



Emerging Markets – Crisis or Opportunity?

Carol Lye |

It's easy to get caught up in the bearishness regarding emerging markets right now. The U.S. dollar is appreciating and U.S. Treasury yields are rising. Outflows from emerging market equities and bonds have started. It certainly reminds us of 2013, if not 2015. So is this a time to get out of emerging markets or is this an opportunity for those who are underinvested?

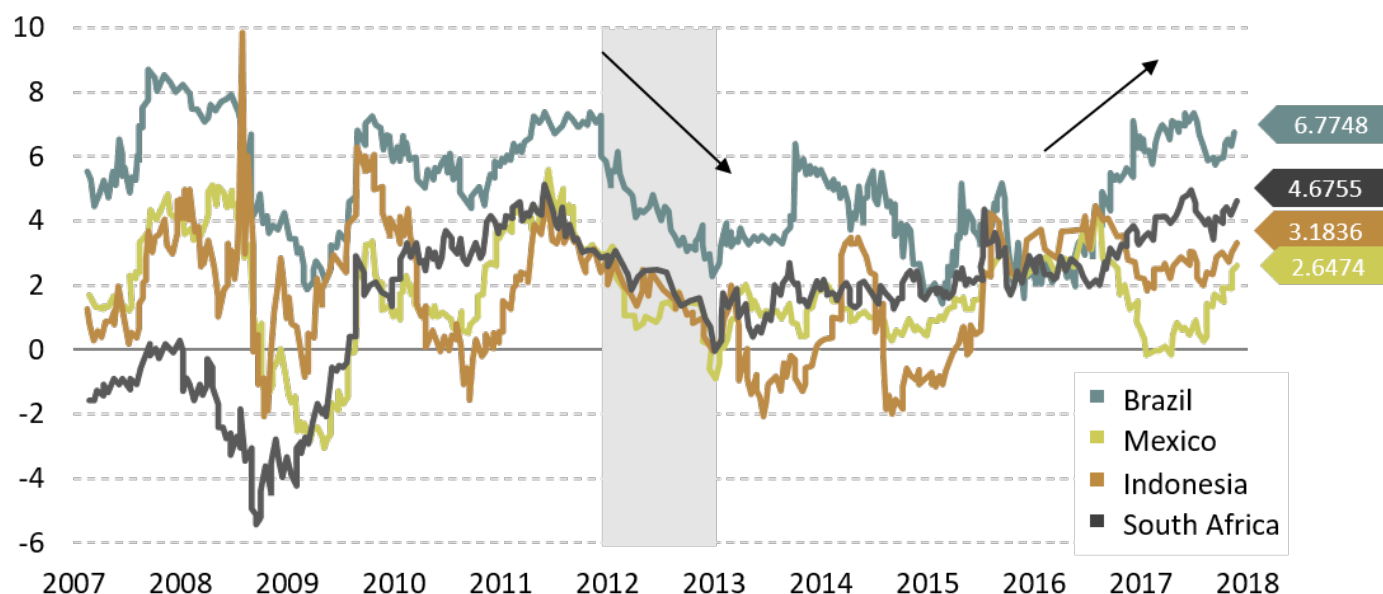
An external driven headwind for some; but not for others

Emerging markets do not perform well in an environment of tighter global liquidity. This is precisely the environment we are in, driven by rising U.S. short-term rates and central bank balance sheets that are no longer expanding as fast as before. What this means is there is now a higher rate used to value investments. For example, since U.S. short-term rates are now yielding the same as U.S. equity dividends, investors have an alternative choice to be invested in U.S. short-dated bonds instead of U.S. equities. In that same light, how should we then value emerging market bonds?

We believe that real yields and its differentials remain a robust value measurement for emerging market bonds. In our [previous blog](#) last year, we had pointed out the differences between now and 2013. Indeed much of that remains true—fundamentals have not deteriorated widely. Real yields remain higher than during 2013 ([Chart 1](#)). Admittedly basic balances have improved for some countries, while for some it has deteriorated.

