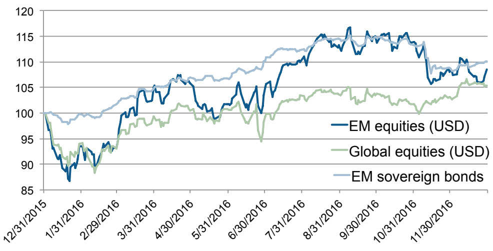
EMERGING MARKETS DEBT: ISSUER SELECTION IS KEY

The focus of the capital markets is shifting back to investments in the emerging markets debt space. Greater political and economic stability, the reduction of current account deficits and the recovery of commodity prices are just some of the arguments in favour of emerging markets (EMs). Future US policy is creating uncertainties, but EM fixed income investments continue to offer plenty of potential. For example, there are a number of promising turnaround stories at country and company level. However, issuer selection remains key – as does an in-depth analysis of the extremely diverse investment universe.

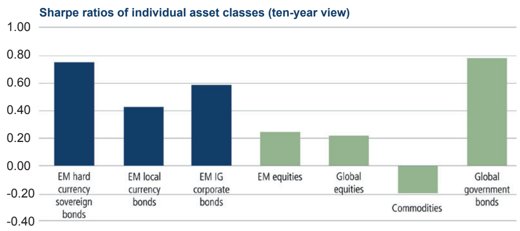
Figure 1: Tremendous performance of emerging market debt in 2016

Indexed performance of selected asset classes*



*Source: Datastream. *MSCI EM, MSCI World, JPM EMBIG Diversified Composite, as at 31 December 2016.*

Figure 2: EM debt investments offer an attractive risk adjusted performance



Source: Merrill Lynch, JP Morgan, Bloomberg, as at 20 January 2017.

Structural improvements

The EMs have grown at a tremendous pace over the past 15 years to become an important driver of the global economy. During this period, their share of global economic output climbed from 20 per cent to more than 50 per cent – and is set to continue rising. This growth has largely been sustainable. A look at the external debt of the EMs, for example, reveals a far healthier structure than in the industrialised countries. Since 2002 the EMs have, on average, reduced their dependency on foreign capital from 80 per cent of their gross domestic product to today's level of 43 per cent. By way of comparison, average government debt in the developed world stands at around 120 per cent of economic output.

Bonds that have been issued in US dollars or euros continue to play a relatively small part in the funding mix in the EM world. To minimise exchange-rate risk, EM countries mainly borrow in their local currencies. And this is exactly the reason why EM paper is becoming increasingly popular with local investors too. Even in the more international corporate sector, hard-currency bonds play only a minor role – which is a real advantage for the companies when their local currency does fluctuate against hard currencies.

Tremendous performance of EM debt in 2016

These fundamental factors are among the reasons why EM investments have recently become much more attractive again for investors. Although funds investing in EMs debt saw outflows both at the beginning of 2016 and at the end of the year, this asset class registered inflows totalling US$ 45 billion for 2016 as a whole. This increased interest from investors partly explained why EM debt investments were among the most successful asset classes in 2016: at index level, government bonds from the emerging economies generated a return of 10.2 per cent; equity prices – expressed in US dollars – also rose, by 8.6 per cent. By contrast, the return on securities from industrialised countries was only 5.3 per cent.

Yet more factors point towards a positive trend in the EMs. Many market observers agree that a number of the EMs have done their economic policy homework in recent years and have greatly reduced their vulnerability to crises. Current account deficits have been brought down, thereby reducing the dependency on other countries. Urgently needed reforms to economic policy have also been initiated and implemented in many places.

Commodity rally providing support

Another factor was the sharp increase in commodity prices in 2016. Many EMs, such as in Eastern Europe, the Middle East and Latin America, are heavily dependent on the mining, processing and export of natural resources. Commodity prices had been falling – in some cases dramatically – in the years leading up to 2016, resulting in significant budget deficits. The trend reversed last year, however, and there were sharp increases in the price of energy commodities, in particular, but also industrial metals. The price of a barrel of Brent crude oil went up by more than 50 per cent over the course of 2016. At the end of November, after lengthy discussions over the course of the year, the OPEC states agreed to a relatively large cut in the level of production until mid-2017. The oil price is therefore likely to remain well supported in the medium term.

There were also substantial increases in the price of aluminium (2016 as a whole: up by 13.6 per cent), copper (up by 17.4 per cent) and, in particular, zinc (up by 60.6 per cent). Decreasing supply was also responsible for this trend. Overcapacities are now being steadily reduced. Certain commodity markets are now even reporting a supply deficit, which is boosting prices.

Pricing is another argument in favour of the EMs as an investment region. Unlike in many other fixed income segments, where the central banks are distorting price formation in the market by their extensive purchases, the pricing of EM bonds remains attractive. It is clear from the risk-adjusted performance measured using the Sharpe Ratio that the inherent risks of EM bonds are rewarded with an adequate premium.

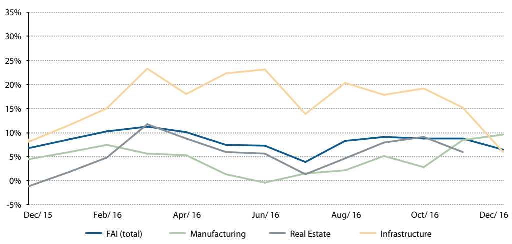
Calmer waters in China

The fact that the situation in China, the largest EM, has calmed again is also having a positive impact. Even at the beginning of 2016, concerns about the country's slowing economy were still weighing heavily on the markets. Doubts about the sustainability of Chinese economic growth together with a significant devaluation of the yuan had caused a sharp fall in prices on the global stock exchanges. In the meantime, however, high levels of government investment in infrastructure and a return to a more expansionary monetary policy by the central bank eased the situation. Chinese economic growth stabilised at around 6.7 per cent, and the leading indicators also suggest that the feared slump will not occur.

