EMERGING MARKETS OUTLOOK 2019

2018 review

Since performing well in the first quarter of the year, emerging market fixed income had a difficult time over the remainder of 2018. It looks highly likely that all the major segments of the asset class will end the year in negative territory in USD terms. At the time of writing this outlook, local debt was the worst performing segment in EMD (down ~8.7% - JPM GBI-EM GD), followed by external debt (down ~4.8% - JPM EMBI GD) and corporate debt (down ~2.0% - JPM CEMBI BD).

This marks a sharp turnaround in the fortunes of emerging debt, which performed strongly over the previous two years. So what exactly caused emerging bonds to fall for most of the year?

It all started off with the ongoing strength of the US economy. While we were optimistic about emerging debt's prospects in our 2018 outlook, we did point out that Fed hikes were a risk to the asset class, and this is exactly what panned out. As it became clear that the US economy was growing stronger than other global economies, thanks to President Trump's tax cuts and increased government spending, the markets priced in further rate hikes by the Fed, leading the USD to appreciate and emerging market currencies to fall.

In addition, a combination of robust US demand and higher geopolitical risks including the war in Syria, Iran nuclear deal and Venezuelan crisis, led to a surge in oil prices, with Brent briefly topping $85 per barrel in October for the first time in four years. Higher oil prices saw a marked re-acceleration in the pace of headline inflation this year. But they also lead to a significant erosion in the terms-of-trade for major oil importing emerging markets, adding further downward pressure on emerging market currencies, as their balance of payments positions deteriorated. This created a "perfect storm" for some of the most troubled emerging economies, as the growing need for external financing coincided with rising costs and declining availability.

Many central banks in emerging markets were forced to hike rates in response. The most vulnerable eventually succumbed to full-blown currency crises, including Argentina (which raised interest rates to 60%) and Turkey (which saw the lira plunge to its lowest-ever level). There were fears that similar crises would develop elsewhere in the emerging world. Investors suddenly reawakened to the risks of South Africa sliding toward full junk status, disappointing growth in Brazil and the need to tackle the budget deficit, and another round of sanctions looming over Russia's head. All of which contributed to deteriorating sentiment, investor outflows and general market weakness.

Aside from a number of idiosyncrasies, emerging markets also faced various other external shocks throughout the year. Balance sheets of the G4 central banks finally started to contract and the gradual removal of their massive bond-buying programmes began to have an impact. Emerging markets have benefited greatly from quantitative easing, as their higher economic growth and relatively high interest rates have made them attractive destinations for hot money flows. But as global liquidity tightens, they're vulnerable to capital outflows. President Trump's aggressive rhetoric about trade was another headwind for the asset class. Indeed, any full-blown trade war with China would impact growth across the emerging universe, and the president didn't just focus on China, he also singled out a number of other emerging countries including Mexico and South Korea, for what he called "unfair" trading practices.

Going into 2019…

The consensus outlook for emerging markets in 2019 is much less optimistic than it was as we entered this year. The general expectation is that the major central banks will continue to tighten liquidity through rate hikes and/or balance sheet reduction throughout next year. As we've seen, tighter liquidity is a major headwind to emerging market assets, not least because emerging market government debt stands at its highest level since the 1990s. What's more, private sector credit in China remains a concern.

However, we see a glimmer of hope that could come from a moderate growth slowdown of developed economies. Indeed, growth in emerging economies, which is more dependent on China, could start to look more attractive on a relative basis. Furthermore, the slowdown in China, which is slowly feeding its way through the emerging world, is already well accounted for.

In addition, we have to consider the eventuality of a prolonged trade war. But China would be able to mitigate its impact initially via a combination of monetary and fiscal stimulus, helping offset the impact of tariffs to a certain extent.

