The Case for Emerging Markets Revisited

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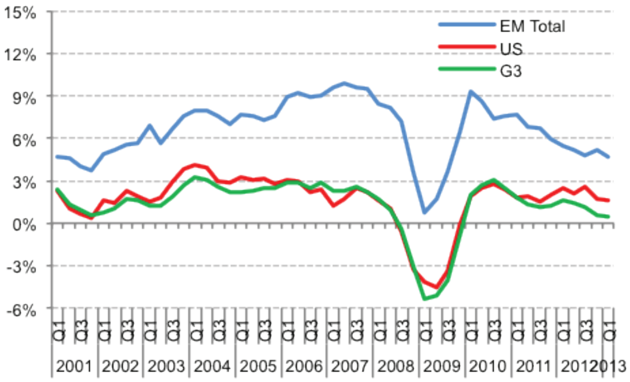
Executive Summary

- We reexamine the investment case for Emerging Markets Debt (EMD) in light of recent concerns about the slowdown in economic growth in EMs and about the vulnerability of EMs to possible capital outflows triggered by the expected tapering of the Fed's quantitative easing (QE) program.
- To summarize our views: we believe that long-term fundamentals remain strong in EMs (higher growth and lower debt than in developed markets, high FX reserves, low inflation), and that the recent concerns about EMs are overdone.
- We expect GDP growth to stabilize in most EMs in H2 and even pick up in several countries. The main drivers are the improving growth outlook in the US and the Eurozone, which will benefit EMs, and stable domestic demand.
- In our view, most EMs are less vulnerable to fixed income outflows than commonly assumed. The largest source of capital flows to EMs continues to be foreign direct investment (FDI). Portfolio inflows have been smaller. While foreign holdings of EM local debt have increased significantly, we believe a large share of that increase is due to strategic allocations by institutional investors whose overall exposure remains small to moderate. As a result, we believe recent mutual fund flow data overstates the risk of further outflows from EMD.
- Valuations have adjusted significantly and we believe they remain attractive relative to other fixed income asset classes. Yield differentials and spreads remain significant and should support continued interest in the asset class.

The Case For Emerging Markets Revisited

Since the beginning of May, global fixed income markets have sold off aggressively. 10-year U.S. Treasury yields have increased almost 100 bps as a reaction to the Fed's tapering discussion, which in turn has been triggered by an improving outlook for the U.S. economy with diminishing tail risks. While the economic improvement has been gradual, market participants have interpreted the explicit discussion of tapering by the Fed as a fundamental regime change for fixed income markets: the beginning of the end of QE and, as a result, the start of a period of rising rates. The immediate consequence of this shift in market perception has been a sharp selloff across global fixed income markets and evidence of retail fund outflows has added momentum to the selloff. The impact on emerging market debt has been particularly pronounced as the fixed income selloff coincided with growing concern over the growth outlook in emerging markets. To be sure, GDP growth in EMs remains much higher than growth in developed markets, but many EMs have slowed down over the past 1-2 years while the outlook in the major developed markets has held up better, especially in the U.S. and more recently in Japan as the country embarked on “Abenomics” (Figure 1).

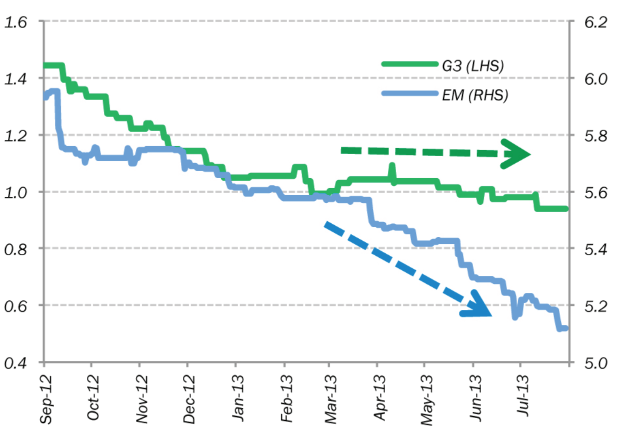
Figure 1: Global GDP Growth



Sources: Haver Analytics, Stone Harbor Investment Partners LP

The economic outlook for the Eurozone remains worse but we see signs that the recession could end this year.

