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INVESTMENT MANAGEMENT

Emerging Markets: Don't Judge a Book by its Aggregates

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A recent Bloomberg article[1] quoting economist Carmen Reinhart has raised concerns about the health of emerging market economies. In the following piece, Morgan Stanley Investment Management's Emerging Market Debt team addresses some of her statements as well as other popular misconceptions about emerging markets.

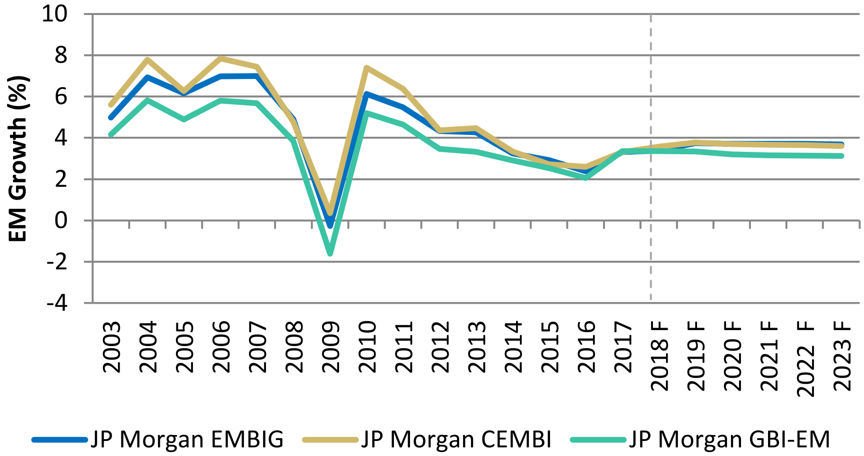
"The overall shape they [emerging markets (EM) economies] are in has a lot more cracks now than it did five years ago and certainly at the time of the global financial crisis,"

We do not have access to the data sources underlying Carmen Reinhart's statement but we suspect that the deterioration she perceives in EM is partly due to the large weight of the Chinese economy in EM. As has been widely discussed, China is undergoing a rebalancing toward lower investment and more consumption, inevitably associated with lower growth and reduced current account surpluses, and that has a sizable influence on EM aggregate data.

However, the share of China in EM fixed income's investable universe is much smaller than its representation in EM's gross domestic product (GDP) (China currently represents 0% of the JP Morgan GBI-EM index, 9% of the JP Morgan EMBIG and 8% of the JP Morgan CEMBI versus the 31% share of the Chinese economy in EM's aggregate GDP). Therefore, and without downplaying the importance of China in the global economy, we recalculate EM aggregates for key macroeconomic variables (using the International Monetary Fund's (IMF's) World Economic Outlook (WEO) data) according to the country's shares on each of our three EM debt benchmarks. We believe that these adjusted EM metrics provide a better gauge of investment-relevant EM macroeconomic performance.

[1] Harvard's Reinhart Says Emerging Markets Worse Than '08 Crisis, Bloomberg, May 16, 2018.

Display 1: Growth lower than in the past, but more sustainable and trending up.



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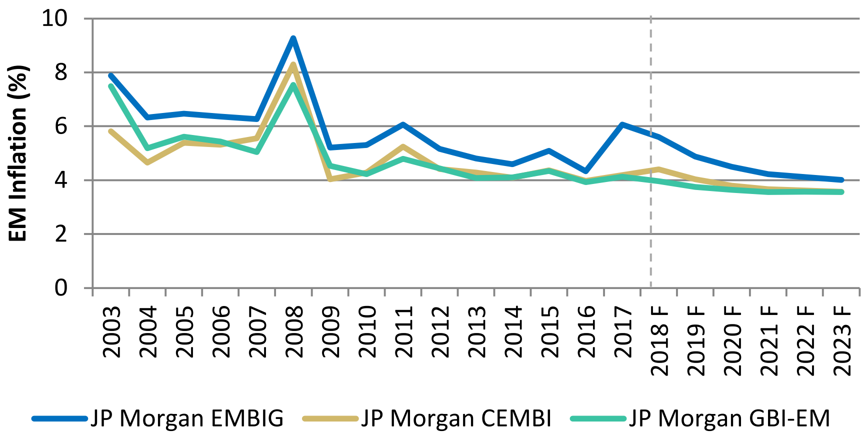
As we see in Display 1, these adjusted EM aggregates show that growth is currently lower than in 2013 and in 2008. However, unlike those two episodes where growth was on a downtrend, EM growth is now picking up and expected to accelerate to levels of 4% in the years ahead. Stronger global growth this time is also more widespread across regions, with three quarters of the world economies posting positive growth. This is in contrast to previous years where the U.S. was the main engine of global growth, amid stagnant eurozone and Japanese economies. A more synchronized global growth bodes well for a sustainable and lengthy global recovery which could be used by EM economies to accumulate buffers, reign in excessive leverage and improve policy frameworks.

