

Emerging Market Debt

Staying the recovery course

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In our previous quarterly we built the case for improved economic prospects and an increase in exposure to emerging market debt, whose prices then reflected a substantial risk of a global economic and financial meltdown. Since that report, data has confirmed an economic bottoming, meltdown has been averted, and emerging market asset prices have surged. At this point, markets seem to be questioning whether the rally has gotten ahead of itself, and whether the road back to recovery may be longer and harder than previously thought, especially with higher energy prices and mortgage rates. One has to remember that the market was overdue for a breather. We certainly do not think the spring rally was simply a blip in a longer bear market. After all, funding costs continue to fall, risk indicators remain tame and the cost of capital is still declining for banks.

Markets have priced in an end to recessions and now even acknowledge that a period of rapid growth is underway in Asia. Both economists and investors, however, remain sceptical that, outside of Asia, the developed economies (which remain beset with balance sheet problems) can do much better than stabilise over the coming six months. Our view, however, is that the cyclical dynamic will play out across essentially all of the recession-hit economies, producing significant rebounds in industrial activity.

The global economic downturn was particularly damaging to the manufacturing sector, which suffered a greater than 15% decline in output in the year ended in March. As previously forecasted, conditions have steadily improved. The process of global cyclical bottoming (measured by industrial production) has occurred over a period of about six months, starting with China and a few other emerging economies late last year and then spreading across Asia. The turn in production from contraction to expansion has been sharp in all of the economies that bottomed early.

Global manufacturing surveys suggest that this dynamic is set to broaden in the coming months. Global IP is likely to hit its peak growth rate over the next several months as the US and large European economies join the recovery, while rapid expansion is still underway among the cyclical leaders in Asia. Indeed, the order to inventory ratio in the U.S. rose almost to a record high in May. This suggests that the underlying recovery in the US manufacturing sector is on track, despite the near-term drag from the auto sector. Global industry is projected to retrace roughly one third of its recession losses by the end of the year.

Two signals that have been most useful in forecasting economic conditions over the past two years have been economic data surprises and the momentum of forecast changes. These variables remain solidly in recovery mode. Consensus economic projections have made significant upward revisions to growth in China and the US. These two countries are the powerhouses expected to pull the world economy forward.

At the core of this recovery is a massive inventory cycle adjustment. With output levels now standing well below final demand, inventories are declining sharply and firms need to raise levels of production to slow the pace of de-stocking. The growth leverage that can be generated from this lift is now being felt in Asia. Even with this increase in production, inventories are still moving lower. Over the past three months, the decline in inventories economy-wide appears to have been bigger as a % of GDP than in any contraction experienced in the post war period. Moreover, the delayed US rebound will come when most of the rest of the world has already entered recovery (and is thus supporting US growth), a very unusual experience for the US, which has typically led global cycles.

Consistent with this improvement in industrial activity is the recovery in trade flows now taking hold. Sequential exports already have stabilised globally, and are rising across Asia. Recent reports show that the base of Asian export demand has broadened from China and other intraregional trade to the G3. With the continued thaw in credit markets, increased trade finance will further expand this trend.

Given the improvement in economic prospects, the market has become more worried about inflation. While nearly everyone expects higher inflation at some point, there is growing recognition in the market of the disinflationary economic overhang. Views on inflation reflect different judgments about the role excess capacity and energy prices. There are also wide differences in opinion about how the mix of unconventional monetary policy and large fiscal deficits will influence inflation expectations.

For the near-term outlook, core inflation trends unfold slowly, as prices respond with a lag to changes in economic conditions and policy. At present, unemployment rates continue to move higher and capacity utilisation rates are only beginning to rise from a historically low base (lowest level in four decades). Wage inflation is low and falling, and there are signs in a number of industrial countries of wage deceleration. These evolving statistics bolster the forecast that developed market core inflation will slide in the coming year. For the developed world, core consumer price inflation is estimated at 1.3%. This is 0.6% below year ago levels. Even after adjusting for the pass-through associated with rising energy prices in the coming months, core inflation rates are on track to fall toward record lows later this year.