There are also country-specific issues to consider. As a result of its problems this year, Argentina is now under an IMF programme that has forced the government to put in place aggressive fiscal policies. While the government seems committed to follow through, the market is sceptical that the programme is sustainable, especially with a general election coming up at the end of October 2019. We are convinced that Argentina will stick to the programme and continue to receive support from the IMF, underpinning its economy.

There are also concerns about Turkey due to the country's highly uncertain political backdrop, weak currency and double-digit inflation. While the Turkish central bank responded late to the crisis it faced this year, many investors are concerned that the measures it has taken are not enough. We believe Turkey will be able to manage the impact of its slowing economy on its corporate and banking sector.

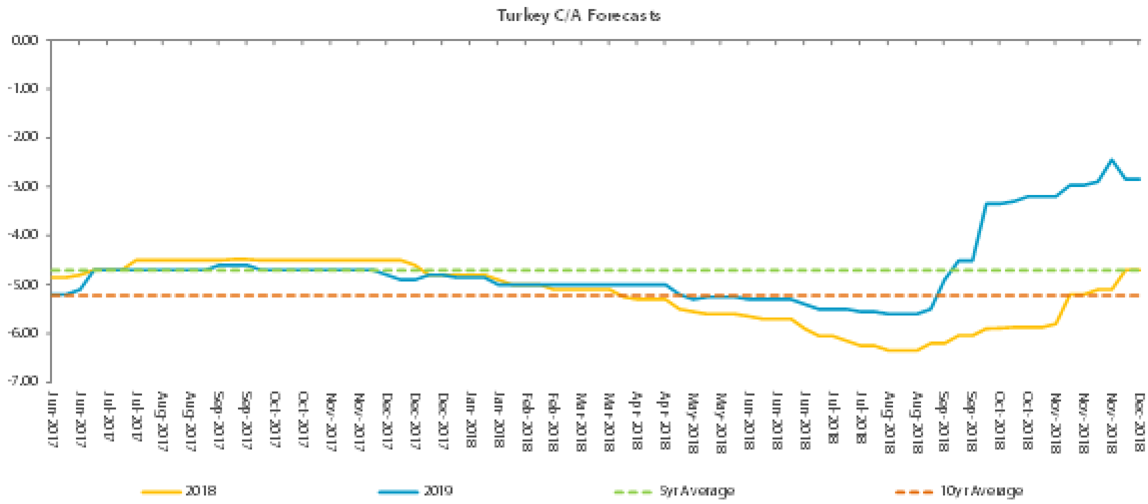
Meanwhile, South Africa now has in place a more business-friendly new president and is determined to regain its full investment-grade rating. Brazil, for its part, finally has a strong, if somewhat controversial leader, but time is running out and pressure is mounting for it to implement reforms in order to reduce its fiscal deficit.

Finally, there's another heavy election calendar next year, and these always create a certain level of uncertainty. The main votes to watch are in Indonesia, India, the Philippines, Thailand (if the military sticks to its promise), Argentina and South Africa. In general, we predict continuity, but upsets can never be ruled out.

A more constructive view

While the consensus view might be bearish, we strongly believe that individual emerging markets will be able to cope better next year. Most importantly, we think that there will be fewer US rate hikes than expected, as attention could turn to the possibility of a recession in the US in 2020 as we progress throughout next year. Fewer US rate hikes would be excellent news for emerging bonds. Neither do we believe that a full-blown trade war between China and the US is a likely outcome. President Trump has been flexing his muscles all year, but at the G20 meeting in November he agreed to a temporary truce with President Xi, suggesting that he may well be willing to compromise. It would be in the interests of both countries, and the rest of the world, if they were able to reach a deal. With its economy slowing, China can't afford an economic war with the US, so it is likely to make concessions. Of course, it's important to remember that emerging fixed income isn't a homogenous asset class. While some countries may suffer next year, that needn't be reflective of the asset class as a whole. More than ever, active management will be crucial to navigate through the volatility.

Glimmer of hope: forced current account rebalancing in Turkey



Sources: Bloomberg, IMF

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