Finally, it is debatable to use 2008 as a relevant benchmark, particularly with respect to growth. EM economies in 2008 were entering the early phase of the global financial crisis (GFC), and as such, activity was still running at a clearly unsustainable pace, as evidenced by the collapse in EM growth and inflation the following year.

Display 2: Inflation unambiguously better than in 2008 or 2013.



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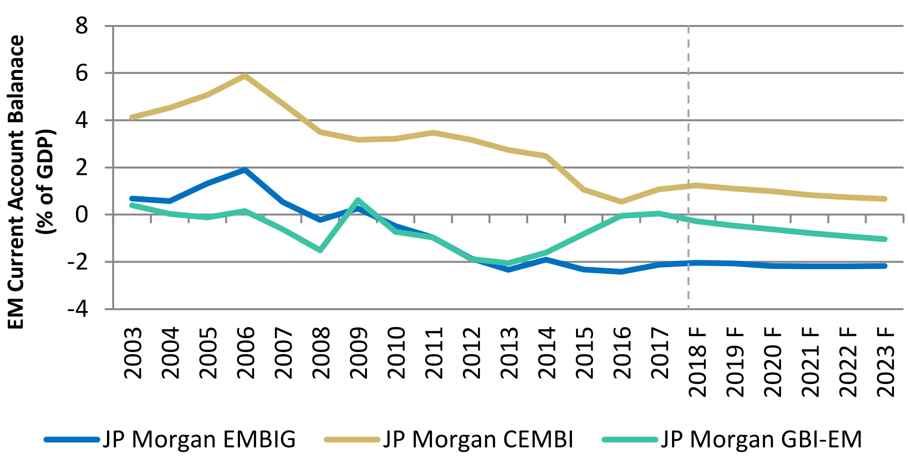
In terms of inflation, EM economies are in much better shape than five years ago or at the time of the global financial crisis. Better policy frameworks (namely, inflation-targeting regimes) in large economies, such as Russia and Brazil, favorable supply shocks (food) and appreciating currencies have aided in the steady EM disinflationary process. A decline in inflation rates, in turn, allowed EM economies to ease monetary policy and stimulate growth. The spike in 2017 EM inflation is due to the influence of Argentina, which together with outlier Venezuela (not included in our data), feature the largest inflation rates in the EM universe. The data compiled using JP Morgan GBI-EM or JP Morgan CEMBI index weights (where Argentina has a lower contribution) show a much clearer disinflation trend, which, in our view, is expected to continue in the years ahead.

Display 3: Current account deficits are very manageable in the aggregate.



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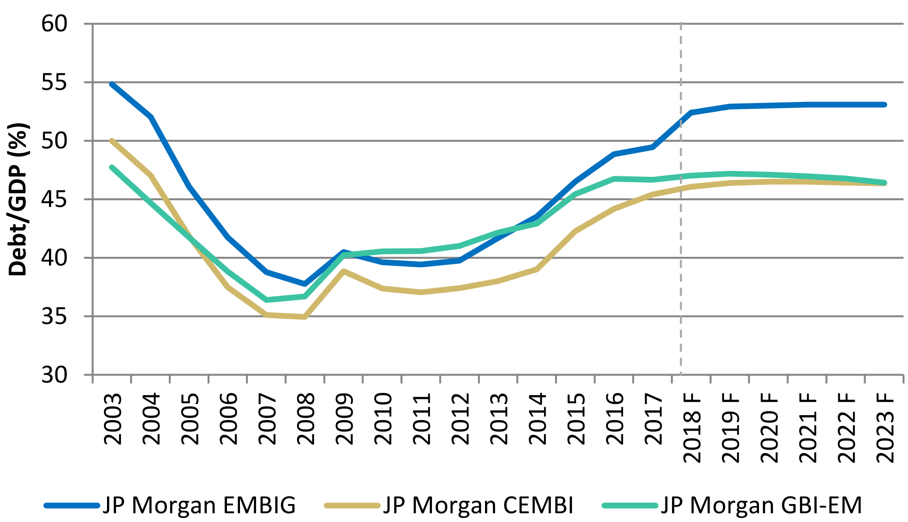
External balances, measured as current account (CA) surplus as a percentage of GDP, do not look particularly worrisome in the aggregate. If anything, they have either improved or remained stable at very manageable levels since the taper tantrum. In fact, the aggregate EM external balance reverted back to balance last year versus a CA deficit of 2% back in 2013. This reflects successful rebalancing efforts by key EM countries such as Indonesia, Brazil and South Africa, which were part of the "Fragile Five" group of externally vulnerable countries.

