**Invesco Fixed Income Investment Insights**

# Emerging markets debt outlook

Q2 2019

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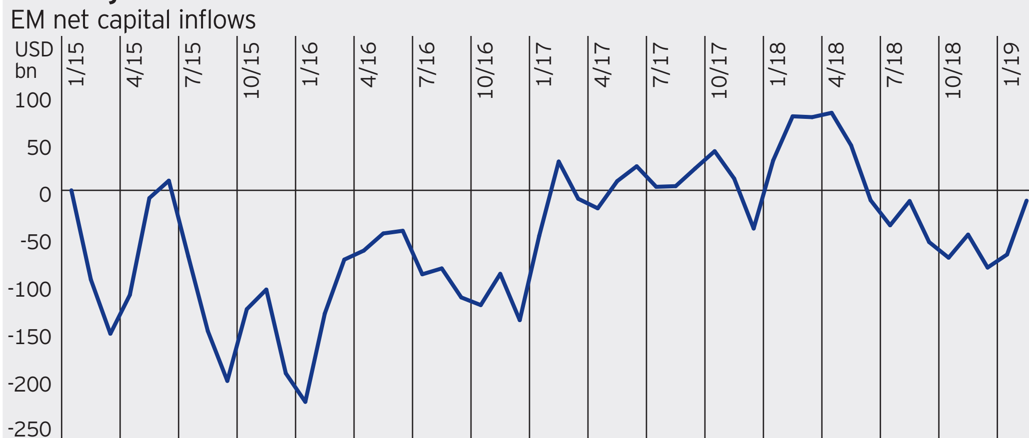
**Key takeaways**

- Emerging markets (EM) assets had a favorable first quarter likely driven by an improvement in external funding conditions and global central bank moves toward policy accommodation. EM credit outperformed the more volatile EM local debt over the period. (Figure 2)
- Going forward, concerns over global growth are expected to result in bouts of market volatility, though we favor increasing exposure to EM credit and local currency due to our expectations of continued global central bank policy accommodation and global growth stability into the second half of the year. We also believe idiosyncratic country developments will remain prominent.
- Risks to our view center around the potential for a sharper than anticipated downturn in global economic activity – particularly in the US, which would likely benefit the US dollar and tighten funding conditions for EM countries.

2019 started off strong for EM and broader risk markets, which recovered from the selloff in late 2018. We believe EM assets benefited from an improvement in external funding conditions, as data indicated a slowdown in US economic activity. This manifested in a weaker US dollar and lower core-market yields. However, concerns over global growth persisted over the quarter, leading to bouts of US dollar appreciation and weakness in EM currencies in February and early March. EM credit remained resilient, with credit spreads trading in a tight range over most of the quarter. We attribute this EM credit performance to strong demand for higher yielding fixed income assets, as core-market yields moved steadily lower. EM sovereign credit outperformed the EM fixed income complex with first quarter total returns of 7%, compared to 5.2% for EM corporate credit and 2.9% for EM local debt (in US dollar terms) over the period. (Figure 2)

**Figure 1: Net capital flows to EM rebounded strongly in January and February, retracing to 2015 levels**

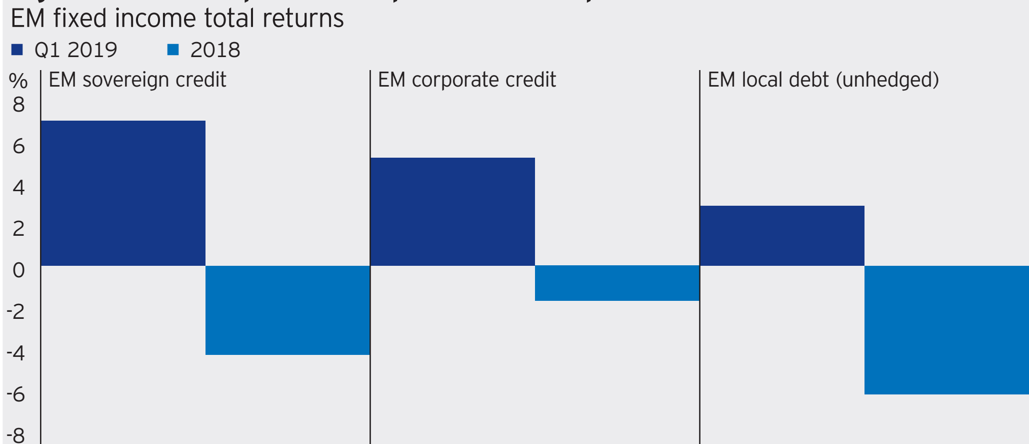
EM net capital inflows




Source: Invesco, Institute of International Finance (IIF), data from Jan. 1, 2015 to Feb. 1, 2019.