Thus, given this short-term disinflationary environment, the Fed is likely to remain more cautious in its monetary policy on this improving growth outlook. Reflecting this caution, it will continue to use language that reinforces the view that policy rates are likely to remain on hold for an exceptionally long period of time, reflecting the economy's large output gap and prospects for core inflation to move lower. Thus, the medium-term path of rates will be determined by the Fed's exit strategy.

On the back of these improved economic and financial market conditions, the normalisation trade dominated most markets in Q2 09 as risk aversion faded, spreads compressed, and asset prices rose amid signs that many major economies were bottoming. The tail risk of a deflationary spiral, which seemed so real some months ago, has now receded greatly.

With markets out of the panic mode and following the massive rally, it is now useful to recalibrate our market expectations, as many factors that were dwarfed by the volatility of the price action are becoming increasingly relevant in the post-crisis landscape. Beyond the initial cyclical bounce, we expect medium-term emerging market growth to be reasonably high, but more in line with country fundamentals, particularly the state of the economy prior to the meltdown. In terms of emerging markets as an asset class, the post-Lehman sell-off was clearly the materialisation of a tail risk to an otherwise solid trend in emerging economic fundamental improvement.

Prior to the Lehman collapse, the market was focused on the ability of emerging economies to decouple from the slowdown in US growth. The free fall of economic activity and asset prices in Q4 put an apparent end to the debate. In our view however, the decoupling debate is still unresolved. There were (and are) good reasons to believe that, in the last 10 years, the sensitivity of emerging economies to US growth fell as the US's importance as a trade partner declined and these economies deepened their domestic capital markets, reducing dependence on external finance. Given the scale of the sell-off, emerging markets assets could not be spared the consequences of the devastating global crisis.

This economic collapse should not be seen as the result of high sensitivity to US growth, but rather as the response to a global financial meltdown. What is critical in this analysis is that due to improved economic fundamentals, these countries were able to undertake countercyclical monetary and fiscal policies for the first time in the history of the asset class to avoid spillover impacts.

It is clear that emerging economies have passed this crisis test. However, the nature of the immediate recovery is now less straightforward, as it should combine cyclical and trend factors. These factors include Chinese growth and its spillover into commodity prices and a further normalisation of risk appetite. This suggests that the cyclical recovery should be fastest in emerging Asia and in commodity exporters mostly in Latin America. We are significantly less constructive on emerging Europe. While tail risks have been largely avoided in the second quarter of 2009, the region still faces substantial challenges to growth, de-leveraging, and fiscal performance that taint the outlook.

The global drivers of emerging market foreign exchange are gradually moving back to those of 2007. However, after overshooting and coming back in tandem, real exchange rates relative to this period are still depreciated and surprisingly similar across currencies, an outcome that cannot be explained by output gap or growth outlook differentials. At the end of this ordeal, we expect emerging market assets to recover in real terms, along a path similar to the one interrupted by the crisis. This firmer outlook favours selected carry currencies such as BRL and IDR. By contrast, the looming risk of a Latvian peg realignment, combined with lingering economic malaise, advises against Eastern European currencies.

We feel the easing monetary policy trend in emerging countries is coming to an end. The output gap in the emerging markets are relatively smaller than in the developed markets, while emerging economies inflation is more sensitive to rising commodity prices. With growth returning, this means that emerging market central banks will be facing a much earlier decision about when to begin to normalise rates. However, we also do not see emerging market central banks hiking rates in the near term. Thus, the longer ends of local rates curves will reflect risk and issuance premia.

Given how far and fast markets have recovered, it is prudent to be somewhat more discriminating, even if the recovery trade persists. Most emerging markets have benefited significantly from the recovery in financial markets and it has been mostly a rising tide that has lifted all boats from a regional performance basis. That is not surprising since all emerging markets were hit extraordinarily hard during the collapse, even in countries that did not have deep-rooted balance sheet problems. Once demand and trade financing stabilised, the economies of many of these countries have shown quite rapid recoveries.

We therefore believe investors should stay invested in emerging markets, but be more discriminating. We favour overweight positions in emerging Asia and Latin America, and an underweight position in emerging Europe, whose performance is likely to be weighed down by debt burdens, possible spillover effects from the economic situation in the Baltics, and strong economic ties to Western Europe, which is expected to underperform.