A final point on CA deficits has to do with economic theory. Intertemporal models of the CA[2] predict CA deficits in growing economies: the optimal behavior of countries that are expected to have higher income in the future and have access to capital markets is to borrow today to increase present consumption and repay the loans in the future when they are richer. That is, they run a CA deficit in the present and use expected future CA surplus to repay the borrowing. Therefore, we believe there is nothing inherently wrong about running a temporary CA deficit, especially if the borrowing is used for investment in productive activities that would likely boost production in the future and, thus improve the ability to repay past loans.

Display 4: Public debt is higher, but its structure has definitely improved.



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When it comes to public debt, Reinhart's quote appears to be backed up by the data. Regardless of the weights we employ, public debt/GDP ratios are undeniably higher than pre-GFC and the taper tantrum, and the IMF continues to see some further upside before they stabilize by 2020. Interestingly, EM debt appears to stabilize at

[2] Obstfeld, M. and K. Rogoff, Foundations of International Macroeconomics, MIT Press, 1996.

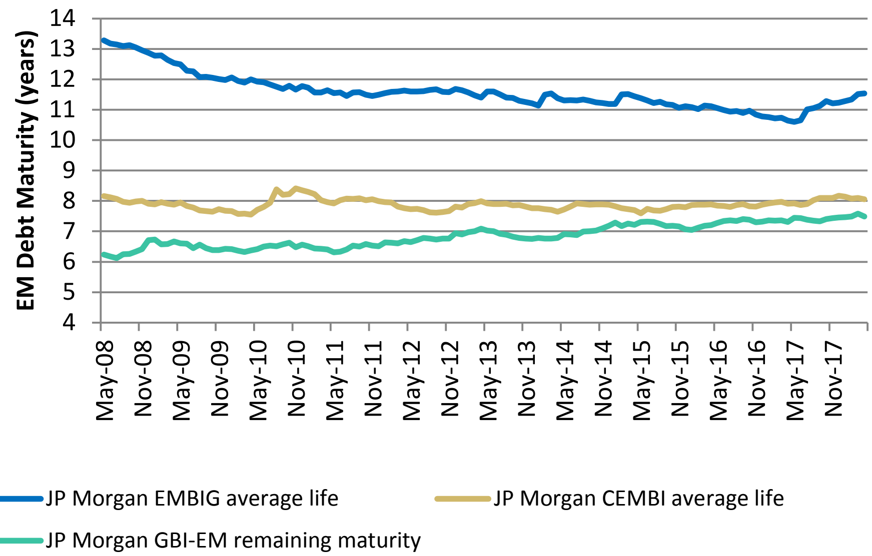
levels below the 60%-of-GDP level threshold (identified by Reinhart and Rogoff[3]) above which debt starts to weigh on GDP growth.

However, besides indebtedness levels, the currency breakdown of public debt also matters. EM economies have been increasingly successful at overcoming the "original sin"[4] (that is, a country's inability to borrow in its own currency), as evidenced by the rapid growth of domestic debt markets in many EM economies. Access to domestic currency financing makes EM economies less vulnerable to external shocks (and/or a stronger dollar), and it also reduces the need for costly measures to mitigate vulnerabilities derived from the original sin (for example, foreign currency (FX) borrowing hedged by holding a large stock of reserves is an expensive negative-carry strategy, or restrictions on the capital account to ensure debt repayments are also onerous).