Nevertheless, the challenge remains to make the Chinese economic model more sustainable. Beijing sought to counteract the dip in growth in 2016 mainly by significantly ramping up government spending. Its emphasis on bolstering industry, which has led to significant overcapacities and inefficiencies, needs to give way to a policy that is more heavily focused on services and consumer spending. The first steps have already been taken: services now account for more than 50 per cent of China's economic output. However, the extensive process of transformation still remains a balancing act. Scaling back state support too quickly without simultaneously expanding the private sector could have a major adverse impact on economic growth.

Figure 3: Dip in growth counteracted by infrastructure spending

Chinese capital spending on plant and equipment, by industry (yoy, %)



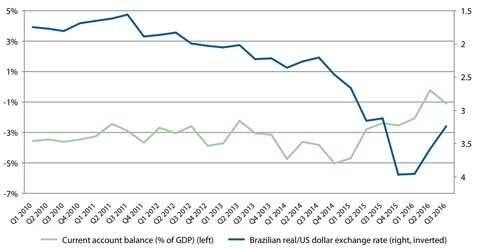
Source: Bloomberg, as at 31 December 2016.

Other countries are already a step ahead in this process. The governments in Indonesia and, in particular, India are taking a pragmatic, pro-reform approach and using infrastructure programmes and other schemes to support the domestic economy. Moreover, the planned introduction of a single nationwide goods and services tax in India in April 2017 should greatly reduce red tape and make it much quicker to move goods across state boundaries. Various measures aimed at fighting corruption are also making the country more attractive to investors.

Opportunities in Brazil and Africa

And in Brazil, too, opportunities are emerging again after years of stagnation. The country had slipped into recession as a result of corruption scandals, including one surrounding the state-owned oil company Petrobras, and because of the long period of political uncertainty caused by impeachment proceedings to remove President Dilma Rousseff. However, a renewed sense of excitement has been in the air since the business-friendly candidate Michel Temer took office. Major reforms are progressively being introduced, and the current account deficit has also decreased. Brazil is likely to return to economic growth for the first time in 2017.

Figure 4: Brazil: sharp depreciation of currency helping to reduce the current account deficit



Source: Datastream, as at Q3 2016.

Opportunities are also emerging in Africa. Sub-Saharan countries are a particular focus. While South Africa – mired in political squabbles and at risk of a credit rating downgrade – will probably stagnate this year, other names are regarded much more positively: Côte d'Ivoire, Ghana and even Zambia have stabilised politically and economically and, in some cases, offer attractive price levels.

Risks are mainly external

Despite all this upside potential, EM investments will not be a sure-fire bet in 2017. However, after a year of primarily domestic problems in 2016 most of the disruptive factors in the coming months will come from the developed world. The new US administration and its still unclear approach to economic policy and trade are increasing the level of uncertainty, as are elections in key eurozone countries.

A taste of how this might impact on the capital markets in the emerging economies became evident immediately after Donald Trump's surprise victory in the US presidential elections in November 2016: investors significantly reduced their exposure to the EMs, which temporarily sent EM bond and share prices plummeting and thereby decreased the amount by which the emerging economies outperformed developed countries over the course of the year. EM currencies were among those that temporarily experienced sharp falls in value because of a firmer US dollar and increasing US yields. The situation has now stabilised, however: spreads on EM bonds narrowed to their pre-US-election level, currencies that had previously come under particular pressure recovered and EM funds registered inflows again. And yet despite all this, the Trump administration's isolationism is likely to cause further uncertainty.

The probable targets of protectionist US policies will be Mexico, which is currently in the media focus because of potential punitive tariffs, and above all China. There are many reasons for this: firstly the imbalance between US exports to and imports from China is particularly high, with China exporting over US$ 300 billion more in goods to the US than it imports from there. Secondly, many jobs of the type held by typical Trump voters have been moved to Asia and elsewhere in recent years. And, thirdly, the agreements with China under the World Trade Organization (WTO) mean that it is still the easiest country for the US to impose punitive measures on.

Domestic political risks remain a problem in Turkey, however, where Erdoğan continues to move the state in the direction of a presidential system. A referendum on the proposed change to the constitution has been scheduled for April after being approved by parliament. This and the ramifications of the failed coup in July 2016 are causing concern both among the population and among investors. Since summer 2016 the Turkish lira has lost almost a quarter of its value against the US dollar, and inflation recently spiked to more than 9 per cent. As the Turkish central bank – partly because of its close political ties – is intervening only hesitantly, this trend is not likely to change any time soon. This is one reason why Fitch has now followed all of the other major rating agencies and withdrawn the country's investment grade status.

Extensive in-depth research is essential

EM investments will clearly still be beset with challenges in 2017. However, we see absolutely no reason for a fundamental reassessment, as there continue to be many factors that point to robust growth in the emerging economies. And, as before, the EMs form an essential component of an internationally well-diversified portfolio. Proactive managers can capitalise on the opportunities in the relevant regions while still controlling the level of risk. This requires an international, intercultural team that is familiar with aspects such as different management cultures, intensive fundamental research and proactive risk management that identifies early signs of downside risk – as well as upside potential – and then reacts quickly. Union Investment has expanded its EM bonds team from eight to eleven employees in recent months and launched new funds. One focus is on the fast-growing high yield segment, particularly in the corporate sector. It is clear, after all, that despite the recent increases, the general low-interest-rate environment is likely to persist in many developed countries. EM investments will therefore remain an essential component of a diversified portfolio that aims to generate appropriate superior returns.

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