**Figure 2: Net flows provided scope for EM asset prices to recover in Q1**

EM fixed income total returns




Source: JP Morgan, data from Jan. 1, 2018 to March 31, 2019. EM sovereign credit is represented by the JP Morgan Emerging Markets Bond Index Global Diversified. EM corporate credit is represented by the JP Morgan Corporate Emerging Market Bond Index Broad Diversified. EM local debt is represented by the JP Morgan Government Bond Index-Emerging Markets Global Diversified.

**Base-case scenario Q2 2019: Ascending, with turbulence**

The improvement in financial conditions experienced since the first quarter provides scope, in our view, for further gains for EM assets in the second quarter. In addition to shifts toward policy accommodation by the European Central Bank (ECB), the People's Bank of China (PBoC) and most notably the US Federal Reserve (Fed), we expect EM assets to be supported by steady global growth convergence, with US growth slowing and the rest of the world stabilizing. These outcomes would likely manifest in a weaker US dollar, which should strengthen EM currencies and lead to compression in EM credit risk spreads and local bond yields. In fact, this backdrop is expected to lend support to EM assets over the balance of the year.

However, we anticipate higher volatility in the second quarter. We expect global growth to slow over the first half of the year, albeit towards trend, and clearer signs of stabilization to show in the second half. This outcome likely limits scope for material improvement in underlying EM macro fundamentals and creditworthiness. In the near term, economic data may prove to be volatile, adding uncertainty to the global growth outlook.

As of this writing, trade negotiations between China and the US are ongoing and could be an additional source of uncertainty. Additionally, the currently heavy election period across EM may raise policy uncertainty in a number of key countries, even if the election results themselves do not throw up big surprises. Therefore, we believe EM valuations will be bounded to the upside over the quarter. Underlying fundamental improvement may remain elusive, making asset performance increasingly reliant on demand for higher-yielding assets, thus limiting the scope for an immediate decline of EM credit risk premia.

As we highlighted in our previous outlook, capital flows to EM depend on prospects for not only interest rates but also growth, in the US and the rest of the world. Therefore, declining US interest rates, due to the recently more-dovish Fed, are likely not sufficient to drive capital towards EM if coupled with slowing global growth. As such, a backdrop of improved US dollar funding conditions but lingering uncertainties over global economic growth provide context for bouts of EM volatility over the quarter. That said, we will seek to use periods of volatility to add exposure to EM due to our expectations for global growth stabilization and a weakening US dollar in the second half of the year. These events may provide context for fundamental improvement and a decline in underlying credit risk premia

**Figure 3: Invesco Fixed Income (IFI) global macro and market assumptions, Q2 2019**

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|---|---|
| **Macro assumptions** | |
| **Growth** | In the US, we expect growth to moderate toward trend over the balance of 2019. Global growth is likely to bottom in first half, and we expect eurozone growth to stabilize and China growth to pick up in the second half due to monetary and fiscal policy stimulus. Global growth is likely to converge as US growth slows towards trend, and activity picks up in the rest of the world. An escalation or moderation in trade tensions would be the main risk to this view. |
| **Inflation** | Policy stimulus may serve to raise inflation expectations going forward, but we expect continued benign global inflation over the course of 2019. EM inflation is expected to continue to moderate over the balance of 2019 given the pass-through of previously weaker commodities and stable domestic currencies. |
| **Market assumptions** | |
| **US dollar** | Fundamentally, we continue to believe the US dollar remains overvalued on an equilibrium basis and further weakness over the next three to six months is increasingly likely as US growth moderates. This could be tempered by geopolitical event risks (such as Brexit, eurozone concerns or global trade tensions). |
| **Interest rates** | Easier financial conditions argue for higher core market yields, though this is tempered by ongoing growth related concerns. Our base case of a benign global inflation backdrop likely limits the extent to which core market yields could rise. |
| **Commodities** | Global supply corrections should continue where the demand backdrop has worsened. Continued OPEC coordination will likely provide a supportive backdrop and may result in range-bound oil prices. We are seeing a slight shortage of copper, with declining mine life and ore grade. A China credit crunch is the key risk here. |
| **Volatility** | Our base case of peak US growth would likely lead to rising financial market volatility as recession risks are priced in, even as markets take back the pricing in of Fed rate hikes in 2019. We expect volatility to subside as growth concerns are more fully priced in. |