Finally, though it is true that public debt levels are higher than in the past, it is also true that the financing costs (both for sovereigns in hard currency and domestic currency, and corporates) have declined, particularly versus 2008. In addition, the average maturity structure of EM debt appears sound hovering around 12 years when using JP Morgan EMBIG index weights and between 7 and 8 years for the JP Morgan GBI-EM and CEMBI indices, respectively. Longer average debt maturities tend to mitigate rollover concerns and allow countries to lock in low rates for an extended period of time. Furthermore, in the case of the JP Morgan EMBIG index's weighted average maturity, the declining trend we saw in the data until last year largely reflects the impact of new issuers into the index, as these countries tend to issue in small size and with shorter tenors. However, systemically important EM economies, such as Mexico or South Africa, for example, have considerably lengthened their external debt maturity structures over the last ten years. Moreover, as we stated in the previous paragraph, EM countries are now more reliant on local currency financing, and they are able to tap this funding source at increasingly longer tenors, leading to more robust public debt profiles.

[3] Reinhart, C. and K. Rogoff, Growth in a time of debt, NBER, 2010.
[4] Eichengreen, B., Hausmann R., and U. Panizza, Original Sin: The Pain, the Mystery, and the Road to Redemption, 2002.

Display 5: Lengthy debt maturity structures can mitigate rollover risks.



The indices are provided for illustrative purposes only and are not meant to depict the characteristics of a specific investment. Source: JP Morgan. Data as of 4/30/2018.

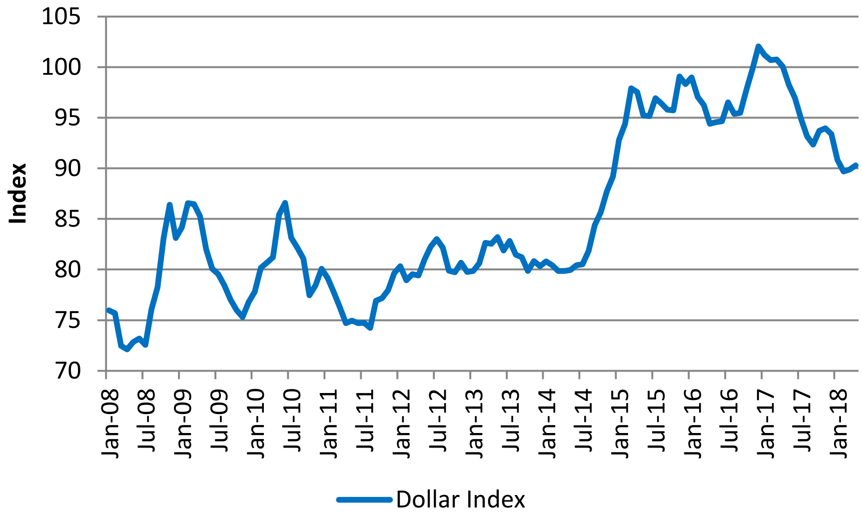
"The inflation story is really about interest rates. It's not the inflation per se. It's what it implies for the reaction of U.S. monetary policy. The bigger the tightening, the more the anticipation that rates will go higher and higher and that has multiplier consequences for emerging markets."

Not really. The U.S. Federal Open Market Committee (FOMC) has been raising rates since 2015, while the European Central Bank (ECB) and Bank of Japan (BoJ) policy stances have been comparatively easy. During this time, there has not been a negative "multiplier consequence" for EM in aggregate. Rather, many EM currencies have actually appreciated versus the U.S. dollar, as external debt spreads tightened, and several EM central banks cut policy rates as inflation collapsed.

"If the U.S. policy becomes tighter and there's no comparable follow-through by other advanced economies, the dollar strengthens. There you have a double-whammy. Also importantly is what it does to their currency: More than two-thirds of emerging-market debt is dollar-denominated, now even more because of borrowing from China."

First, it remains to be seen whether the current bout of dollar strength is permanent or not. U.S. fiscal easing applied this late in the business cycle, with unemployment at all-time lows and no obvious signs of economic slack, may exacerbate macroeconomic imbalances and worsen the CA deficit down the line, thus requiring a weaker USD in the future. Furthermore, the USD appears to us to be overvalued on a trade-weighted basis, leaving reduced scope for further significant appreciation.

