SEP 25 2017

Featured G

Can Emerging Markets Hold Steady?

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China stepped on the stimulus gas pedal last year, marking the turn for emerging market (EM) assets. The weakening trend in the U.S. dollar and rising commodity prices also have been supportive for EMs. Additionally, EMs have benefited from the non-inflationary global growth environment. Against this backdrop, EMs have been one of the better performing asset classes this year. EM local currency government bonds are up approximately 14% for the year to date while EM equities are up roughly 28%. Given the gains this year, is it time to question whether EMs will continue to provide a return on capital for investors?

Holding Steady or Falling Back?

One could certainly make the case that given the gains seen over the past year and half in EMs, it may be time to start paring back on EM exposure. Moreover, we are entering a period where developed market central banks may be starting to tighten up on liquidity. But, perhaps EMs are better able to weather the storm after the 2013 U.S. taper tantrum and 2015 Chinese deleveraging episodes?

Why this Time Could Be Different

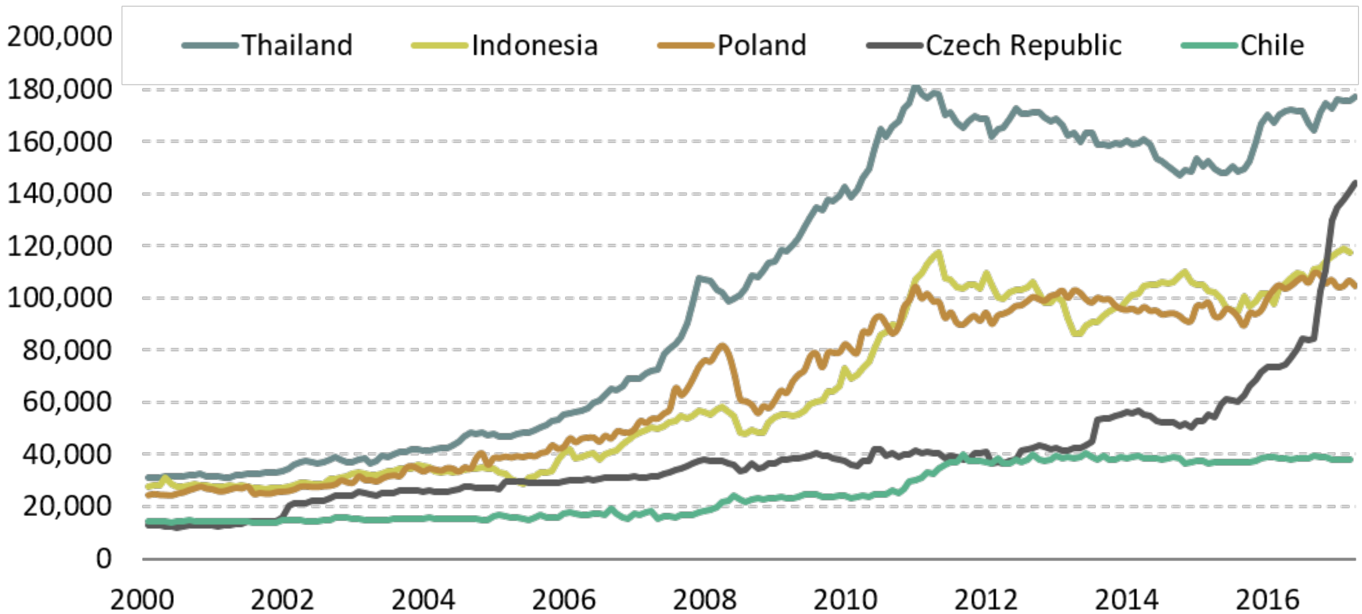
First, the 2013 and 2015 episodes led to a cutback in EMs' current account and fiscal deficits. We have seen that theme play out from Indonesia to Brazil, South Africa to Turkey. Looking ahead, as their economies recover further, leading to higher imports, current account deficits may widen out. However, credit growth in emerging markets and oil prices remains moderate, which we believe should help to contain a dramatic widening in current account deficits.

Second, several EM countries have embarked on economic reforms to boost infrastructure, fiscal revenues, and competitiveness. Examples include Brazil's pension reform, Indonesia's policy reform in investments, India's new Goods and Services Tax (GST) and "Make in India" initiative, and Mexico's energy reforms. These changes have led to an uptick in foreign direct investment in a majority of these countries.

Third, many EMs have been accumulating foreign exchange reserves. Some countries have resisted excessive real effective exchange rate appreciation, resulting in more gross reserves as compared to 2013. This notable increase in currency reserves is true for Indonesia, Thailand, Czech Republic, Poland, and to some extent Chile (see Chart 1).

