

As good as it gets?

Emerging markets outlook appears healthy despite possible pressure on some deficit countries

BY MARC VAN DE WALLE

AS 2017 progresses, the outlook for most emerging markets (EM) continues to look healthy, buoyed by the pick-up in global trade and commodity prices, as well as the domestic policy improvements of the past few years. Even when compared to four years ago, when we saw a sharp adverse reaction to then-Fed chair Ben Bernanke's "taper tantrum", the situation looks much more solid. We can expect pressure on some deficit countries as US interest rates continue to rise, and the cost of attracting capital becomes more expensive, but this does not seem likely to become a systemic problem.

Fed factor: We continue to expect the Fed to raise interest rates another two times this year and four times in 2018. The US economy is at full employment and inflation is only marginally below the 2 per cent target, so the Fed should be uncomfortable with interest rates around 2 per cent below neutral levels. We could see hikes in June and September, followed by a pause in December when the Fed outlines its strategy for cutting back the size of its balance sheet.

Different story for commodities: The fear that lower commodity prices could hurt EM exporters was diffused when the March dip in oil prices caused merely a hiccup in EM debt markets. The lack of reaction has to do with the cause of the selloff. Unlike 2014-2015, when a commodity price plunge was led by demand destruction, the recent

downward pressure on oil prices was prompted by a mild supply shock. Should oil prices fall further, the extent of the selloff is expected to be contained by solid world demand, especially as global growth improves.

First cracks in EM facade appearing: Thus far this year the EM credit market has shrugged off potential Fed policy tightening and the likely end of the long-run secular bull market. Technical factors have been and continue to remain solid. Inflows into the asset class have continued unabated and demand for new issues remains robust.

On the fundamental side, defaults have been virtually non-existent and lower than consensus expectations. However, after reaching post-Lehman tights in early March, spreads have widened by 15-20 basis points (bps). While hardly an alarm, it should remind investors that returns are likely going to be much more modest for the remaining eight months as compared to the first four months.

Continue to favour Latin America: We continue to maintain our now fairly long-standing bias towards Latin America and then Central & Eastern Europe, the Middle East and Africa (CEEMEA) versus Asia. Both Argentina and Brazil possess positive macroeconomic stories with potentially positive GDP (gross domestic

product) growth in Brazil after several years in negative territory.

Mexico appears much more stable as US President

Donald Trump's policies appear much more pragmatic than Candidate Trump's campaign pledges. Furthermore, with tight valuations the higher yield (carry) in the region will become increasingly important. Meanwhile, Asia remains the lowest-yielding region in a yield focused world, and faces a potential technical headwind from heavy issuance from China.

CEEMEA is our next preferred region: Within CEEMEA we would maintain an overweight with a much more nuanced approach than in Latin America. Although we remain constructive on Russia from a macroeconomic and political viewpoint, valuations appear

full. The Middle East is also no longer particularly compelling from a pure valuation perspective as the rise and stability in oil prices have lifted regional bond prices. Conversely, yields in Africa and Turkey appear much more compelling, although we would remain very selective in our approach towards these regions.

Barbell strategy

Maintain barbell strategy in overall portfolio: From a portfolio perspective we would advocate a barbell strategy. We would balance short-dated High Yield credits with longer-dated (from 10-30 year) Investment Grade credit names (particularly BBB and cross-over). This enables investors to take advantage of the potential for ongoing US Treasury curve flattening (the 10-30 US Treasury has flattened over 20 bps thus far this year), steep 10-30 corporate spreads and the strong technical bid from insurance companies which we believe will anchor 30-year, EM corporate bonds.

Overweight on EM high yield and market weight EM investment grade: Valuations on both High Yield and Investment Grade currently are near post-Lehman tights. However, in a reflationary environment with higher rates, we believe that coupon/carry will become an increasingly important component of total return.

With its higher corporate spread component, High Yield should be somewhat better insulated from the adverse impact of higher rates. Furthermore, High Yield is better positioned to benefit from a thus far substantial decline in overall default rates in 2017 versus 2016.

Potential distressed opportunities in private market: While the general outlook for credit remains benign with low signs of default, on the non-public or private market side, we believe that there could be attractive distressed credit opportunities. The increase in the size of leveraged credit in private markets would likely put some of the over-levered companies through some distress, for example in the refinancing of maturing debt, especially as banks tighten their lending (due to various regulatory reasons such as Basel III) and as interest rate rises.

Some of these companies could be good companies, but with poor balance sheets which would present the opportunities for alternatives to banks such as private debt or private equity players. Experienced private equity managers, who do more than serve as a lender or a distressed debt trader, could provide the operational expertise of managing and turning these companies around.

We believe that investing in such distressed credit opportunities adds diversification or a contrarian strategy to a client's investment portfolio. Hence, earlier this year, Bank of Singapore offered an exclusive private equity fund opportunity with a top-tier manager, which invests in distressed debt and special situations. **W**

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