Display 6: Current bout of U.S. dollar strength: permanent or temporary?



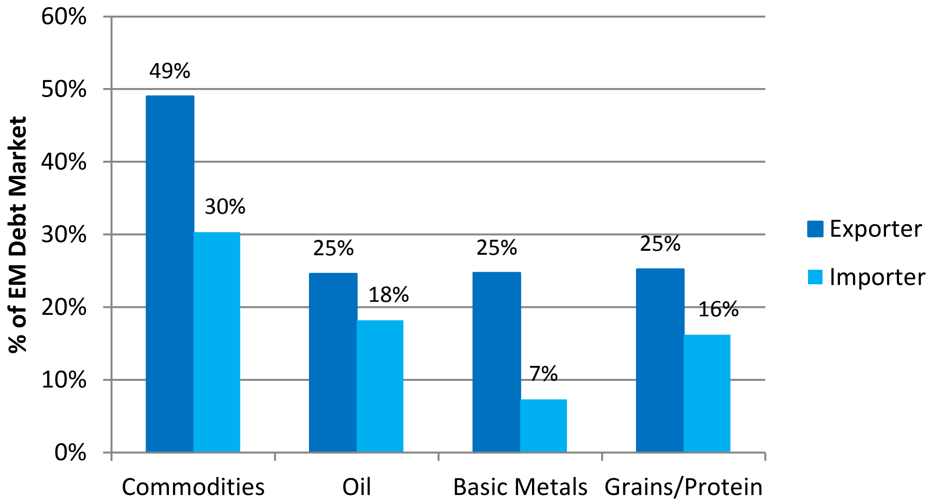
Source: Bloomberg, MSIM. Data as of 4/30/2018.

In addition, the source of USD strength is important. If it is due to a spike in global risk aversion triggering a flight-to-quality, we believe it will unambiguously hurt EM economies and EM assets (weaker currency, higher spreads and yields). However, if USD strength is driven by relatively stronger growth prospects in the largest economy in the world, positive spillover effects to EM economies can mitigate the negative implications of a stronger dollar. Rising U.S. Treasury yields and well-supported commodity prices (oil hovering around $80 per barrel) as we are witnessing today provide strong evidence in favor of the second hypothesis.

Moreover, higher oil prices have dissimilar effects across countries, creating winners and losers even within the EM world. In fact, as the chart below shows, oil exporters comprise a sizable portion of the JP Morgan EMBIG index (25%), slightly larger than the share of oil importers[5]. Furthermore, this heterogeneity extends to other group of commodities, such as basic metals and grains/proteins, underscoring the need for a more nuanced analysis of EM economies.

[5] JP Morgan. Introducing the EMBI Commodity Sector Indices. July 2017. Commodity exporters/importers are defined as countries where commodity exports are at least 10% of total exports/imports.

Display 7: Not all EM countries are created equal. Diverse exposure to commodities has created winners and losers even within EM.



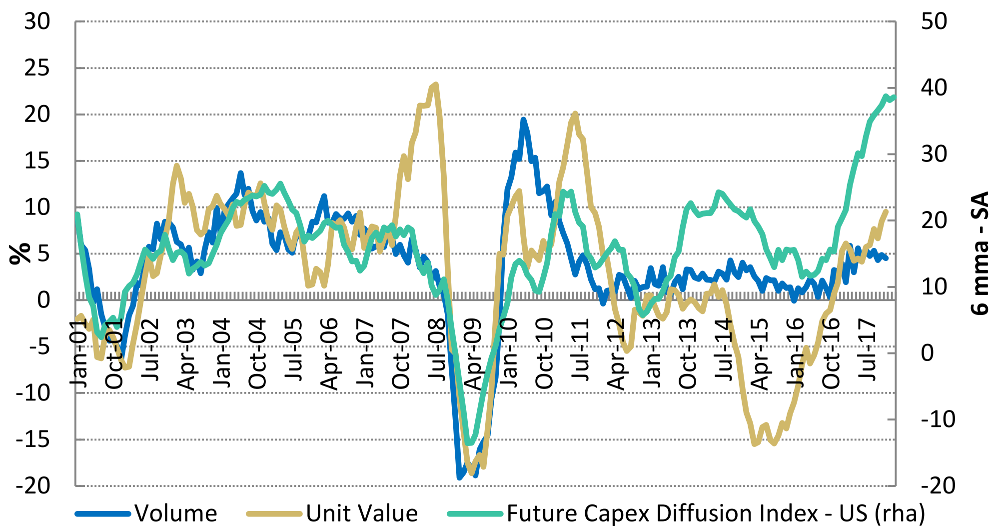
Source: JP Morgan. Data as of 7/20/2017.

