For Emerging Market Debt, A Sustainable Recovery

After several difficult years, improved fundamentals are yielding a sustainable recovery in emerging market local currency-denominated debt

After several difficult years, the outlook for emerging market debt (EMD) denominated in local currency has brightened considerably. From May 2013 to January 2016, local currency EMD dropped 33% in US dollar terms as the US Federal Reserve (Fed) tightened monetary policy, the US dollar strengthened and commodity prices fell. Since then, however, the tightening of US monetary policy has become well understood by the market, the rise of the US dollar has come to a halt, commodities have stabilized and economic conditions in many emerging-market nations have improved. These conditions, which have led to a strong recovery in emerging market local currency debt, are likely to continue. We expect this combination of supportive external drivers and improving domestic fundamentals to yield strong total returns for the asset class this year and likely into 2018.

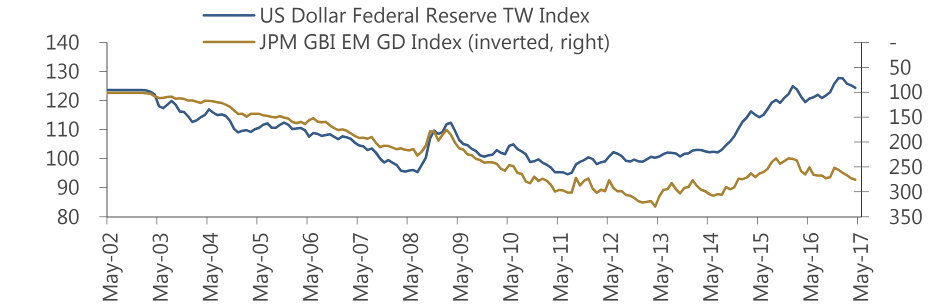
The external drivers that account for much of the variability of total returns— global rates, the US dollar and commodity prices—are explained in further detail in our November 2016 white paper, "Understanding Risk and Return in EM Local Currency Debt." In the next few paragraphs we explain why these external drivers have turned more supportive of the asset class over the last year or so.

Currency headwinds subside

The super strong US dollar was one of the greatest headwinds facing the asset class from 2013 to 2016. However, history shows that the US dollar mean reverts in real terms over long economic cycles.[1] We believe that the current dollar-up cycle is in a mature stage; it is currently one of the world's most expensive currencies.

While a weak dollar would be a tremendous benefit for local currency EMD, a stable dollar is all that is necessary for the asset class to deliver high single-digit returns. For example, as shown in Chart 1, from mid-2010 to April 2013 the dollar remained relatively stable but yet local currency EMD posted a cumulative return of +36% in US dollar terms.

Chart 1: USD Trade Weighted Index vs EMDLC



Source: Bloomberg as of May 31, 2017

Fed policy changes have been absorbed

Policy tightening by the US Federal Reserve was another headwind for local currency EMD. Beginning in May 2013, the Fed announced that it would begin to curtail its policy of purchasing debt known as quantitative easing; this triggered abrupt selloffs of emerging

[1] There are solid macro reasons behind this, but out of the scope of this paper.

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market debt by investors and prompted painful readjustments to EM economies with large current account deficits, which had come to depend on foreign investment to fund economic activity. Now, four years later, the Fed is only very gradually raising interest rates and unwinding unconventional monetary policies. This process is already priced into asset valuations; hence, we do not expect the actual delivery to create much market disruption.

Oil, fracking and EM

The technological revolution in the energy sector paved the way for the introduction of unconventional oil production methods, changing the very structure of the oil market and triggering a massive collapse in the price of oil between 2014 and 2016. This had a huge impact on EMD local currency; as many emerging market countries are commodity producers, their external and fiscal accounts are heavily influenced by the prices of the commodities they produce. Since that time, however, conventional producers (both OPEC and non-OPEC members) have intensified their efforts to improve the balance between demand and supply in the coming years. We expect these efforts to produce a much more stable price of oil during our investment horizon.

EM domestic fundamentals are also improving

In addition to the improving picture on the external front, a good portion of the emerging-market nations in our universe are also in better shape now than previously. Following the painful readjustments of the past several years, many now enjoy smaller current-account deficits and significantly lower inflation.

During the decade prior to 2013, many EM currencies appreciated, domestic products and assets became more expensive for the rest of the world and imbalances accumulated. The resulting deficits required incremental financing from abroad and made the local currency more vulnerable. Fast forward to today, in countries such as India, Turkey and South Africa, current-account deficits have compressed materially due to slower growth and currency depreciation, reducing their external vulnerability.

To fight currency depreciation and higher inflation expectations, central banks tightened domestic rates materially between 2014 and 2016. Now, inflation is dropping materially, providing room for central banks to ease monetary policy, which will provide impetus to incipient growth recoveries.

Lower vulnerability to external shocks, lower inflation and improved domestic growth prospects make emerging market debt local currency more attractive as well.

Table 1: Current Account Deficits Have Shrunk

Country	Peak Deficit	Year	2017	2018 Forecast
Brazil	-4.2	2014	-1.3	-1.7
Chile	-4.1	2013	-1.4	-1.7
Colombia	-6.4	2015	-3.6	-3.3
Indonesia	-3.2	2013	-1.9	-2.0
Peru	-4.9	2015	-1.9	-2.0
South Africa	-5.9	2013	-3.4	-3.6
Turkey	-8.9	2011	-4.7	-4.6

Souce: Standish and IMF as of June 16, 2017

Table 2: Inflation Has Come Down in the Worst Behaved Countries

Country	Peak Inflation	Year	2017	2018 Forecast
Brazil	9.0	2015	4.3	4.5
Chile	4.4	2015	2.9	3.0
Colombia	7.5	2016	4.2	3.5
Indonesia	6.4	2013	4.4	4.2
Peru	4.0	2017	4.0	2.6
South Africa	6.3	2016	5.3	5.0
Turkey	10.0	2017	10.0	8.0

Souce: Standish and IMF as of June 16, 2017

We believe the combination of more supportive external drivers and improved domestic fundamentals make a very strong case in favor of local currency EMD over the remainder of this year and likely into next year.

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