Chart 1: Foreign Reserves

Millions of USD, As of 7/31/2017

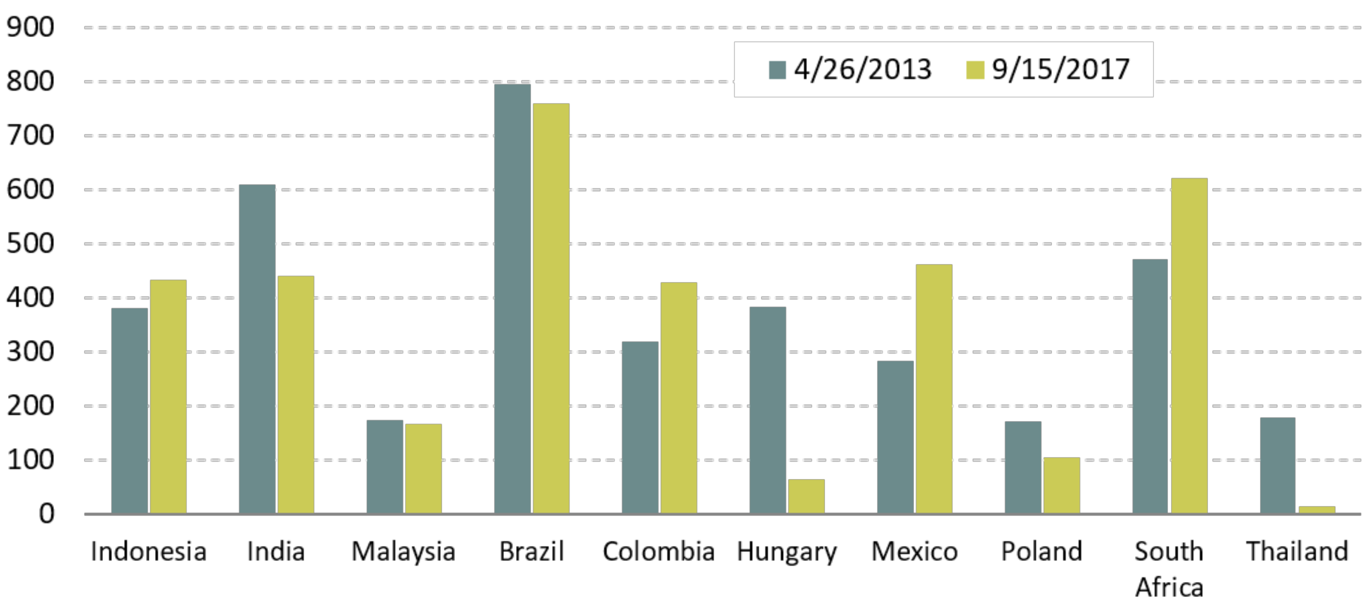


Source: Bloomberg (© 2015, Bloomberg Finance LP)

In addition, valuations are not as lofty as seen before 2015. Moderately high real rates are providing a cushion. Spreads to U.S. Treasuries for some EMs, like Indonesia, Colombia, Mexico, and South Africa, are still wider than in 2013, although going forward there could be further compression as developed market rates normalize (see Chart 2).

