Emerging debt in 2017 and beyond

7 More left in the turnaround story

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Emerging Market assets have been the darling of 2016. As of end-September, EM Debt was up 17% and 15% across Local-currency and Hard-Currency debt respectively. Despite the strong performance in 2016, we maintain a positive outlook on emerging market debt in the year ahead. Admittedly, risk factors remain, such as (i) China's growth and the risk of the bursting of the housing and credit bubble, or (ii) the prospect of monetary policies becoming less accommodative, or iii) the possible adoption of D. Trump's program measures that are not conducive to global trade and emerging economies. Despite these risks, and the necessary caution, especially before we can see more clearly the decisions of the US Congress, we continue to favor Hard Currency debt compared to local debt. In the latter we favour EM rates to EM FX exposure.

We believe three key factors will continue to drive positive returns for EM assets in 2017: Technicals, Fundamentals, and Valuations. We will address each of these in turn:

1. **Strong Technicals:** EM debt assets have seen more than USD 50bn of inflows in 2016, the highest since 2012. Will these inflows continue going forward? We believe they will. We think there is a comparison to be made between today's post-Brexit environment, and the Greek financial crisis of 2010-2012. Those three years marked an extreme level of political uncertainty in the Eurozone, and the wider European Union, as well as the financial crisis that gripped much of the continent's peripheral countries. The heightened level of political and economic uncertainty in Europe during the 2010-2012 period made Emerging Markets look more attractive in comparison. As a result, EM Debt was recipient to its largest inflows ever recorded during those three years, leading to a total return of 45% and 36% in hard currency and local currency debt, respectively. We think the current political risks in developed markets, including the repercussions of Brexit and the highly uncertain elections in the likes of Germany and France in 2017, add to the attraction of Emerging Markets, where we believe the political cycle has troughed and will likely see an improvement in dynamics going forward. In addition the absence of yield in developed markets, further adds to the attraction of EM debt, above and beyond what was the case in 2010. As such, we do not think the inflows year-to-date are at risk of reversal. Rather, we expect these inflows to continue over the next twelve months.

   On the supply side, EM sovereigns went through 2014 and 2015 with negative net issuance of external debt. Net issuance will be positive in 2016, but only because of unprecedented external borrowing from Argentina and GCC countries. Without these countries, net issuance in the rest of EM sovereigns will most likely be negative. Furthermore, even EM corporates are likely to experience negative net issuance of debt in 2016, as Chinese corporates resort back to borrowing in their domestic market rather than the external market. Negative net supply adds to the technical support for EM assets: we see more demand for EM debt as inflows continue, whilst supply continues to diminish.

2. **Healthy fundamentals:** Fundamentals in Emerging Markets are better than consensus has been arguing for in our view. The key weakness is on the growth side, where we do not expect to see a significant acceleration in the context of a Chinese economy that is at best stabilizing and at worst continuing to slow down. But as bond investors, we are more mindful of external vulnerabilities, particularly when it comes to hard currency debt. On this front a key metric is current account balance. Investors

The essential

EM debt assets have had a stellar 2016. The rally is not over. Remember the Greek Financial crisis of 2010-2012? The financial and economic woes of Europe added to the attraction of EM debt, leading to unprecedented inflows and returns during those three years.

Brexit may do the same for Emerging Markets… Three factors will drive continued positive returns going forward: strong technical factors encouraging inflows; much better than consensus fundamentals; and still attractive valuations. Three major concerns dominate: China, the post-election of Trump situation and the gradual end of accommodative monetary policies. The election of D. Trump may be a favourable factor... but only if growth expectations grow and tariff increase do not materialise. The risks related to China will probably be limited, despite some occasional jolts. Finally, it is unlikely that the impact of a possible tapering will be as negative for the emerging markets as in 2013. EM countries have much lower external vulnerability, and investors are not as overweight as they were when taper tantrum hit. Hard currency debt remains our preferred asset class within EM fixed income.