Finally, due to the invoice effect, the USD has historically been negatively correlated with commodity prices. However, this doesn't seem to be the case now: this latest episode of dollar strength (4% stronger) starting a month ago has taken place amid higher oil price (+11% for Brent, 8% for WTI) and agriculture prices (for example: wheat +7%, corn 4%).

On a related note, the tax reform passed last year by the U.S. Congress provides strong incentives for business investment spending (via full expensing of new investments, lower marginal corporate tax rates, and a move toward a territorial tax system). IMF research[6] shows that business investment in the developed world is positively correlated with global trade. Thus, several small open economies in the EM world should benefit from the U.S. tax system overhaul.

[6] IMF, World Economic Outlook, Chapter 2: Global Trade: What's behind the Slowdown?, October 2016.

Display 8: Global trade and developed market investment spending picking up.



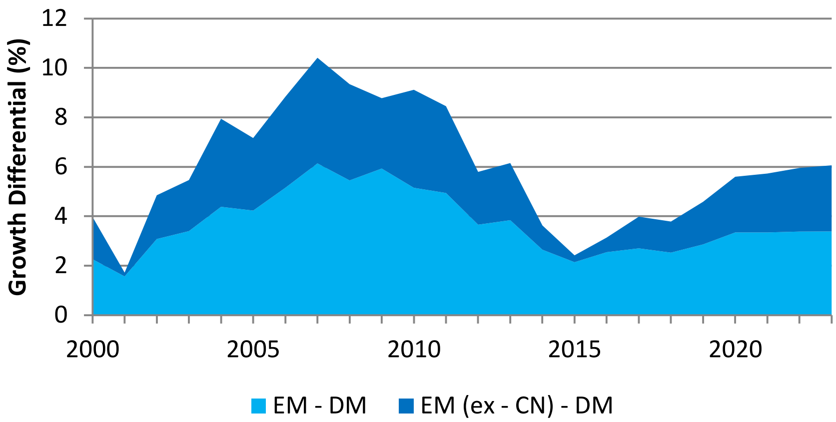
Source: Netherlands Bureau for Economic Policy Analysis. Data as of 12/31/2017.

"If you look at capital flows to EM, it's also closely connected to volatility. It's not just that interest rates were low but volatility was non-existent for a while. Volatility is on the rise and neither of those bode well for inflows to EM."

It's not only volatility, but volatility-adjusted expected returns. Following the recent EM selloff, valuations now look more compelling both on external debt and local currency debt. Furthermore, currencies have depreciated about 7% in the last three months, from still fair to slightly cheap levels (except for currencies affected by idiosyncratic risks such as the Mexican peso, which looks very cheap versus fundamentals). In addition, flows into EM are positively correlated to growth differentials between EM and developed markets[7], and if anything, we expect that spread to play in favor of EM economies in the years ahead, as large EM economies like India, Brazil and Russia rebound from past slowdowns/recessions.

[7] Hannan, S., The drivers of capital flows in Emerging Markets Post Global Financial Crisis, IMF Working Paper 17/52, March 10, 2017.

Display 9: Growth differentials bode well for portfolio inflows into EM



Source: IMF WEO. Data as of April 2018.

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The **JP Morgan Government Bond Index-Emerging Markets (GBI-EM) Index** is a comprehensive global local emerging markets index that consists of regularly traded, liquid fixed-rate, domestic currency government bonds and includes only the countries which give access to their capital market to foreign investors (excludes China, India). The index is market capitalization weighted, with a cap of 10% to any one country.

The **JPM Corporate Emerging Markets Bond Index-Broad Diversified (CEMBI)** is a global, liquid corporate emerging markets benchmark that tracks U.S. dollar denominated corporate bonds issued by emerging markets entities. The returns shown prior to September 28, 2015 are that of the JP Morgan Emerging Markets Bond Global Index, the fund's benchmark prior to the merger.

The **JPM Emerging Markets Bond Index Global (EMBGI)** tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

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