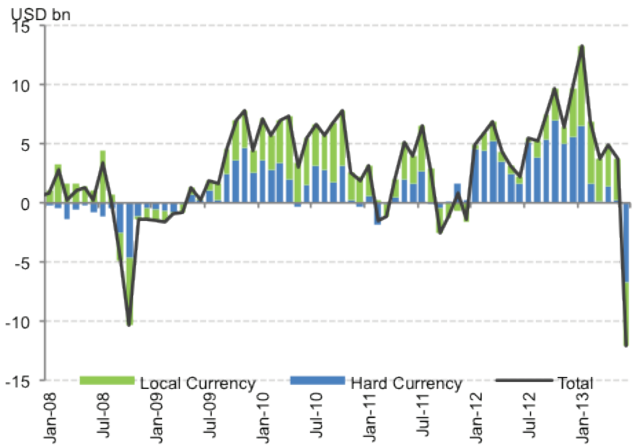
Figure 2: Consensus Forecast for 2013 GDP



Sources: Bloomberg, Stone Harbor Investment Partners LP

The deteriorating sentiment regarding EM growth becomes clearly evident in the evolution of growth expectations. Figure 2 shows how the Bloomberg consensus expectations for 2013 growth have changed over the past year. It highlights the perceived divergence between the DM and EM growth outlook. During the second half of 2012 and through Q1, 2013 expectations have been lowered gradually both in DMs and in EMs. However, starting in April 2013, the outlook diverged as EM growth expectations continued to decline while the G3 outlook remained steady. Within EMs, growth downgrades have been broad-based and evenly spread across regions. Concerns over the growth outlook have been exacerbated by fears about capital flow reversals. The prospect for higher U.S. Treasury yields and outflows from fixed income funds (Figure 3) have raised the question if EMs have become overly reliant on easy

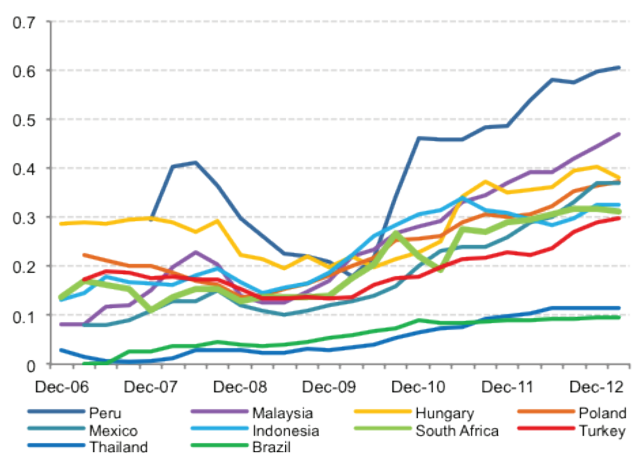
Figure 3: EM Debt Mutual Fund Flows



Source: J.P. Morgan

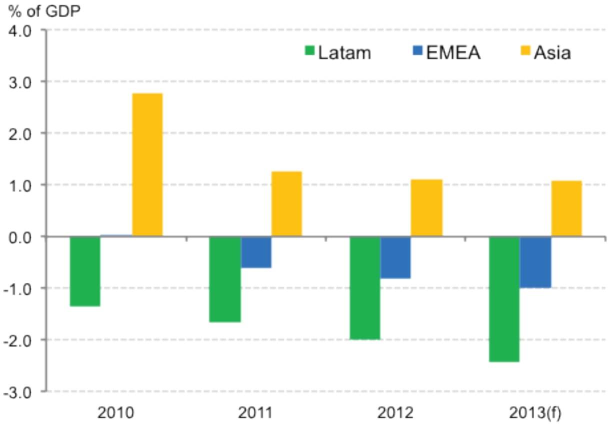
capital inflows. Foreign ownership of EM local bond markets has risen significantly in recent years (Figure 4). Meanwhile, current account deficits requiring

Figure 4: Foreign Ownership of EM Local Debt



Source: J.P. Morgan

Figure 5: EM Current Account Balances



Sources: Haver Analytics, Stone Harbor Investment Partners LP

ongoing financing have appeared or widened in several EM countries (Figure 5). In this environment many investors are wondering if the investment case for EMD no longer works. Over the past few weeks many analysts and strategists have suggested just that.