Chart 2: Interest Rate Differential versus U.S. Treasuries – 2013 versus 2017

BPs, As of 9/15/2017

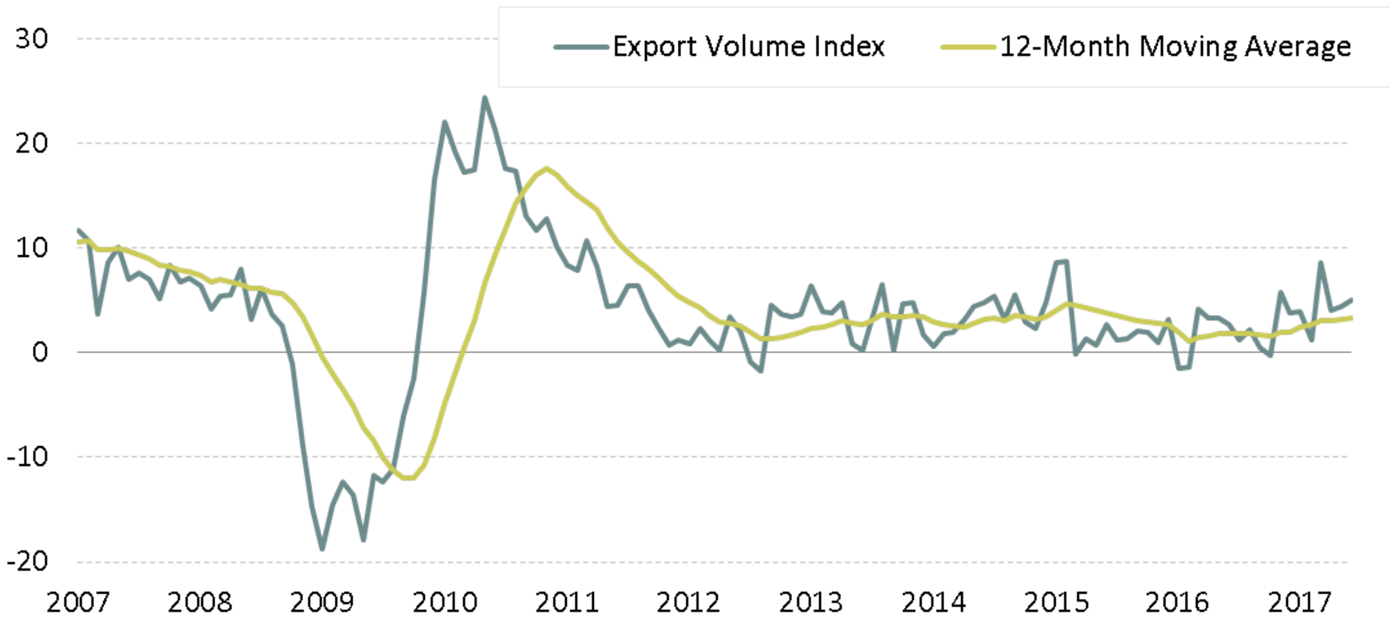


Source: Bloomberg (© 2015, Bloomberg Finance LP)

Broadly, EMs are now taking on a life of their own. Exports to developed markets were among the first EM indicators to pick up as global growth reflated (see Chart 3). The good news is that fixed investment, corporate profits, and consumer spending are now slowly picking up as well (see Chart 4). Meanwhile, inflation has been falling as currencies have been appreciating against the weakening U.S. dollar. We believe that declining inflation and rate cutting by some central banks in developing countries should provide further stimulus, leading to an upward cycle of accelerating growth in emerging markets. Most important, the world is in a state where developed markets across the U.S., Europe, and Japan are seeing synchronized growth. Generally, developed market growth and credit conditions are equally important for EMs.

Chart 3: Emerging and Developing Countries – Export Volume

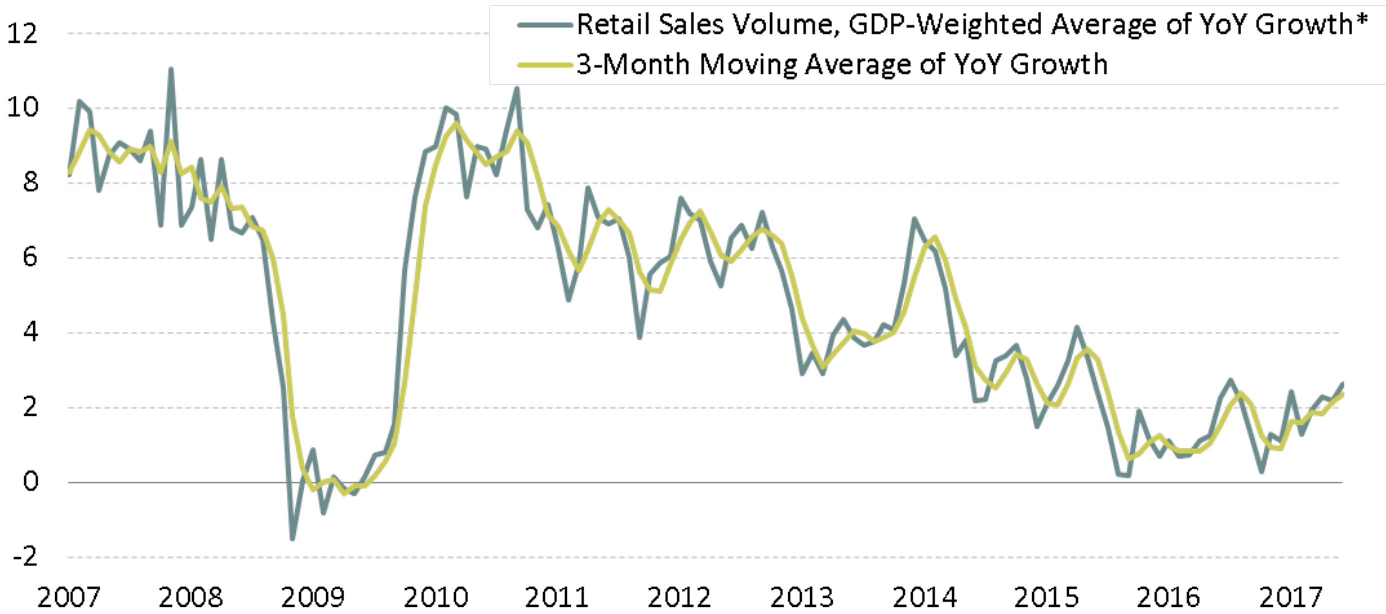
% Change – YoY (with 12-Month Moving Average), As of 6/30/2017



