BlueBay
Asset Management

Seven questions for EM debt in 2019

Following a highly volatile 2018, we are approaching the next year with cautious optimism balanced by heightened risk awareness.

These seven questions highlight, in our view, key themes that will be important to monitor over the next year in order to strategically engage with the opportunities presented by the emerging market debt asset class.

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"Being cautious isn't the same as not taking prudent risks, and that is the disconnect we are observing in the market."

Polina Kurdyavko, Head of Emerging Markets

1. Turkey and Argentina nearly came to the brink this year. Which issuers could face heightened scrutiny from the markets in 2019?

Graham Stock, EM Senior Sovereign Strategist

The heightened scrutiny arose because Turkey and Argentina had very large external financing needs, which were harder to meet in an environment of US dollar strength and rising US interest rates. Their current account deficits are already adjusting rapidly, and Argentina has secured alternative funding from the IMF. There aren't many other major emerging markets (EM) that are likely to have large *twin deficits* in 2019, in part because floating currencies have adjusted to narrow current account deficits, particularly relative to the more extended levels that prevailed in the run-up to the taper tantrum in 2013.

There are still a few major countries that are running large fiscal deficits but have deep domestic debt markets – Brazil and South Africa stand out, although both could be vulnerable to outflows by foreign investors from their local markets. Among smaller markets, I worry that domestic political challenges could complicate financing for countries including Pakistan, Sri Lanka, Costa Rica, Lebanon, Zambia and Tunisia. The IMF might be an option for several of these, but discussions will require transparency with respect to existing debt levels, particularly if China is a major creditor. We will be watching developments around the hard currency debt of these countries for signs of stress.

2. Could you see the renminbi (CNY) pushing through 7, or even 8, against the US dollar (USD)?

Zhenbo Hou, EM Sovereign Strategist

At the time of writing, CNY is at 6.93 against USD. A mere 1% move could push the currency through the psychologically significant 7 CNY/USD barrier. In my view, though, this remains unlikely in the short term.

The latest ceasefire at the G20, albeit temporary, has meant the escalation of the trade war is now likely to be postponed at least until March. It's quite possible that the Chinese government would endeavour to use this window of opportunity to address some of the ongoing concerns from the US, such as forced technology transfers, intellectual property theft and unfair competitive advantages of SOEs. I will be cautiously monitoring these developments, but the currency should not move solely on trade-dispute sentiments during this period. However, beyond the deadline of 1 March, if trade tensions were to resurface, a 1% move in CNY cannot be ruled out.

For the currency to push through the '8' level against the US dollar, I believe a lot of factors will have to align against the Chinese economy. An even-stronger US dollar led by an even-larger monetary policy divergence between the Federal Reserve (Fed) and the PBOC, combined with meaningful reserve outflows, could push the currency weaker. However, given the tight capital controls and the lessons Chinese policymakers learnt during 2015, I would assign a rather low possibility that such a sharp depreciation would materialise.

Let's not forget though, there could be more upside surprises coming from China next year. In that scenario, we may very well see strength rather than weakness in the currency.

3. If sanctions on Russian sovereign bonds do materialise, how severe would the impact be?

Anthony Kettle, Senior Portfolio Manager

The possibility of sanctions to include Russian sovereign debt has been on the cards for some time, but hasn't yet materialised. With the conclusion of the US mid-term elections, however, I think Congress is set to issue further sanctions early in its new term – perhaps egged on by information stemming from the ongoing Mueller inquiry. This looks set to be a mixture of the 'DETER' and 'DAASKA' bills, but likely including a provision to sanction the primary issuance of Russian sovereign debt.

If this does occur, I think in the short-term Russian assets will be hit and spreads will further widen. Although potential sanctions have been well telegraphed, there will still be an element of forced selling from investors despite the underweight positioning, which may lead to further underperformance. However, in the long term, we shouldn't forget that Russia runs a relatively large current account surplus and sits on sizeable FX reserves. Russia itself is also capable of buying back substantial amounts of outstanding debt. Ultimately, I don't think Russia is likely to default under such circumstances.

However, the impact of sanctions on the banking sector could be more meaningful as, despite decent liquidity and low FX loan-to-deposit ratios, the hit to confidence would impact banks' access to funding.

Although not the base case, the more nuclear option would be increased sanctions on the banks themselves, or on companies with ownership structures tied to Russian oligarchs. As we have seen in the case of Rusal, this has the potential to create severe stress for the sanctioned entities.

4. Crisis appears to have abated somewhat in Turkey, for now. Could it make a comeback?

Timothy Ash, EM Senior Sovereign Strategist

If the buzzword of 2018 was 'overheating', I think the theme and challenge for policymakers in the year ahead will be countering the impacts of 'recession'. The recession should create a disinflationary environment, which could see inflation surprise on the downside, creating great value and opportunity in the local rates space. The risks here are that policymakers look to loosen policy too quickly, which would risk de-anchoring the exchange rate and plunging Turkey back into a vicious cycle. Local elections are due in March 2019 and there will inevitably be a temptation by the Erdogan administration to loosen fiscally. Here, the questions 'how much?' and 'when?' could become critically important. Recession will, in any event, have a negative impact on the banking sector, through rising non-performing loan levels. However, as long as the currency stays anchored and policy reasonably orthodox, these pressures are manageable when set against the still well-run banking sector and healthy sovereign balance sheet.