We disagree with this view. As we argue below, EM fundamentals remain strong, EM economies are likely to benefit from a recovery in DMs, and the adjustment in valuations and technical positions is creating investment opportunities in EM debt and improving flows going forward. However, differentiation across countries is becoming increasingly important in this environment.

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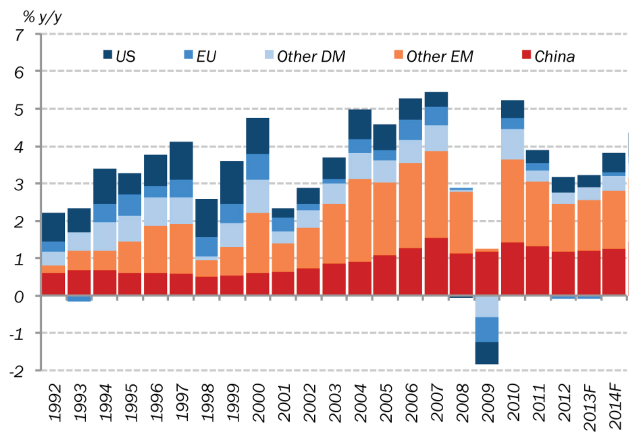
EM Growth Outlook

The first point to keep in mind is that despite the slowdown over the past two years, most EMs still grow significantly faster than DMs, including the U.S., and EMs still generate more than 70% of global GDP growth (Figure 6). However, that growth gap has been narrowing and sustained improvement in the outlook for EMD will hinge on some reacceleration of growth in EMs. We believe that is likely to happen in the second half of 2013.

Figure 6: Contribution to Global Growth



Sources: Haver Analytics, Stone Harbor Investment Partners LP

Better U.S. growth is expected to benefit EM economies. The U.S. remains the world's largest importer. Higher U.S. growth means more demand for EM exports. Similarly, we expect a better outlook for the Eurozone and Japan to benefit EMs.

A case in point is Mexico. The U.S. accounts for about ¾ of Mexican exports, and Mexico has been increasing its market share in the U.S. in recent years.[1] Thus, Mexico is likely to benefit from a pickup in U.S. growth. In addition, Mexico is implementing structural reforms, which are likely to increase the potential growth rate. Meanwhile, actual growth has

[1]Sources: Instituto Nacional de Estadistica Geografia e Informatica (Mexico) and U.S. Department of Commerce.

dropped to the lowest rate since 2009 and the central bank has cut interest rates, putting the country in a very good position for higher growth going forward.

Outlook For China

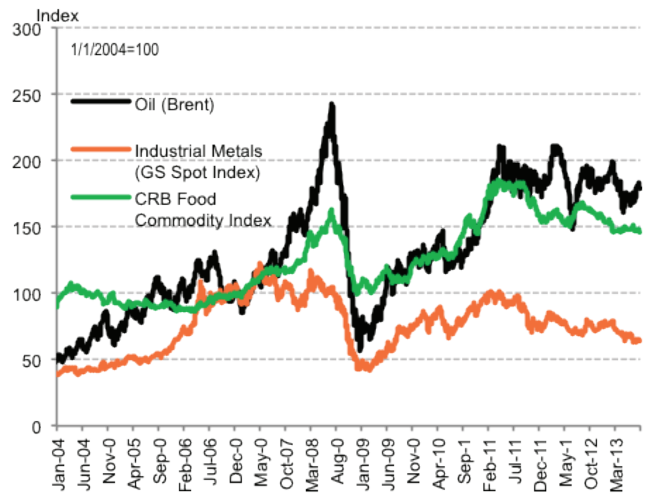
The outlook for China remains particularly important for EMs more broadly because of China's critical role for global commodity demand. Growth expectations for China's economy have been lowered gradually over the past two years. While China has been able to avoid the feared "hard landing" so far, policy makers have made it clear that they are satisfied with lower growth rates than in the past. Thus, we are not expecting any aggressive stimulus measures. In fact, Chinese authorities seem more concerned with curbing economic imbalances, in particular the real estate market and more recently the so-called "shadow banking system" and overcapacities in selected industries.