Chart 1: Real Yield Differential For Selected Emerging Markets

As of 05/16/2018

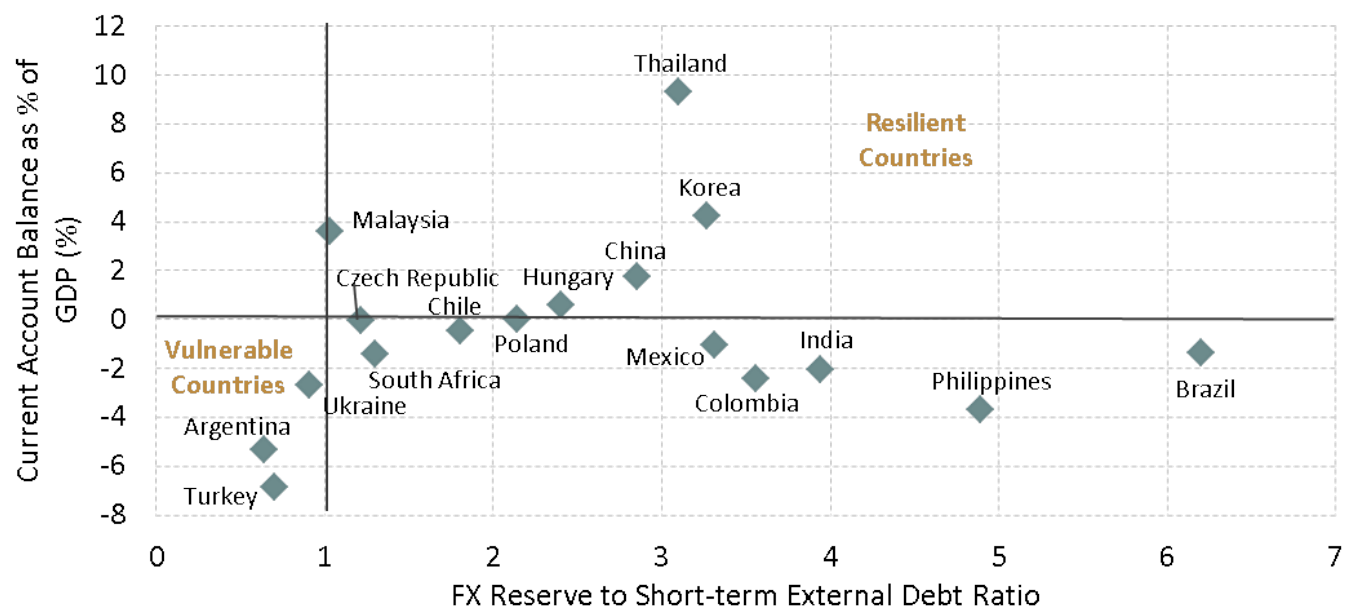


Source: Bloomberg (© 2018, Bloomberg Finance LP)

And as mapped out in last year's blog, policy normalization and the resurgence in U.S. dollar strength were concerns that have flared up recently. How has that transmitted to emerging markets? During the low volatility days, investors do not make an issue out of the debt load of a country. But in an environment of tighter liquidity, countries with large external debt and high current account imbalances tend to find themselves caught without liquidity, as portfolio inflows turn into outflows. Since many emerging market corporates borrow in U.S. dollars, a rising dollar results in higher debt servicing costs for them as they receive revenues in local currency. Indeed that is precisely what we are seeing now with Argentina and Turkey, as being the most vulnerable ([Chart 2](#)). What we are experiencing as well is some kind of contagion that is spilling over to all emerging markets. Volatility in emerging markets will likely linger on for as long as markets continue to re-price assets with rising U.S. short rates. But therein lies the opportunity to pick emerging markets with better macro and debt fundamentals that are selling off in the short term. In particular, emerging markets that stand out are those that benefit from higher commodity prices, with independent central banks, and economies where inflation has either rolled over or is about to turn.