## Risks to our view: pricing in of US recession

The most important risk to our view continues to be a material pricing in of recessionary risk in the US, which could support safe-haven assets, strengthening the US dollar and further weakening EM currencies. This would likely place additional funding pressure on EM issuers and lead to a downward repricing of EM assets. An escalation in trade tensions between the US and trading partners (China and Europe) could also lead to a material pricing in of global recessionary risks. Additionally, should China's efforts at economic stabilization falter, concerns over the pace of global economic growth may rise.

## IFI asset allocation: EM sovereign credit, currency preferred

Our asset allocation favors EM sovereign credit and local currency bonds, unhedged, over EM corporate credit (Figure 4). Since the February selloff in EM local currencies, valuations are attractive, in our view, especially given the prospect of steady US dollar weakening into the second half of the year. Local duration performed well in the first quarter, and with an expected backdrop of still-moderating EM inflation, we believe further compression in inflation risk premia is likely.

**Figure 4: Asset class outlook**

| | Q2 2019 view | Comment |
|---|---|---|
| **EM credit** | **Slight overweight** | Valuations are less compelling than previously, but market technicals remain strong and fundamentals are likely to improve as global growth stabilizes. |
| **EM currency** | **Overweight** | We expect EM currencies to resume favorable relative performance as global growth convergence sets in, particularly given attractive valuations relative to the US dollar. |
| **EM local interest rates** | **Slight overweight** | Favorable excess inflation risk premium in select local yield curves, with scope for inflation expectations to moderate on prospective currency stability. |

For illustrative purposes only.

In **EM credit**, we believe valuations are less compelling than last quarter, but market technicals continue to be supportive on favorable net supply and continued scope for crossover investors to reallocate to the asset class. Though broader credit market concerns may limit gains for EM credit over the course of 2019, we believe EM credit is a better value than US investment grade and US high yield on historical valuation grounds. The fundamental EM outlook of renewed growth impulse and earnings momentum is likely to improve in the second half of the year as funding conditions continue to ease. Therefore, we believe there is opportunity to capture value in EM credit as global growth moderation becomes fully priced in, allowing for steady spread compression and earning carry as 2019 progresses. We favor EM sovereign credit over corporate credit, largely on valuation grounds. We also prefer EM high yield over EM investment grade as we see better value in high yield and expect it to exhibit a more favorable response to improvements in global growth conditions as we head into the second half of the year.

We continue to believe that **EM currencies** stand to benefit from a pricing in of US growth moderation versus the rest of the world. As stated previously, this may weaken the US dollar and induce broader credit (and equity) volatility. In our view, EM currency valuations are not compelling on a broad, trade-weighted basis. This factor limits the case for benefits to net trade resulting from currency valuation, with the exception of Argentina and Turkey, a factor that boosted growth outcomes for many EM countries into 2016 after EM saw large currency adjustments between 2013 and 2015. That said, we believe there is value in select EM currencies on a narrower basis, relative to the US dollar. As stated in our previous outlook, the appreciation of many EM currencies versus the US dollar was considerable in January, arguing for allocating to EM currencies at better entry levels. EM currencies have since retreated versus the US dollar, providing compelling entry levels, in our view.