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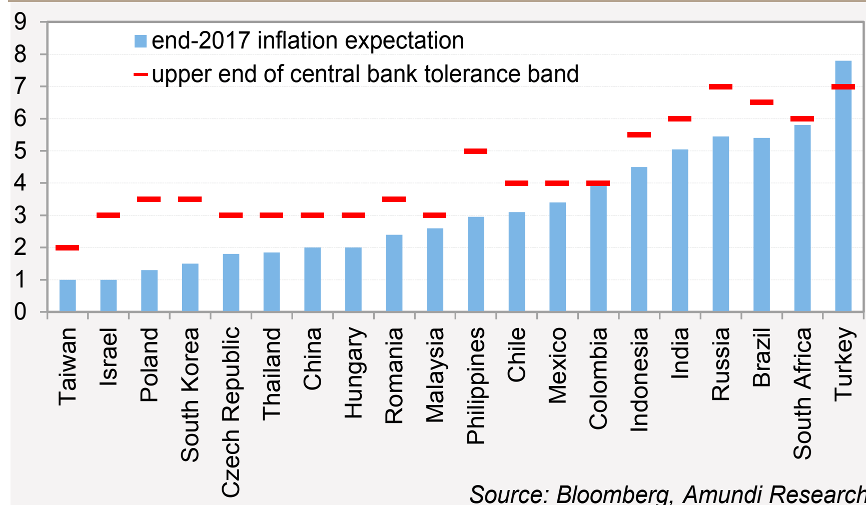
will remember the 2013 taper tantrum sell-off that was concentrated on the so-called 'fragile 5' of India, Indonesia, South Africa, Turkey and Brazil. Since then we have seen significant improvements in all these countries, and the average current account balance amongst major emerging market countries is its highest level since the early 2000s. We have also seen continued deleveraging from external debt amongst EM sovereigns. This has been achieved despite the huge negative terms of trade shock of 2014-2015.

3. **Valuations are far from being expensive:** Let us start with Hard Currency sovereigns, where the benchmark now has a spread of ~350b, roughly in the middle of its five-year range. We have tightened significantly this year, especially since Brexit, and the key question is whether spreads con tighten towards 250bps, the lower-end of the 5-year range. Many argue that such a spread tightening would be unwarranted given that 250bp takes us back to mid-2014 levels when oil prices were above $100pb. We disagree, and believe that it would not be unreasonable to see EM sovereign spreads tighten towards 250bp even with oil prices remaining stable around $50. The key driver of EM spreads is fundamentals, and given our view that EM external vulnerabilities have actually been falling in previous years, especially since mid-2014, the return of spreads to those levels would be justified. This is particularly the case given that technical in emerging markets are significantly better today than they were in mid-14. This is all the more the case due to the prevalence of negative yields in developed markets.

   On the local debt side, we have also seen a meaningful compression in rates. However, EM local bond yields remain high compared to US Treasuries. More importantly, when we compare the real yield on EM rates compared to DM rates, we see a differential that is close to multi-annual highs. The point is that EM rates have lagged the significant compression in inflation, and there is room for further tightening. This is particularly the case when we look at forward-looking inflation expectations. These suggest that looking into end-2017, every single major EM country – with the exception of Turkey – is expected to have inflation at or below the central bank's upper target. We continue to see plenty of value in high yielders such as Brazil, Russia and Indonesia.

Inflation expectations well within central bank targets

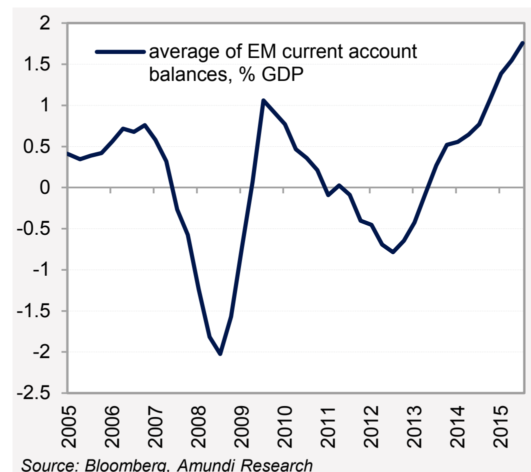


Source: Bloomberg, Amundi Research

QE tantrum: can a reduction in central bank purchasing programs hurt emerging markets?

There is growing concern that a tapering of asset purchases by developed market central banks, including BoJ and ECB, can cause another sharp sell

1 improving current account balances



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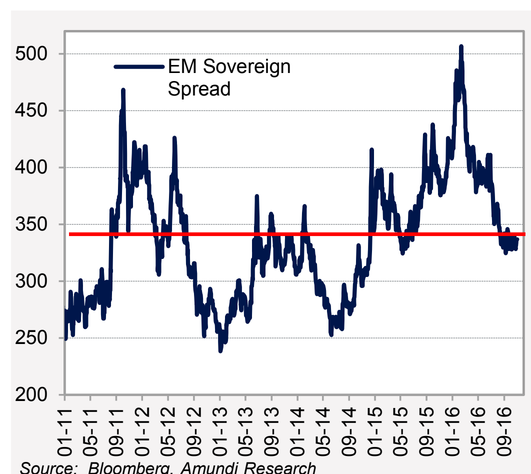
"EM debt assets remain cheap given fundamental developments of past few years"

2 spreads mid-range, room for more tightening



Source: Bloomberg, Amundi Research

off in EM assets. We acknowledge that should central banks in developped markets adopt a more hawkish tone, EM assets are likely to suffer as they are characterised by a negative beta. However, we think EM debt can be surprisingly resilient even in an unlikely scenario of asset purchase tapering by major DM central banks, for a number of reasons:

1. EM fundamentals are much healthier today compared to the taper-tantrum episode of 2013. As we argued, there has been a substantial reduction in current account deficits across the EM space, even in commodity exporters such as Brazil and Indonesia. The significant reliance that EM countries had on portfolio inflows in order to finance their C/A deficits back in 2013, is no longer an issue. We see much healthier balances of payments across EM, including in the fragile five.

