Diverging markets

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Emerging markets have been a focal point for major shifts in the global investment environment in 2013, repricing as the tailwinds of US stimulus and China's boom subside. Looking ahead, returns on emerging market debt are likely to better reflect the diversity of the asset class. More than ever, it pays to know your market.

2013's market upheaval was unusually harsh for emerging markets (EM) investors, but some fallout was to be expected from the first stirrings of a profound shift in the global macroeconomic environment. With the slowdown in China's growth and the prospect of policy tightening in the US, two of the strongest drivers of global risk appetite over the past five years are receding. As a result, some investors are wondering what the tide will leave for emerging markets. They need only look at what was always there - the strengths and weaknesses of individual economies at various stages of their integration into the global economy and marketplace. Looking ahead, the implication for investors is that performance will likely be more dispersed than it has been in the recent past. The ability to differentiate between the stronger and weaker credits will account for a rising proportion of EM returns in the years to come.

1. FED VERSUS FUNDAMENTALS

"Emerging markets" is an unlikely asset class. Individually, many of its constituents are too far ahead of developed-world growth to be considered "emerging". Collectively, it's too diverse to be considered an asset class at all. Then came the overwhelmingly unifying effects of China's double-digit growth, surging commodities prices and the 2008 global financial crisis, when a wave of central bank stimulus swept emerging markets up in rallies across risk assets worldwide.

EM debt markets have certainly benefited from the abundance of liquidity the Fed, in particular, has provided since the financial crisis. The momentum had to give way at some point, and it should come as no surprise that some EM investors headed for the exit at the Fed's first suggestion that it may start reducing asset purchases in 2013.

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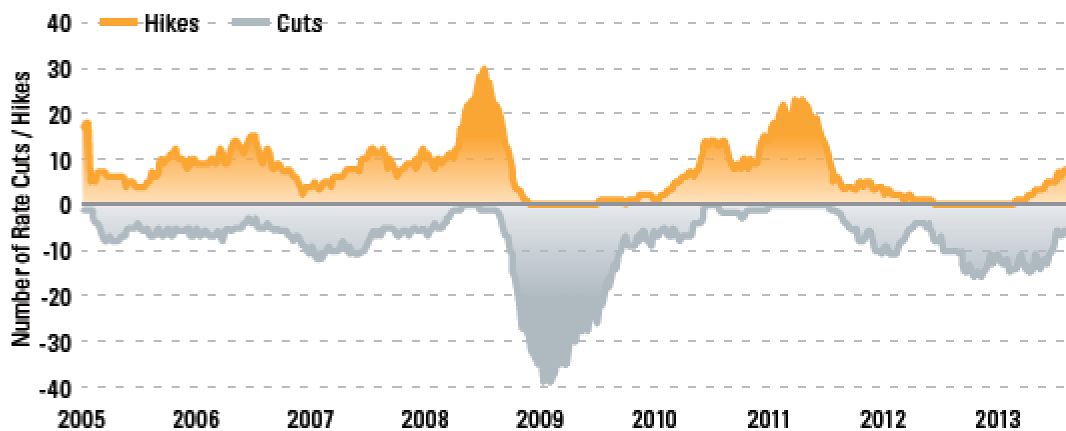
Figure 1: Emerging Market Rate Policies are Diverging Based on Local Fundamentals



Source: GSAM. As at 23 October, 2013.Countries included in the above representation are Brazil, Chile, Colombia, Czech Republic, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Peru, Philippines, Poland, Romania, South Africa, South Korea, Thailand and Turkey.

Although the Fed has opted to continue its US$85bn per month pace of purchases for the time being, citing insufficient economic conditions, a gradual reduction is on the table in 2014.

Liquidity is only part of the story, of course. The long-term trend of flows to EM is the result of complementary forces - the "push" of monetary stimulus and the "pull" of a growing opportunity set accompanied by robust EM fundamentals. As the push subsides, the pull is likely to endure. After all, even as China's output slows, EM growth is still more than double that of the developed world, at 4.5% versus 1.2% in 2013, and headed for 5.1% versus 2% in 2014, according to IMF data (IMF October 2013 World Economic Outlook). Moreover, relatively low debt-to-GDP and tighter fiscal policy remain among the key attractions of EM debt.

That said, the pull that will direct flows in years to come will be less generic to the EM asset class as a whole. The search for yield over the past five years benefited risk assets across the board, whereas the fundamentals that will continue to attract investors will be particular to specific economies and markets, reflecting the diversity of the asset class. As a result, performance is likely to become more varied across EM as investors grow more selective in their allocations.