**EM local interest rates** have continued to compress along with core market yields, but we continue to see excess inflation risk premium in several EM local yield curves. Coupled with currency stability, this will likely lead to favorable gains for EM local assets in 2019, in contrast to the volatility experienced in 2018. Therefore, we believe EM local bonds, currency unhedged, may outperform EM credit over the course of 2019 as the US dollar retreats. We are cognizant of the downside risks to global growth. Even in the context of moderating US growth, this could lead to sharp bouts of volatility for EM, particularly in the local currency space. That said, reward versus risk has improved, and we will look for opportunities to continue to add exposure to EM local rates.

**Country selection: politics take center-stage**

We continue to expect ever-widening divergence in fundamental outcomes among countries, suggesting that idiosyncratic developments will likely be prominent drivers of overall EM performance in 2019.

Politics in EM will likely be a focus for markets over the quarter. For starters, the quarter will continue to be marked by several elections, including those scheduled in India and South Africa. Already this year, there have been elections in Nigeria, Thailand, Turkey and, Ukraine and most recently, Indonesia. Indonesia's elections met our expectations, and similarly, we do not expect a surprise in South Africa. Incumbent parties will likely secure victory and, depending on the strength of mandate, spur the ruling parties to push for deepened structural reform.

Recent election results have been a mixed bag. In the Ukraine, a run-off on April 21 for the Presidential election pits two market-friendly candidates against one another, and in Turkey local elections seem to have decreased support for the ruling Justice and Development Party, at least at the municipal level, with opposition victories in Ankara and Istanbul. This result, if upheld, may complicate domestic policymaking, which is already an area of concern among market participants as the country navigates an economic slowdown.

We continue to believe fiscal outcomes will be critical in assessing creditworthiness for many sovereigns. The fate of long-awaited social security reforms will be closely watched in Brazil. Markets anticipate eventual passage. So far, signals from the new government are encouraging but need backing from the Congress. The extent of state support for government-owned entities in Mexico and South Africa – PEMEX (the state-owned oil company) and ESKOM (the state-owned power utility), respectively – are also being closely monitored and may influence sovereign creditworthiness in the months ahead.[1]

1 PEMEX stands for Petróleos Mexicanos (Mexican Petroleum). ESKOM is the Electricity Supply Commission.

**Figure 5: Country views**

| | Macro assessment | Market view |
|---|---|---|
| **Argentina** | Early signs of improving economic activity has caused us to revise up our base case scenario of 2019 GDP growth from -2% to -1.5%. Agriculture and tourism sectors have outperformed. Fiscal results continue to reflect outperformance with an improved rollover rate of short-term paper. Risks to the outlook include managing inflation expectations amid an uncertain October election. | Sovereign credit is cheap relative to fundamentals and has over-priced the risk of a credit event, in our view. However, due to elections between March and November, spreads will likely remain choppy in the near term. The currency provides attractive carry relative to the US dollar, in our view, but will likely remain volatile due to continued domestic demand for US dollars. |
| **Brazil** | Brazil's recovery is expected to continue into 2019, albeit at lower levels. Downside risks to the outlook have moderated somewhat in recent weeks, following the recent dam incident, with inflation remaining subdued. The top issues will be the success of the presidents proposed social security reform, which could either place debt levels on a sustainable path or unravel recent macro stability. | Cheap valuations do not justify an overweight position, in our view, given risks around pension reform. We see value in select state-owned enterprises with attractive balance sheets and growth prospects. We like interest rate swap receivers due to the low inflation risks, while the currency is more attractive, in our view, given its recent adjustment. |
| **Indonesia** | We expect general elections in April to lead to policy continuity and allow for stable growth and moderate inflation. Central bank policy has focused on stimulating domestic credit growth while mitigating external risks. Reform efforts would enhance the medium-term growth outlook. | Sovereign credit is broadly fairly valued, in our view. We favor exposure to local currency government bonds and the Indonesian rupiah, largely on valuation grounds. |
| **Mexico** | The current administration is attempting to balance ambitious political and fiscal agendas. Risks to PEMEX are the most urgent. The company accounts for 1-2% of GDP. That could mean the difference between a fiscal deficit of 2.5% of GDP versus between 3.5% and 4.5%. The latter number could risk downgrades to Mexico's sovereign credit rating. | The market continues to trade on policy priorities versus political noise as most are convinced that President López Obrador will provide support to PEMEX, or risk the entity being downgraded to a high yield credit rating. We believe there is considerable room for credit to recover if policy turns more pragmatic. |
| **Russia** | Russia's macro is driven by three main considerations: bringing inflation to the 4% target, limiting oil price impacts and shielding itself from sanctions. 2019 is about how inflation behaves through the cycle. As the inflation outlook improves, the central bank may resume its rate-cutting cycle, possibly starting mid-year. Growth remains weak in the 1.5-2% range. Announced infrastructure projects are unlikely to have a near-term impact. | Western sanctions appear to be moving in the direction of punishing future behavior rather than past deeds and possibly away from broad sectoral measures toward more targeted ones. As a result, sanctions on primary sovereign debt have been delayed, possibly for a long time. Uncertainty nonetheless remains. Absent sanctions, we expect local bonds to drift tighter as the ruble remains broadly stable. Hard currency sovereign external debt remains attractive, on valuation grounds. |