However, key fundamental drivers of strong growth in China remain in place: a high investment rate, continued urbanization trend, development of the country's interior regions, and high productivity growth. While growth will not return to double digit rates seen in the past, we see good reasons for stabilization. Policy makers have started to emphasize again the importance of keeping growth in a "reasonable range" and the absence of price pressures in the economy suggests that potential growth remains at or above the current growth rate. With that in mind we expect growth to stabilize at around 7½% this year.

Since the rate of Chinese real import growth well exceeds real growth rates in most other EMs, we believe that exports to China will continue to support growth in EMs.

In our view, this outlook for China is supportive for growth in other EMs. Chinese imports have grown around 10% y/y, in volume terms, so far this year and about 60-70% of Chinese imports come from other EMs.[2] Since the rate of Chinese real import growth well exceeds real growth rates in most other EMs, we believe that exports to China will continue to support growth in EMs. However, quantities are only one side of the equation, the other are prices. China consumes a large share of global commodity production. This share is particularly large in the metals markets, at about 40% of global use. The market is concerned that weaker growth in China, and especially slower investment growth, will pressure commodity prices and thus hurt the commodity exporters among EMs. We believe several key factors mitigate this concern. First, the main risk to global commodity demand in recent years has been the "hard landing" scenario in China involving a sharp decline in investment. This risk has weighed on commodities markets for some time now Figure 7), affecting metals in particular, which would be hardest hit by lower investment. We believe that significantly weaker demand (than

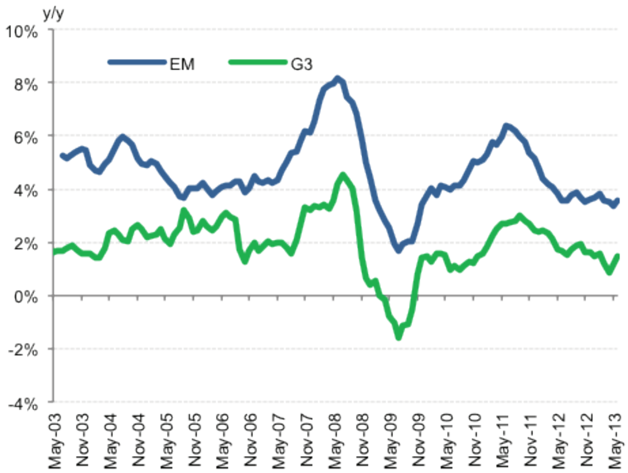
Figure 7: Commodity Prices



Sources: Bloomberg

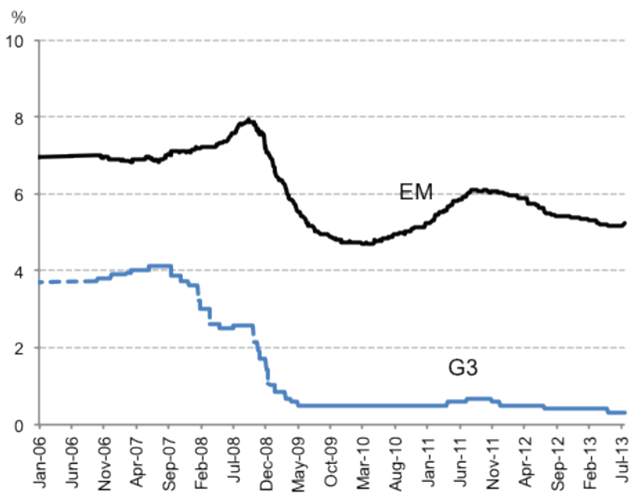
[2]Source: China Customs.

Figure 8: Global Inflation



Sources: Haver Analytics, Stone Harbor Investment Partners LP

Figure 9: Monetary Policy Rates



Sources: Bloomberg, Stone Harbor Investment Partners LP

expected a couple of years ago) has already been priced in as China's growth has slowed. In addition, the risk of a hard landing is lower now given the improvements in China's real estate market. And we believe a better DM outlook with lower tail risks compensates for downside risks in China. Agricultural and energy commodity markets are relatively less dependent on China in general and Chinese investment in particular. Demand should hold up better in an adverse scenario, especially demand for agricultural commodities.