2. TURNING POINT IN EMERGING MARKETS

Investment decisions in EM, whether in US dollar-denominated or local-currency debt, government or corporate markets, should start with a consideration of the country's credit

quality. Two major factors help determine credit quality: economic fundamentals such as growth, debt and deficit metrics; and, the policy environment including the quality of monetary, fiscal and other political decision-making that can affect a country's economic prospects. These conditions will require close attention in the coming years, as EM growth dynamics are shifting, and policymakers will need to take careful steps to keep their economies on a sure footing.

The overall pace of growth across EM fell to 4.5% in 2013 compared with a peak of 8.7% in 2007, according to IMF estimates (IMF October 2013 World Economic Outlook). Two developments are widely cited for the decline since the global crisis - a marked slowdown in China over the past couple of years, and the not-unrelated decline in commodities prices. Both factors contributed to the pressure on EM throughout the recent global markets correction, particularly concerns that China may miss its 2013 7.5% growth target.

On the policy front, the pressures of balancing growth versus concerns over inflation and other risks are getting increasingly challenging in an uneven global recovery. Evidence of divergence in central bank policy is already apparent, as monetary cycles across EM are parting ways, reversing the trend of convergence since the crisis. In the past few months, Chile, Mexico, Romania and Hungary have all cut rates, and Brazil, Indonesia, India and Turkey are among those that have hiked. This scenario of simultaneous tightening and easing cycles in EM is a symptom of the increasing dispersion of global economic and market performance as developed-world liquidity becomes less of a driver of capital flows.

These are significant turning points in EM, but they are not inherently ominous. China's economic cooling is a managed process in the longer-term interest of the country and, by extension, the global economy. Though policy missteps are a risk, China's policymakers are attempting to promote quality of growth over quantity, engineering the economic rebalancing to accommodate middle-class expansion and the demands of a global marketplace. Moreover, many other EM countries are already on improving trajectories of their own, having applied the policy discipline necessary to weather external shocks and promote more sustainable growth.

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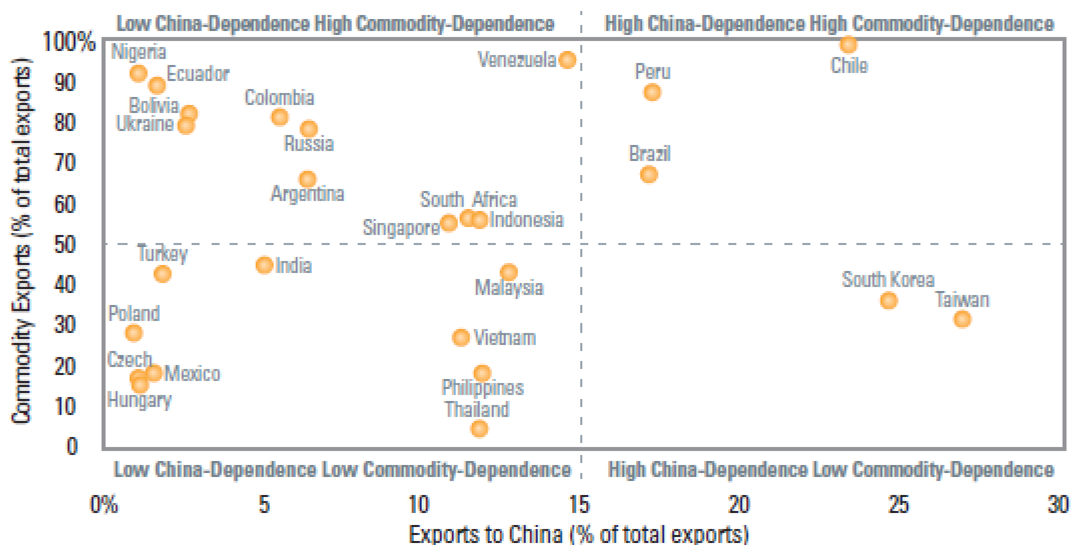
Figure 2: Slowdown in China and Commodity Price Changes May Have a Differentiated Effect on EM Growth



Sources: Citi Research, GSAM, based on IMF data. As of November 2013.

3. FUNDAMENTALS – BUYER BE AWARE

Few would disagree with the view that sovereign debt across EM remains at sustainable levels and, although growth is slowing and risk premiums have risen, that defaults are not a major concern. Drilling deeper into economic fundamentals, no single set of metrics exists to identify credits that will underperform, particularly given the heterogeneous nature of EM debt. However, a combination of factors may make some markets more sensitive than others to capital outflows and lead investors to demand higher risk premiums.