2. The market went into 2013 in no way prepared for commentary surrounding tapering of QE by the FED. Going into 2017, further rate hikes by the Fed are very much expected, and there is widespread discussion around tapering of asset purchases by the ECB, BoJ and a general discussion about the inefficiency of monetary policy at current levels. Whilst there are arguments that pricing is complacent, we think the shock from tighter DM monetary policy would not be as significant as it was in 2013.

3. The three years preceding 2013 saw unprecedented inflows into Emerging Market assets and very high returns. The market was significantly overweight EM. By contrast, the three years preceding 2016 saw three years of almost no inflows, very negative returns on local debt and largely flat returns on hard currency debt. Therefore the underlying technical going into 2017 are healthier than they were in 2013.

EM fundamentals are much healthier today compared to the taper-tantrum episode of 2013

Trump tantrum: Can the Trump election permanently endanger emerging markets?

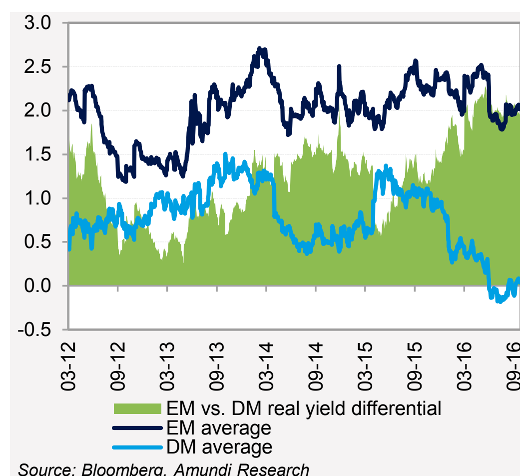
The election of Donald Trump to the presidency of the United States has to do with the decline of the emerging markets. It must be said that the reading of its campaign program was not satisfactory for these markets: prohibitive tariffs, a very significant and negative effect on world trade, and a significant and negative impact on the US debt, deficits and global growth. The question is how far this program can be applied. We will not have a clear and definitive answer for a few months (investiture to the presidency on 20 January, then negotiations with Congress), but we already know that some of Trump's «spectacular» measures cannot be adopted: the United States will not send back to their country of origin 11 million migrants, they will not impose 45% tariffs on China, they will not dramatically increase their deficits and debts ... The Congress will not accept it, even if it is dominantly republican. While waiting to learn more, the uncertainty clash associated with the election of D. Trump has done its work.

For emerging markets, two distinct scenarios can be distinguished:

- Either the new US government causes deficits and recession, which will be extremely damaging for risk aversion, volatility and risky assets such as emerging.
- Either the new government is able to «boost» growth expectations, which will go hand in hand with a resurgence of some inflation expectations, a rise in bond yields rates and Fed rates. At first mixed for the emerging countries, this scenario of stronger growth should be favourable to them, and the technical factors, the fundamental factors and the valuation aspects developed above will return to the foreground.

In short, it is not because interest rates are rising that emerging markets will necessarily suffer. The reason they go up is much more important. If this rise is motivated by a rise in growth expectations, emerging markets will benefit. This is the scenario we believe, at least for 2017.

3 EM real rates are much higher than DM



Source: Bloomberg, Amundi Research

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Conclusion

We do not fully eliminate the risk associated with the central bank's asset purchase programs or the risk arising from Donald Trump's election to the White House, but it seems that the main risk we identify for Emerging markets by 2017 is still the macroeconomic situation of China. Whilst we expect stabilization to continue into end-2017, there is a risk that the sharp rise in house prices will trigger tighter policy by Chinese authorities. There is also a risk that capital outflows resume at pace, exerting more downward pressure on the currency. Of particular concern to us is the continued build-up of corporate debt, which remains on an unsustainable footing. However, we believe the domestic nature of this debt, and the fact that a majority of corporate debt is quasi-sovereign, should ensure that any deleveraging process is smooth rather than disruptive.

In summary, we think strong technicals, healthy fundamentals, and still attractive valuations, should ensure that total returns remain strongly positive in 2017. We think a tapering of asset puchases by DM central banks is unlikely to have as negative an effect on EM as it did in 2013. The key macro risk for EM remains China, but a sharp deterioration there is a tail risk, and not a base case risk.

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