Finally, it is important to note that many EMs are net importers and benefit from lower commodity prices. Thus, commodity prices are more of a risk for specific EM countries, rather than for the asset class as a whole.

Overall, we consider external conditions for EM growth to remain reasonably supportive. But domestic demand will have to be the key driver for EM growth given still muted growth in DMs. The key question is if EM domestic demand can stabilize or even pick up in the second half of the year. The monetary policy cycle has been an important factor behind the EM growth slowdown. Global inflation pressures picked up in 2010/2011 as the global economy rebounded from the financial crisis and commodity prices rose sharply (Figure 8). In response, many EM central banks tightened monetary policy (Figure 9). With the usual transmission lag of 4-6 quarters, EM economies slowed down in late 2011 and through 2012. The slowdown was further reinforced by weaker Eurozone growth as the Euro crisis intensified at the same time. Inflation responded with some lag and has been declining sharply since the peak in 2011. This allowed many EM central banks to gradually ease rates again, leaving current monetary conditions significantly more accommodative. While a few central banks have very recently started to raise rates, others are still cutting. As real activity follows monetary policy with a lag, we believe that accommodative monetary conditions will support gradually stronger internal

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demand in the second half of the year and into 2014 in countries that have eased policies over the past two years. In addition, we believe that the FX depreciation over the past two months will prove to be supportive of growth in EMs, while fiscal policy remains neutral in most countries.

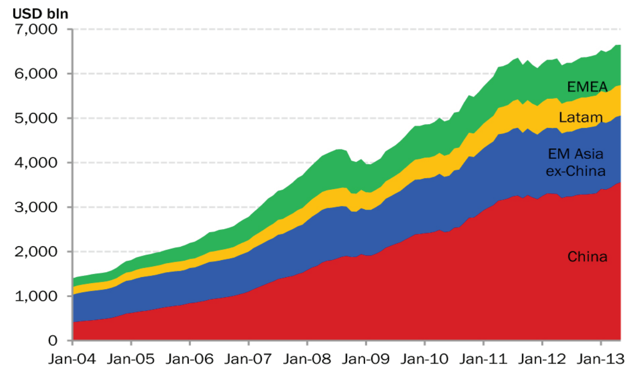
To summarize the growth outlook, we see somewhat supportive external demand for EMs, monetary easing has created room for improving domestic demand, and fiscal policy is broadly neutral. On that basis, we expect gradually rising growth rates in H2 2013 and into 2014. However, this will not be a rapid rebound. We believe potential growth has fallen in some large EMs compared to pre-crisis levels (e.g. China) but most EMs are currently growing below potential providing room for a gradual acceleration.

Global Liquidity and Capital Flows

This leaves us with another critical question for investors in EM debt: How vulnerable are EMs to the end of QE, rising rates in DMs, and potential fixed income portfolio outflows? The discussion of the Fed's tapering of QE has led many investors to reexamine their outlook for fixed income markets. One historical episode that is often referenced is the 1994 Fed rate hiking cycle. Long-term investors in EM will remember that it played a role in triggering the financial crisis in Mexico, which was the first in a series of EM financial crises over the following years (Asia 1997, Russia 1998). One common element in these crises has been the role of the sudden stop of capital flows to EM.

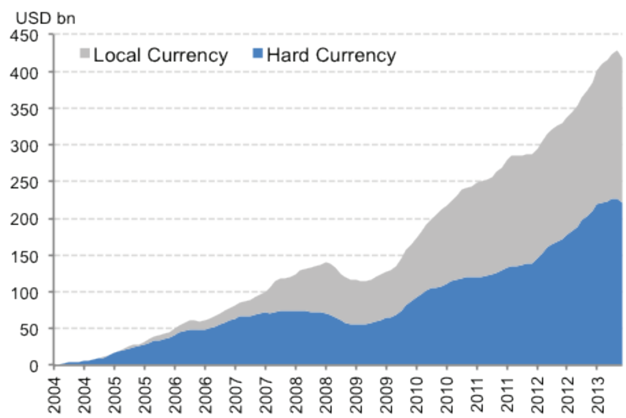
However, we believe that these episodes are a very poor blueprint of what might happen to EMs in the current environment. Most importantly, EM fundamentals are much stronger now. Most debt is denominated in local currency and has a much longer maturity profile (e.g., the average maturity of Mexico's public debt is now more than 14 times longer than

Figure 10: Emerging Market Reserves



Sources: Haver Analytics
Includes Argentina, Brazil, Chile, Colombia, Mexico, Venezuela, Hungary, Kazakhstan, Poland, Romania, Russia, South Africa, Turkey, China, India, Indonesia, Malaysia, Philippines, Korea, Taiwan, and Thailand.