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| **South Africa** | South Africa continues to struggle for economic growth. As a result, a revenue shortfall and ESKOM support make fiscal consolidation difficult. The central bank is close to anchoring inflation expectations, and risks to the realized inflation outlook of around 4-4.5% are balanced. The central bank can cut the policy rate over the next year. Going forward, the focus will be on the reform agenda, especially regarding ESKOM, following national elections in May, where the ruling African National Congress (ANC) is expected to perform well. | Moody's kept South Africa's investment grade rating unchanged with a stable outlook, giving the ANC and President Ramaphosa a chance to address reforms following the May 8 national elections. We will be monitoring reform announcements and implementation. Local duration in South Africa looks attractive and hard currency sovereign bonds look fairly valued at this stage. The rand also appears attractive, following a selloff on the back of the ESKOM/Moody's concerns in the first quarter. |
| **Turkey** | The economy is moving in the direction of a hard landing, while inflation remains high. Repeated confidence shocks from policy errors and the domestic and external credit crunch may only deepen the contraction in the coming quarters. Fiscal balances are a concern given downside risks to growth and increase in non-interest expenditure. On the positive side, the current account deficit corrected sharply on domestic demand weakness, but the overall balance of payments gap remains large. | Ongoing domestic and external political uncertainty and policy errors will likely weigh on the market. Current valuations do not compensate for the risks in local currency bonds, in our view. Hard currency sovereign bond valuations appear more interesting, but performance will likely hinge on the policy mix going forward. Tighter monetary policy and targeted fiscal loosening to support a comprehensive banking sector clean-up would likely change the trend, but we do not expect a wholesale revamp of policy making at this point. |

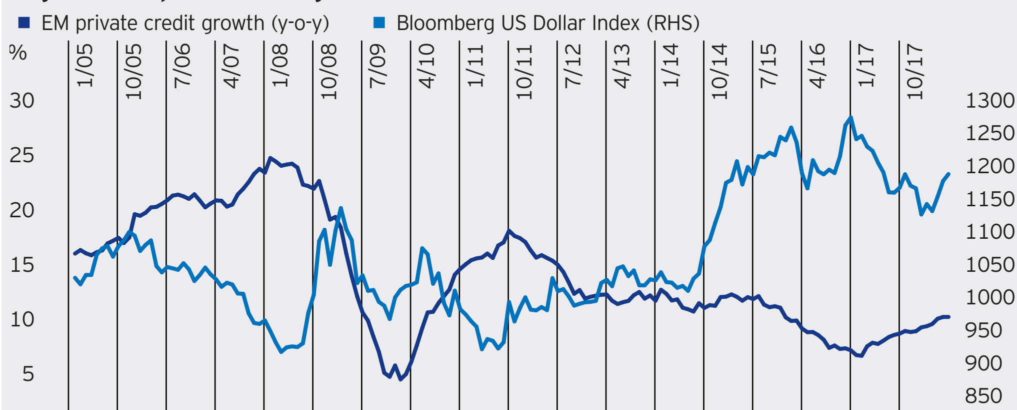
Source: Invesco, April 17, 2019.