5. Gulf Cooperation Council (GCC) countries are going to be included in the JPMorgan hard currency index beginning 31 January. What does this mean for investors?

Jana Velebova, Portfolio Manager & Som Bhattacharya, Institutional Portfolio Manager

Index provider JPMorgan has recently updated the inclusion criteria for its hard currency index. Consequently, the JPMorgan EMBI Global Diversified Index – the benchmark most followed by US dollar EM debt investors – is to add five new GCC countries (Saudi Arabia, Bahrain, Qatar, UAE and Kuwait), significantly increasing its exposure to the Middle Eastern region. Starting in February 2019 and phased in over a nine-month period, the index will increase its weighting to these countries to up to 11%.

It is important to note that consultations have been ongoing for some time and many active managers have already incorporated some of these changes in anticipation of the index transformation. For example, an overweight to the GCC region, Qatar in particular, has been a strategic position for our portfolios throughout 2018, benefiting from spread compression of these highly rated credits. A further boost for these assets could come from allocations by passive managers next year. These fund structures, which have grown significantly in popularity, could result in an inflow of some USD2.8 billion to these credits over the inclusion period, based on JPMorgan estimates.

What does this mean for investors? The inclusion of nearly USD111 billion of new bonds should lead to greater geographical diversification and a slight improvement in the quality and liquidity of the index. The index spread overall is likely to tighten by an estimated 21bps as the weight of other, higher-yielding countries (Mexico, Indonesia and the Dominican Republic to name but a few) decreases simultaneously. The oil sensitivity of the index should also increase given the GCC's heavy reliance on oil revenues.

6. Which currencies could post double-digit positive returns next year? Which currencies are likely to post double-digit losses?

Gautam Kalani, EM FX Strategist/Portfolio Manager

It seems that the most difficult question has been reserved for me! It's a perilous task predicting currency moves, but I would say one of the candidates for a 10% appreciation is the Brazilian real (BRL). The currency's fundamental picture is robust, with a good balance of payments, low inflation and high real rates, which should support demand for Brazilian assets. Growth is also expected to pick-up to above 3% next year. If there is positive movement on the fiscal reform side, double-digit appreciation may be on the cards for the BRL.

At the other end of the spectrum, I feel the Indonesian rupiah (IDR) has much bleaker prospects. Indonesia remains a structurally poor story, with a large current account deficit and high imports due to infrastructure spending. There is dwindling investment in the energy sector and no foreign direct investment. Elections next year add further risk, especially given crowded positioning in the bond market.

That said, I would caution that currency moves have to be put in the right context against the overall environment for the asset class. If the US dollar continues to soften and we see a rally in the EM local currency sector as a whole, there may not be any currencies in negative territory at all.

7. Will 2019 be a re-run of 2018 for the EM universe?

Polina Kurdyavko, Head of Emerging Markets

At the beginning of this year, I expected 2018 to be a benign environment for EM, underpinned by low expected default rates in the asset class. While the default rate has been close to historical lows, the performance of EM risk assets has been disappointing. As a team, we underestimated the impact of tighter global liquidity and the shift in the volatility regime as we transition from a QE-to-QT paradigm. This meant that EM governments and companies had no room for error, and investors had no tolerance for any policy slippage, as the examples of Turkey and Argentina demonstrate. It is reasonable, therefore, that every investor should be doubly cautious on the asset class.

Yet being cautious isn't the same as not taking prudent risks, and that is the disconnect I am observing in the market. Investors are not just being cautious, they are avoiding the asset class altogether. At a time when the currencies are very cheap, wider spreads look attractive, and both US Treasuries and the US dollar remain anchored, I see widespread negative sentiment among investors. And therein lies an opportunity…

For starters, I think that markets are largely pricing in the worst possible outcome for China in terms of a trade spat with the US. I feel that we might be surprised positively, even though the base case remains heightened trade tensions.

Other positive surprises could come from three areas:

1. The US and China could agree on a tentative trade deal, China could unleash larger easing domestically and Chinese growth may end up withstanding the trade friction much better than the market anticipates.

2. Additionally, Barclays Global Aggregate indices will start to include Chinese local debt from 1 April 2019, reaching about 5.6% of index weight over the next two years. That is approximately three trillion dollars based on the index market capitalisation. Flows into Chinese bond markets could provide strong technical support. If Chinese assets stabilise, the commodity complex and EM could benefit. Even a lower oil price, as we have witnessed in November 2018, could prove positive for global growth, leading to somewhat lower inflation pressure.

3. Last but not least, we must not discount the possibility of a more dovish Fed.

As we approach the end of a turbulent year, the echoes of early 2016 resonate loud and clear. There too, we were approaching the year with a decidedly negative view on EM following 12 months of brutal price action, a number of concerns regarding the Chinese economy due to reserve outflow, and the plunge in oil prices. However, when the Fed turned dovish in February 2016, the market landscape changed dramatically. I certainly wouldn't want our team to miss that opportunity should the moment arise again.

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