Figure 11: Cumulative Inflows Into EM Fixed Income Since 2004



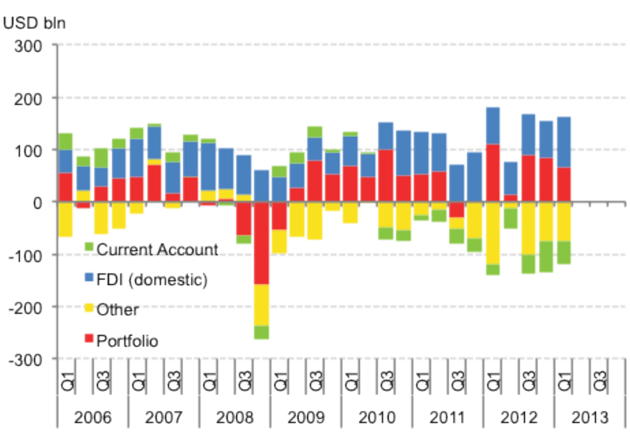
Sources: Bloomberg, Stone Harbor Investment Partners LP

in 1994). Inflation is low, domestic financial markets are less dollarized, and EM current accounts are in much better shape. Most EM financial, corporate, and public sector balance sheets can withstand currency depreciation, and central banks have high FX reserve levels that can be used to finance outflows—as happened during 2008/2009 (Figure 10).

Nevertheless, large capital outflows would significantly affect EM debt and currency markets, so it is important to analyze the vulnerabilities. Recent years have seen a steady flow into EM securities markets (Figure 11). And this flow has been increasingly directed at local currency debt. As a result, the share of foreign ownership in local debt markets has increased substantially and now represents a large share of total outstanding debt (Figure 4). Obviously, this leaves countries more vulnerable to outflows from foreign investors.

However, contrary to common perceptions, portfolio flows have not been the dominant source of financing for EMs. Figure 12 shows balance of payments flows to EMs (excluding China where portfolio flows are suppressed by capital controls). Both foreign direct investment (FDI) and portfolio flows in this chart refer to domestic investments by foreigners. In the case of portfolio flows this means net foreign buying of domestic debt and equity securities. Portfolio flows have been large but FDI inflows have been even larger and also more stable. Meanwhile, current accounts have moved into deficits but remain relatively small so they are more than fully financed by FDI flows and do not require net portfolio inflows (though this is not the case in all countries—some do rely on portfolio inflows to finance their current account deficits).

Figure 12: Capital Flows to EMs (ex-China)



Sources: Haver Analytics, Stone Harbor Investment Partners LP

The available fund flow data overstates the magnitude of total outflows from EM debt markets.

The next point to consider is that the available fund flow data overstates the magnitude of total outflows from EM debt markets. Figure 3 shows the sharp reversal of monthly flows in June reaching 4.7% of AUM of the funds covered. But the fund-flow data only covers dedicated EM open end mutual funds and ETFs and those only represent about 20% of the tradable EMD market[3]. The data has a large retail bias and retail flows tend to be driven by recent performance. We believe that much of the other 80% not covered in the fund-flow data tend to be more stable and more sensitive to valuations. Institutional flows have been large in the EMD space and tend to be more strategic. Allocations to EMD have been increased in recent years due to improving credit quality of EMD issuers (EMD is now a predominantly investment grade-rated asset class), the inclusion of more EMs in global bond indices (e.g. Mexico and South Africa in the WGBI), better access to some local EM debt markets (e.g. the ability to settle Russian local bonds through Euroclear, or the recent elimination of Brazil's IOF tax), and not least the rising weight of EMs in the global economy.

