# The year ahead for emerging market debt

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We begin with our view on developed market trends. Lifted by enormous policy supports, the longest and deepest economic downturn since the 1930s appears to have ended. Last quarter saw real GDP growth and it seems likely that the global economy will post another solid increase this quarter. However, growth has yet to produce a shift in private sector behaviour sufficient to generate the job gains that will be necessary for a self sustaining expansion in the developed world.

We do feel that the shift in the private sector will take hold in the coming months as the business sector responds to 2009's surge in profitability, improvement in financial market conditions and synchronized global growth. Importantly, a modest change in business behaviour from depressed levels of activity can produce sustained above-trend growth. Thus, our forecast of a gradual but broad based move to an end of the de-stocking cycle, alongside an alignment of investment spending, will be sufficient to generate forecasted average developed world GDP growth of 3.5% in the coming quarters. Viewed from a historical perspective, this outcome should be seen as disappointing as these economies have tended to generate considerably higher growth after a deep economic downturn.

Tempering the powerful forces that have tended to lift the global economy, three meaningful drags persist: credit market tightness, which is expected to limit the recovery in investment and consumer durable spending; the lasting damage to household balance sheets; and job security, which is expected to promote further increases in household savings. If we are correct, the economic landscape will be marked by an unprecedented tension between persistent elevated growth and depressed levels of activity over the coming quarters.

In particular, we expect to see unemployment above 9% - two years into the expansion, expected growth will not be sufficient to lift operating rates meaningfully. High unemployment rates for labour have brought a remarkably sharp slowing in unit labour costs and wage growth. Core inflation is already low and set to be pushed lower by these supply/demand imbalances created by the recession. Thus, we anticipate core inflation to slide to a historic low.

These trends will clearly put the Fed on hold for most of 2010. With unemployment expected to remain high for some time and core inflation falling, it is unlikely that the FOMC will move policy rates higher this year. Actions to reduce the size of reserves may be taken if financial conditions improve, but rate hikes are not anticipated until late 2H 2010 at the earliest.

The emerging markets debt investment thesis for the past year was about country and region selection that would be least impacted by the expected reduction in liquidity that we saw in the third and fourth quarters of 2008. And the expected compression in risk premiums as global markets improved. Over the course of the year, our Global Emerging Markets Local Currency Bond Strategy had a distinct regional bias towards Latin America and Asia and away from Emerging Europe. In terms of portfolio strategy, over the course of 2009 we positioned the portfolio for a stronger-than-expected economic recovery and that the risk of a double dip recession would gradually dissipate as investors started to see increasing evidence of a more broad-based recovery. This positioning was supported by the fact that valuations were not stretched, investors still seemed more anxious and pessimistic than  warranted, and the 'wall of money' moving into risk assets seemed likely to buoy emerging markets debt. This portfolio positioning allowed us to achieve our expected alpha over the benchmark in 2009.

Whereas 2009 was a year of overall risk premium reduction, we feel that 2010 is going to be about country specific and yield curve specific selection in emerging debt markets. While there appears to be some life left in the risk premium compression trade, we think the time has come for investors to sharpen their pencils and focus on differentiation across countries and investment instruments. There is further room for re-rating emerging markets debt, but this is likely to be gradual and marginal compared with the violent market tightening of 2009.

After economic adjustments that ranged from abrupt to brutal last year, emerging market economies began to recover in the second and third quarters of 2009. We expect growth to be uneven across countries and regions, with commodity exporters likely to benefit most from the global recovery. Generally, subdued prospects should prevent inflationary pressures from emerging, but substantial differences in the pace of recovery are nevertheless leading to divergent monetary policies in emerging market countries.

A historical differentiation point of this crisis was that emerging market countries were able to pursue aggressive countercyclical policies, particularly monetary policy, for the first time. Emerging countries appear to be closing their output gaps on average at a faster rate than developed nations, and thus, one would expect them to tighten more aggressively than core countries. However, major uncertainty remains about the size of the output gaps, how that is exerting itself, and how robust global growth will be once we exclude fiscal stimulus and inventory accumulation. We expect the tightening process to be gradual and vary significantly from country to country.

All regions of the emerging world are in recovery. In Asia, the recovery is broad and mature enough to bring monetary policy tightening to the fore. Overall, it seems pretty clear that Asia will lead the recovery thanks in part to aggressive policy stimulus, notably in China. Since Asia's recovery will be accompanied by some rise in inflationary pressures, policymakers in the region will need to tighten policy gradually through a combination of nominal exchange rate appreciation (including China) and rising interest rates.

With ample global liquidity going into 2010, recovery prospects for Latin America should be well supported, and here too there will be pressure on central banks to tighten policy. While some of that policy tightening will be achieved through currency appreciation, nominal interest rates will also have to rise, although in some countries not by as much as the market is currently pricing in.

Central Eastern Europe, Middle East and Africa (CEEMEA) will remain the weakest link in the emerging market story, particularly in countries whose pre-crisis growth rates were heavily supported by plentiful flows of credit. Low levels of credit extension will constrain recovery in these countries, particularly given relatively poor prospects for import demand in the Eurozone. Public finances will give more cause for concern in CEEMEA than in other parts of the emerging world.

On a top down basis, we expect emerging markets to play a central role again in 2010, but the story may change. Emerging Asia is likely to pass the baton to Mexico and emerging Europe – countries that were hit hard in the downturn. We do not expect a broad-based upturn in emerging world inflation, but emerging Asia – the region that led the global recovery – is likely to lead the return to inflation. Policy responses to inflation, using both interest rate and exchange rate tools, are likely to be a key issue for the year ahead.

In conclusion, we doubt that continued risk premium compression will be the dominant theme when we look back on 2010 as a whole. The market context will inevitably become more balanced as the financial conditions improvement matures. As it does, the broad, market-directional themes that have been our focus will need to be replaced by a renewed vigilance toward overshoots and corrections and, above all, an emphasis on relative value and asset selection – in other words, to rely a little less on beta and focus on alpha.