## Focus on US dollar

We have found a close empirical relationship between movements in the US dollar and EM asset prices. To a large extent, movements in the trade-weighted US dollar typically reflect changes in funding conditions for the US dollar, which impact EM issuers' ability to refinance in US dollars. On balance, the weaker the US dollar, the more abundant US dollar liquidity is and, therefore, the easier it is to refinance, and vice-versa. The ability to refinance is a function of both the supply of US dollars and the cost of borrowing dollars that are available. If the cost of borrowing is low (historically speaking) but US dollars are scarce, the ability for an EM issuer to refinance would still be challenged.

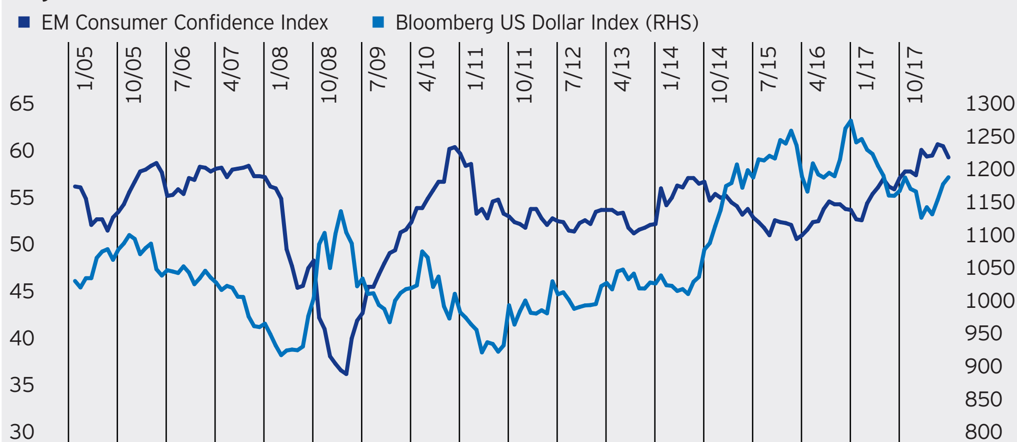
A stronger US dollar is also often associated with lower commodity prices, which tend to adversely impact many EM countries' terms of trade. But the relationship goes even deeper. In our view, movements in the US dollar also impact domestic funding conditions for EM countries. This is a result of the impact of US dollar movements on domestic balance sheets and the impact that a weaker domestic currency has on consumer sentiment. We observe a strong relationship between movements in the US dollar and both EM consumer sentiment and EM domestic credit growth.

**Figure 6: EM private credit growth versus US dollar**




Source: Invesco, Bloomberg L.P., MacroBond, data from Jan. 31, 2005 to June 29, 2018

**Figure 7: EM consumer confidence versus US dollar**



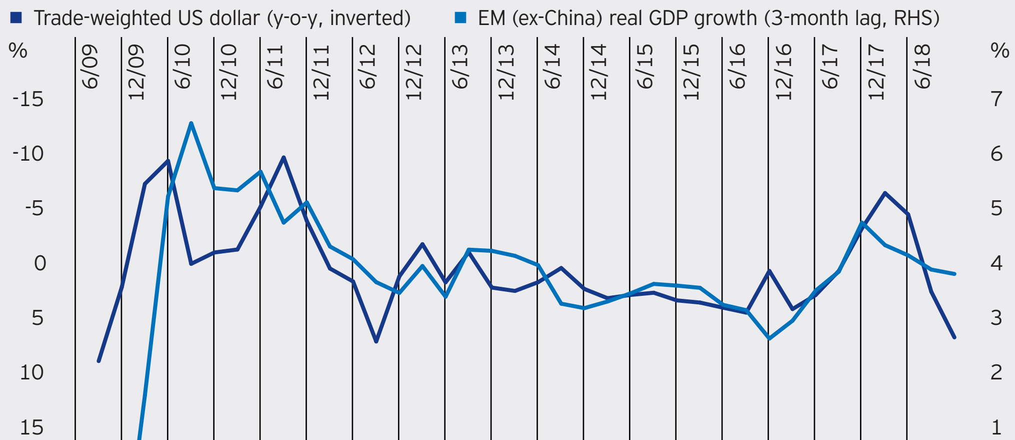

Source: Invesco, Bloomberg L.P., MacroBond, data from Jan. 31, 2005 to June 29, 2018.