Chart 2: Reserves To Short Term External Debt vs. Current Account As % Of GDP

As of 12/31/2017



Source: Haver Analytics

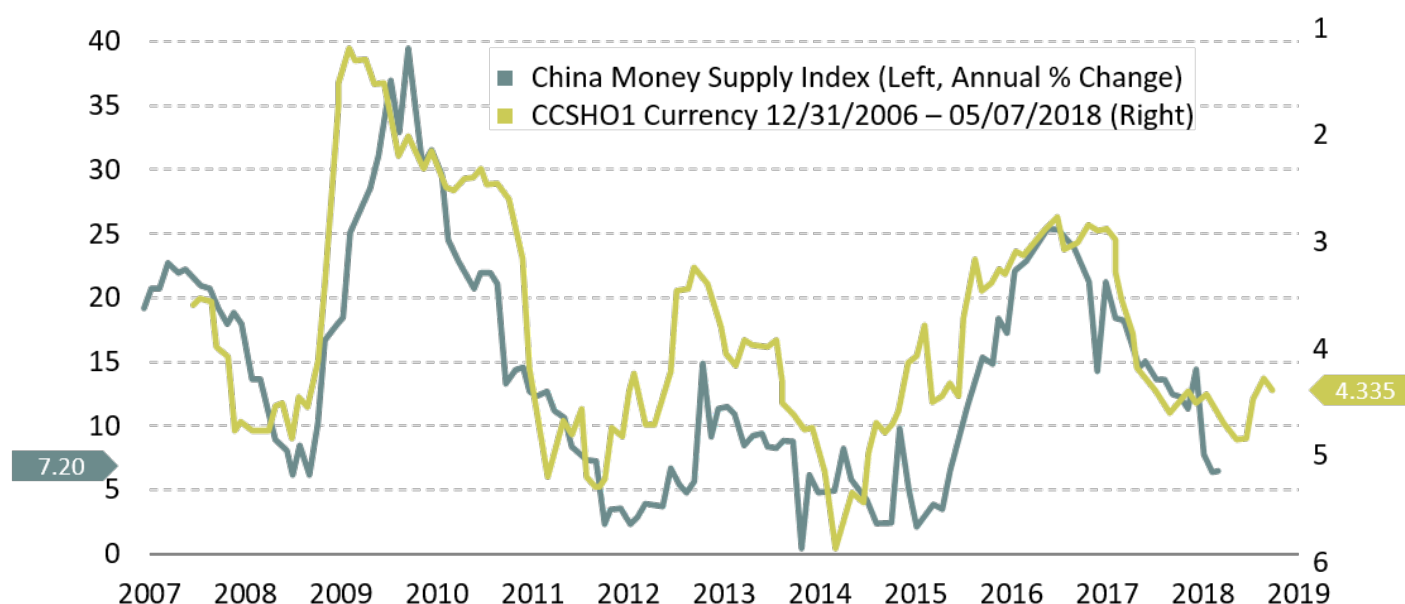
The importance of China

Ultimately how much stress emerging markets will come under also depends on China. Growth in China may show some moderation as infrastructure investment and the property market slows. After all, the growth rate has had a good run since mid-2016. But, we are unlikely to revisit the kind of widespread weakness seen in 2015-16. While policymakers have been tightening lending to financial, infrastructure, and property sectors, lending to other consumption sectors and net exports are helping to offset that decline. With the mini crisis of 2015-16 not too distant in policymakers' memories, they are likely to be more flexible this time. Indeed we have started to see an increase in government expenditure and one-year swap rates are indicating a more flexible monetary policy—this tends to lead money supply in China.

The last thing the world needs now is a liquidity tightening shock from China.

Chart 3: China's Money Supply, 1 Year Swap Rate

As of 04/30/2018



Source: Bloomberg (© 2018, Bloomberg Finance LP)

Conclusion

As long-term value investors, we see value in the emerging market space. However, we do expect short-term volatility as the Federal Reserve (Fed) unwinds unprecedented stimulus. It's difficult to outline precisely what the effects of stepping away from a decade-long monetary experiment will be. Are emerging markets in store for a taper tantrum similar to 2015 or 1990s style contagion? The Fed seems to think that emerging markets will be able to withstand this tightening cycle; however, we think the central bank should strongly consider tightening slowly. While positive fundamentals like global trade, stabilizing commodity prices, and relatively nascent business cycles should provide a cushion for emerging markets, a policy misstep from central banks remains the biggest risk.

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