. Oil price is represented by Brent.

Q: What are the main political risks for EM in 2017?

Rashique: There are few scheduled elections in EM countries this year, with many more in play for 2018. For 2017, political events in developed markets are much more likely to impact EM. Most importantly, diplomatic relations between the US and rest of the world will likely dominate headlines. We are most focused on how markets will calibrate political risk related to President Trump's policies and rhetoric toward China and to a slightly lesser extent Mexico. China is holding the 19th National Party Congress later this year, which is likely to see changes to the top leadership of the Communist Party and signal the direction of policy and reform going forward. Moreover, elections in Europe – including in the Netherlands, France and Germany – will be a key focus throughout the year given concerns over a rise in populism and the fate of the euro and eurozone membership. Should the future of the euro come into question, spread compression in Eastern European names – the so-called euro convergence trade – could begin to unwind.

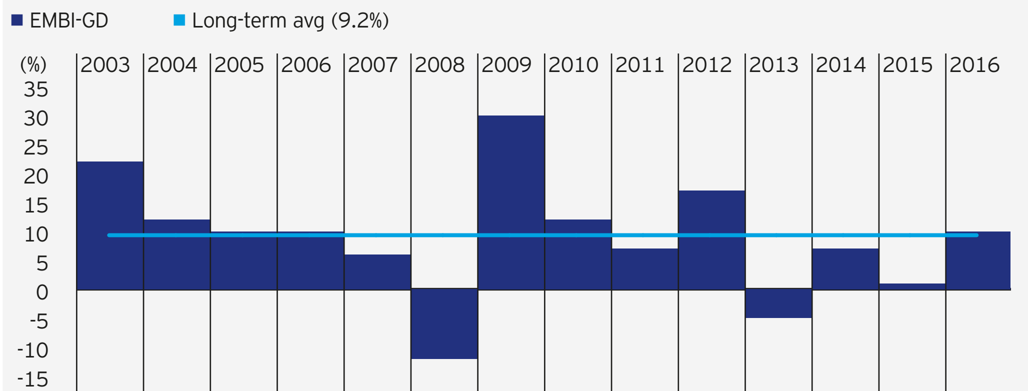
In EM, the mid-term legislative elections in Argentina, Presidential elections in Chile and general elections in Ecuador all bear watching. In Argentina, the elections can be seen as a referendum on President Macri's policies and whether there is scope to rein in recent fiscal expansion – which will likely be a barometer of the country's bond issuance needs and creditworthiness. Chile will swear in a new President after its November election, as the incumbent President Bachelet cannot seek immediate re-election. Similarly, in Ecuador, the February election casts uncertainty over who will govern the country for the next five years.

We will also be closely monitoring political developments in Brazil, South Africa and Turkey. Though the so-called 'Lava Jato' investigation and related plea-bargaining in Brazil is winding down, other corruption investigations are continuing. We are monitoring events which may compromise President Temer's popularity and his administration's ability to push through much needed fiscal and pension reforms. In South Africa, the African National Congress (ANC) Conference in December 2017 may provide clarity on the party's future leadership. President Zuma has confirmed that he will not run, but there is considerable uncertainty regarding his ability to position one of his allies for the post. ANC leadership is important as the president of the ANC is widely considered to be the front-runner for the presidential elections in 2019. In Turkey, the country is gearing up for a constitutional reform and referendum to transform itself from a parliamentary to presidential republic.

Q: Where do you see the biggest opportunity and risk right now in EM?
Michael: Stability in global growth and broadly more favourable supply/demand dynamics have supported commodity prices and we see this persisting in the first half of 2017. Emerging markets' relatively high correlation with equities, with growth being the common factor, suggests that EM assets can perform well under these circumstances. We therefore currently favour exposure to commodity-producing countries, currencies and credits. This stability in commodities coupled with a stronger US dollar is also likely to lead to higher inflation in many EM countries later this year. Commodity producers themselves are an exception, such as Brazil, Chile, Colombia, Russia and South Africa, where in most cases a disinflation dynamic has taken hold – arguing for being overexposed to their local bonds. At the same time, we expect capital outflows from China to continue, which is likely to lead to further depreciation of the renminbi. This depreciation pressure is likely to lead to weakness in many other Asian currencies particularly versus the US dollar. Given lingering headwinds for China, we believe a less certain outlook for Chinese growth, or global growth more broadly, would pose a downside risk for EM in the year ahead. Though we don't expect this, our research suggests that an unanticipated and aggressive Fed rate-hiking cycle may negatively impact emerging markets if capital flows suddenly reverse.

Q: Despite the sour ending to 2016, EM posted strong returns. What might investors expect in 2017?
Rashique: EM is unlikely to repeat its strong 2016 performance, as US interest rates are biased to rise over the course of 2017. We expect a year of mid-single digit returns for EM credit, supported predominantly by positive carry. Sovereign credit is likely to outperform corporate credit, as we believe valuations are much more attractive for sovereigns as we begin 2017. Relatively stable, if subdued, global growth, firming commodity prices and moderate inflation provides a still-favourable backdrop for EM credit, in our view. The prospect for steady US dollar gains during 2017 may put downward pressure on EM local assets, via EM currency depreciation and the pass-through to higher inflation. That said, fundamental EM currency valuations have improved and in most cases external deficits have moderated from just a few years ago. On balance, as with EM credit, we forecast mid-single digit returns for EM local currency investments in 2017. Importantly, the ongoing search for yield and the under-allocation to EM that prevails on the part of institutional investors suggest that the momentum of flows into EM assets will likely continue, and support the asset class.

Figure 3: History of strong returns; optimism amid caution for 2017



Source: Bloomberg L.P. Data from Dec. 31, 2002 through Dec. 31, 2016. Past performance is no guarantee of future results. The EMBI-GD is the JPMorgan Emerging Markets Bond Global Diversified Index.

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