To the extent that a domestic currency weakens and the US dollar strengthens, the resulting balance sheet impairment likely inhibits the incentive to lend domestically, thus curtailing domestic credit growth and softening aggregate demand. Furthermore, a weaker domestic currency is associated with capital outflow, which if met by the sale of US dollars by the central bank to help stabilize the domestic currency, reduces the monetary base via a decline in net foreign assets. This also has the effect of dampening domestic credit growth. Moreover, with less robust domestic institutions and central banks that may be challenged for credibility, arguably in several EM countries the domestic currency serves as an important nominal anchor. A weaker domestic currency is associated with a higher pass-through to inflation, which can lower consumption.

We estimate that every 1% appreciation in the trade-weighted US dollar leads to a 0.3% decline in EM real gross domestic product (GDP) growth, year-over-year (Figure 8). Thus, a rising US dollar has a measurably adverse impact on EM macroeconomic conditions. By the same token, a declining US dollar has a measurably beneficial impact on EM macroeconomic conditions. We find these dynamics take time to manifest, with US dollar moves impacting EM economic activity after an approximate three-month lag.

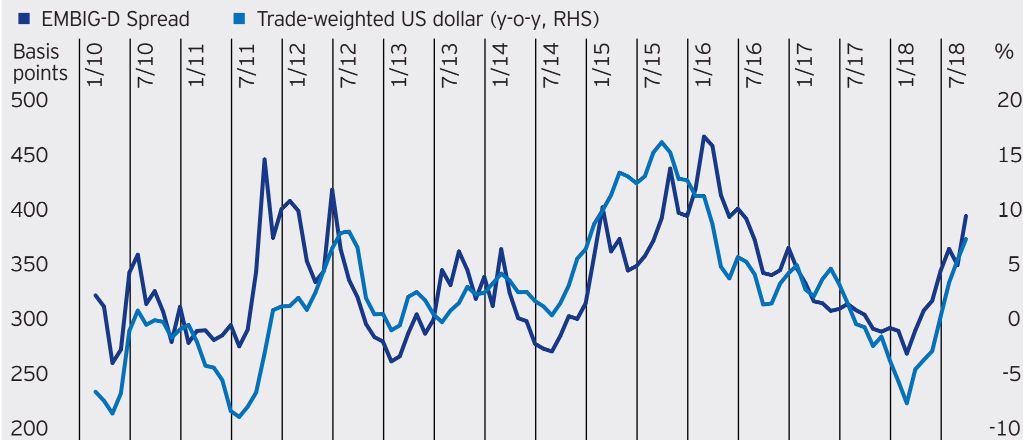
Weaker domestic currencies and a stronger US dollar are also associated with wider credit spreads as the two reflect a rise in risk premium. We find that the same 1% appreciation in the US trade-weighted dollar is associated with a 10 basis point rise in EM credit spreads, year-over-year, all else equal (Figure 9). We believe this US dollar move implies an adverse impact on commodities prices – especially oil – and an adverse impact on domestic economic activity via a decline in credit growth.

**Figure 8: EM (ex-China) real GDP growth versus trade-weighted US dollar**




Source: Invesco, Bloomberg L.P., MacroBond, data from June 30, 2009 to Sept. 30, 2018.

**Figure 9: EMBI Global Diversified spread versus trade-weighted US dollar**




Source: Invesco, Bloomberg L.P., data from Jan. 29, 2010 to July 31, 2018. EMBIG-D is the JP Morgan Emerging Markets Bond Index Global Diversified.

Other factors, such as China's economic prospects and policies, also influence and drive EM macroeconomic conditions and asset performance. We do not intend to ignore other factors in this discussion, rather we aim to emphasize the importance of US dollar dynamics and the importance this has on our EM outlook. Note, for example, how recent appreciation of the US dollar has been associated with a steady moderation in EM real GDP growth (Figure 8).

The bottom line is that prospects for a rebound in EM economic activity and continued favorable asset performance depend considerably on the fate of the US dollar, in our view. The prospect of global growth convergence and an accommodative Fed imply that the US dollar could weaken – supporting our more constructive view on EM going in to the second half of the year.

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