Valuations

Local currency yields (yield on the GBI-EM GD index) widened by about 120 bps since the beginning of May, pushing the yield pickup over 5y U.S. Treasuries back above to 500 bps despite the 70 bps move in 5y US

[3]See "Delving deeper into EM bond fund flows," by Sandeep Tharian, Standard Chartered, July 2013

treasuries (Figure 13). This is about 80 bps above the average level since inception of the GBI-EM in June 2005. However, just looking at the index yield hides important differentiation across countries, which has again created interesting opportunities. EM currencies have also adjusted significantly. Figure 14 shows an index of EM currencies (based on the GBI-EM GD index). Currencies have depreciated by an average of 17% since the peak in early May 2011, back to a level last seen in 2009, and many EM currencies now have reached attractive valuations.

Figure 13: Local Currency Yields and Spreads

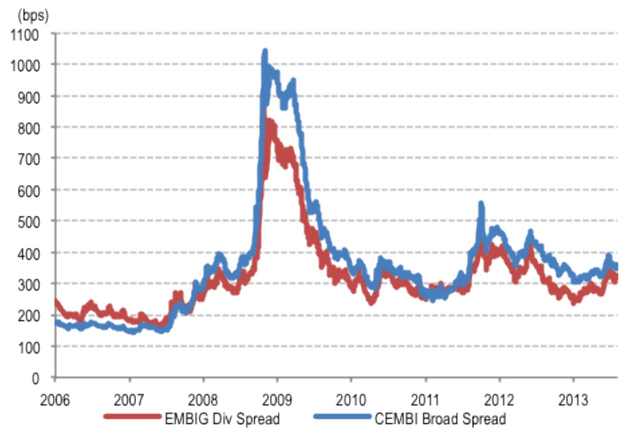
Sources: Bloomberg, Stone Harbor Investment Partners LP

Figure 14: EM Foreign Currency Spot Index

Sources: Bloomberg, J.P. Morgan, Stone Harbor Investment Partners LP

We expect opportunities to arise for investors able to identify countries with sound fundamentals.

Figure 15: Hard Currency Spreads



Sources: Bloomberg

We also see more willingness of EM central banks to intervene to prevent further currency weakness at the current FX levels. Moreover, the widened rate differential with DMs should help support EM currencies. In this environment we expect opportunities to arise for investors able to identify countries with sound fundamentals. On the external debt side we see a similar adjustment in valuations, both in sovereigns and corporates (Figure 15).

Spreads are now slightly wider than the average since mid-2009, again with significant differentiation across countries.

Conclusions

EM debt markets have been hit hard in the recent fixed income selloff driven by two key themes: concerns about a shift in global growth momentum away from EMs and towards DMs, and the perception that EMs are particularly vulnerable to tighter liquidity and rising rates in DMs. We believe both arguments are overdone. While the EM growth outlook has been revised down significantly, growth in EMs still exceeds DM growth by a very large margin. And we expect to see signs of stabilizing growth in EMs later this year. This view is driven by expectations of better DM growth which will benefit EMs and by the lagged effects of past monetary easing and more competitive exchange rates in EMs. We also believe that the dependence of EMs on QE-driven portfolio inflows is generally over-estimated. Portfolio inflows are not the main source of capital inflows and a substantial share of past portfolio inflows are strategic allocations that are far less volatile than measured retail flows would suggest. We find current valuations attractive relative to other fixed income asset classes that have not been hit as hard during the recent selloff. Yield differentials provide substantial pickup over U.S. Treasuries and other credit asset classes and thus offer a cushion against further rises in U.S. rates for investors able to see through short-term volatility. However, we expect these views to be only gradually reflected in market prices and, as a result, we believe differentiation between countries and sectors will be particularly important in this environment.

Should you have any questions regarding this paper please contact you relationship manager.

Steffen Reichold, PhD*, is chief economist for emerging markets. Prior to joining Stone Harbor in 2009, he served as an economist for the Asia and Pacific Department as well as an economist for policy development and review at the International Monetary Fund. He attained an M.Phil in Economics from Johann Wolfgang Goethe-Universität in Frankfurt, Germany and an MA and PhD in Economics from Columbia University.*

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