Source: Haver Analytics

Chart 4: Emerging Markets – Retail Sales Volume

Annual % Change, As of 6/30/2017



*Includes Czech Republic, Poland, Hungary, Romania, Korea, Hong Kong, Singapore, Indonesia, Brazil, and South Africa

Source: Haver Analytics

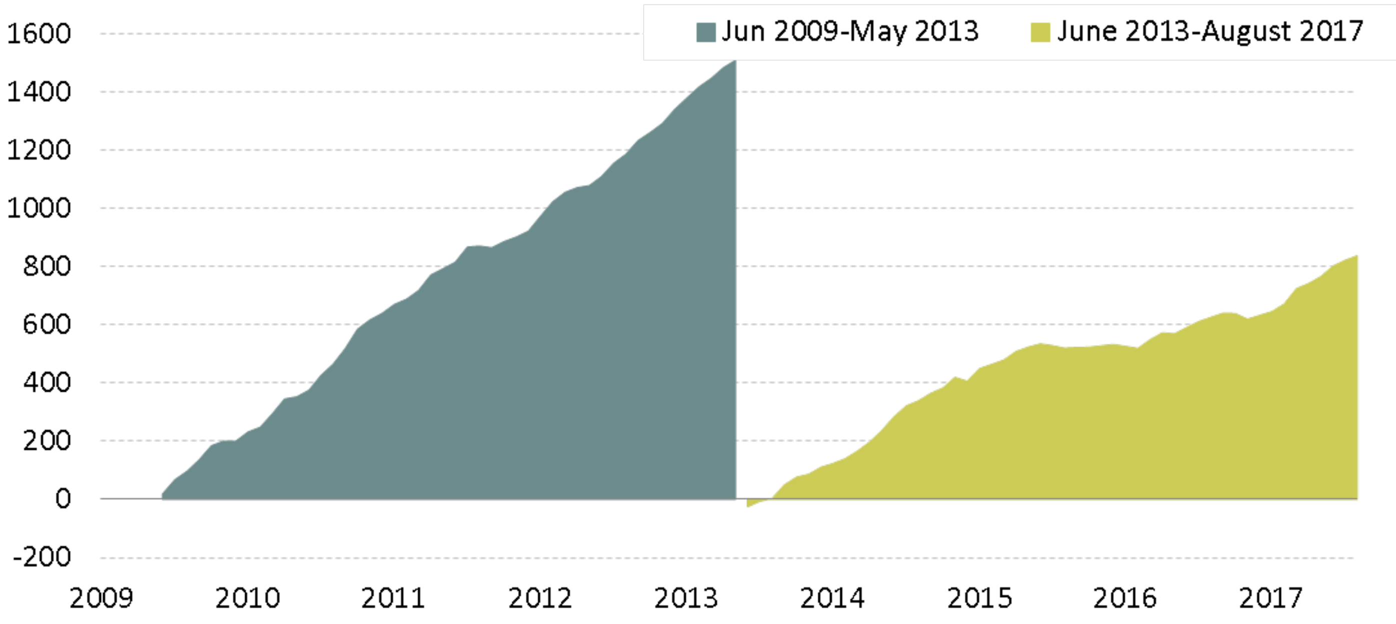
Proceed with Caution

Remaining invested in EMs is, however, not without risks. Expected tightening of liquidity within developed markets remains a concern. However, normalization should occur against a backdrop of stronger global growth and a "go slow" tightening stance (refer to my colleague Jack McIntyre's recent blog, "Bridges Freeze before Roads: Go Slow." A recent study by the Institute of International Finance (IIF) estimated that a cumulative decline in the Federal Reserve's balance sheet equaling USD$65 billion could result in a reduction in EM portfolio flows, to the potential amount of USD$6.8 billion. The IIF also found that cumulative flows into EMs since the end of the taper tantrum through the present are still less than the surge in flows prior to the 2013 tapering (see Chart 5). This historical trend should give some comfort to investors in EMs.

Another risk to EMs pertains to China. Any further slowdown in China may once again cause concerns on the sustainability of growth in EMs. A structural reversal of the U.S. dollar weakness poses one final risk. With respect to all of these concerns, we remain watchful.

Chart 5: IIF Tracker of Total External Portfolio Flows into Emerging Markets

Percent, As of 6/30/2017



Source: The Institute of International Finance

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