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The delightful debt dynamics of emerging markets

September 2014

Boys and girls dream in their sleep of being given toy cars, dolls and superhero figures, whilst the finance ministers of developed markets might dream of low debt ratios, sustained by the labours of millions of productive young people. Boys and girls are, unfortunately, more likely to see their dreams come true – most finance ministers of the world's rich and ageing nations are, in this respect, more powerless than little children.

Aspirations of a light debt burden are, however, well within the bounds of reality for the finance ministers of many emerging markets. Mexico has a debt to gross domestic product ratio of only 37 percent, for example. Indonesia's is only 26 percent.

These low debt numbers are supported by highly favourable demographics. The average age of a German is 46. The average age of a Brazilian is 31; in Mexico it is only 27. Many emerging markets have, in other words, far fewer older people, whose pensions and healthcare must be funded from the state's coffers.

When it comes to year-to-year fiscal deficits, some emerging market nations have not been as diligent in reducing imbalances as investors in their debt would like. However, several have made good progress or are poised to do so. In Indonesia Joko Widodo, the new president, plans to trim the deficit by increasing tax revenue and phasing out the country's enormously expensive fuel subsidies. The United Arab Emirates trumps them all, with a fiscal surplus of 10 percent – something beyond even the wildest fantasies of developed market finance ministers.

The numbers show, therefore, that the risk of default of many emerging market countries is low.

This is not much to cheer about if the value of emerging market debt is going to be eroded by currency depreciation. In fact, however, emerging market currencies are far more stable than before. This is because the bad old days of runaway inflation have passed – and central banks are determined to ensure those days do not return. Brazil's central bank, for example, has ratcheted up its interest rate to 11 percent to keep inflation at bay, despite pressure to keep borrowing costs low to boost growth. In response to this inflation-fighting zeal, the Brazilian real has stabilised, and recently even strengthened slightly. Mexico's central bank has an inflation target of 3 percent – extremely tight for a fast-growth economy, but reassuringly so for its debt holders.

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Speaking more broadly, the entrenchment of sane and sensible monetary and fiscal policy has prompted a great increase in the number of emerging market countries with investment-grade credit ratings.

There are, certainly, some emerging market countries which are not serious enough about fighting inflation or keeping debt within reasonable limits, but enough countries have embraced this to make investment in emerging market debt worthwhile.

If there are no rational arguments to avoid emerging market debt, there is, surely, always irrationality to fall back on.

But even irrationality is, like nostalgia, not what it used to be. Russian debt and the rouble have, despite the long-term promise of Russian bonds, both been hit by the dispute with Ukraine. Other emerging market bonds and currencies have not, however, reacted much to this conflict. Nor have they, either, to the Argentine government's recent default on some of its bonds. Emerging market debt no longer falls in value across the board just because investors feel that a crisis in one particular emerging market should, in some vague way they cannot fathom, prompt a crisis in others.

Given that the case for investment in emerging market debt is strong, the next question is: how?

The best strategy is a blended one – putting money in local and hard-currency debt, and in corporate as well as sovereign bonds. This broad approach gives investors a much wider range of candidates, than if they insisted merely on dollar or euro-denominated sovereign debt. By increasing diversification, this stance also maximises the return for a given level of risk. Investors should not be put off by the fact that much emerging market corporate debt is issued by companies which they might not have heard of. This lack of name recognition is, rather, one of the reasons to invest – it generates bargains. For the same credit rating from international agencies, investors can earn higher yields for emerging than for developed market businesses.

Sceptics argue that putting money in emerging market debt is, like having a picnic in a hurricane, a textbook case of the right idea at the wrong time. They suggest that yields will rise and currency values will plunge in emerging markets when the US Federal Reserve begins raising interest rates, as American money returns home in reaction to monetary tightening.

It is, however, hard to see those emerging markets with current account surpluses, such as the United Arab Emirates or Venezuela, suffering financial crises as US rates tighten – they do not need foreign capital. Many other emerging markets, including Mexico, have perfectly sustainable current account deficits: small and largely based on stable foreign direct investment. Others with wide deficits could be more vulnerable.

This divergence in the fortunes and financial positions of emerging market countries underlines the need for intensive research to differentiate between good and bad investments. Some investors may want to put money in emerging market bonds as a convenient risk-on, risk-off play on global economic conditions. Emerging market bonds do not, however, work in this way, because they are not monolithic. Emerging markets are, in fact, more diverse than developed markets. This is, for macro risk-on, risk-off investors, an inconvenient truth.

If they are so diverse, should we avoid talking about emerging markets at all, in the same way that we no longer talk about the Third World, or the civilised world, or the Warsaw Pact countries?

Emerging markets do, in the end, have one extremely important characteristic in common. They are, most of the time, high-growth. This rapid economic expansion will continue to support their debt dynamics – increasing the tax revenue on which bonds' creditworthiness is ultimately based. Time is on their side.

Brett Diment,
Head of Emerging Market and Sovereign Debt

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