One key factor is external financing risk, as economies with current account deficits and high near-term debt servicing costs relative to foreign currency reserves may be less able to weather short-term reversals in capital flows. Another point of vulnerability is a relatively high proportion of foreign ownership in domestic bond markets, which can leave countries more exposed to offshore selling on a turn in global risk appetite. Countries with high foreign currency or debt liabilities relative to GDP face similar risks. Combinations of these external financing and foreign liability risks are apparent in Eastern Europe. In Asia, rapid credit growth is a more prevalent source of risk, as domestic credit is high relative to GDP and on a rising trend in some of the region's largest economies, including Malaysia, Thailand and China. On the flipside, the Asian region has led the broader EM trend towards solid current account surpluses.

Moreover, the general focus on the downside of US policy tightening on EM has tended to obscure the associated positive implications of stronger US – and, by extension, global – growth. In fact, the anticipated US growth acceleration in 2014 should buoy those open EM

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economies most exposed to the global economic cycle. Similarly, as Europe pulls clear of crisis and recession, developing economies closely linked to Europe via trade and financial sector ties should gain. Bigger challenges may lie ahead for those economies more exposed to slowing Chinese growth and potential sustained declines in commodities prices.

4. FINDING A FIRM POLICY FOOTING

Looking ahead, the extent to which government and financial authorities can uphold prudent policies and pursue further reforms to enhance growth will be a differentiating factor in their performance and a key driver of alpha in EM. However, investors concerned about a return to the EM boom-and-bust cycles prior to the late 1990s should note that developing countries have already made substantial provisions to protect against shocks. More than a decade of strong growth since the Asian currency crisis has been a support for good policy decisions, enabling much of EM to amass foreign reserves and remove currency pegs. Many countries have improved their debt profiles, lengthening debt maturities and shifting more liabilities into local currency.

In addition, most major EM central banks have succeeded in entrenching counter-cyclical monetary policy to protect their economies from potential shocks. That is, they have hiked rates to curb the pace of growth and inflation in boom periods and cut rates to support growth in more adverse conditions. This discipline is paying off for many today. For example, Romania has steadily deleveraged and tamed inflation to the point that policymakers can now cut rates to tackle weak domestic demand. Other economies face a tougher struggle amid broader policy slippage. For instance, having run monetary policy too loosely in recent years, Brazil has had to hike interest rates, despite slowing growth, in order to cool inflationary pressure stemming in part from a government-subsidized consumer credit boom.

Indeed, Brazil's challenges have earned it a place in EM's newest collective term, the "Fragile Five". Along with India, Indonesia, Turkey and South Africa, Brazil suffers from a combination of slowing growth, inflation risks and twin deficits (current account and fiscal). These traits have weighed heavily on the Five's currency and debt markets, raising the pressure on policymakers to act. Each country faces distinct but familiar challenges, including the need to cut red tape and open up to more foreign direct investment, reduce subsidies to national industries and overhaul corporate taxes. Unfortunately for the near-term outlook, each country also faces elections in the coming year that will test their leaders' commitment to unpopular policies. On the positive side, none of these economies suffer pressing solvency problems. Debt-to-GDP ratios are still low relative to the developed world, and debt-servicing costs and schedules are more manageable than they used to be.

While some countries will struggle to strike the right balance between reform and growth, others are making good headway, presenting a compelling case for investment. Mexico, for instance, is a model for the reform-oriented EM economy, with proposals to reopen the nation's oil and natural gas fields to foreign investment and to bring competition to the

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telecommunications sector. Markets have embraced this approach.

5. PRICING THE NEW EMERGING MARKETS

The summer's volatility was an unusually sharp blow for investors who had bought into the strong gains in EM debt over the past decade or more. Yet many also found value opportunities as a result of the indiscriminate selling across external, local and corporate bond markets. As a result, in the weeks following the Fed's 18 September announcement that it would maintain market support at current levels, benchmark indexes reversed substantial portions of their year-to-date declines.

That said, the rally has lacked the momentum of previous, liquidity-fueled episodes, due mainly to general recognition that the Fed's first reduction in market support is not far off. Further volatility is likely as this process gets underway. However, as markets find their equilibrium between the drawback of rising US interest rates and the advantages of global recovery, the value of substantially underpriced EM debt will likely become more apparent. And risk premium has certainly returned to EM debt, burnishing the appeal of assets that had become overstretched after years of rallies.

On a larger scale, 2013's EM shakeout highlights a turning point in the global investment backdrop and an increasing awareness of the changing growth dynamics across EM. As the wave of developed-world stimulus recedes, the performance of EM assets will depend to a greater extent on their individual merits. Against this backdrop, a discerning approach backed by insights into the relevant markets will be increasingly important.

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