Outlook 2016: Emerging Markets Debt Absolute Return

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After yet another challenging year for emerging market debt characterised by a collapse in currencies and a spike in a number of local bond yields, attractive investment opportunities have started to appear.

The recent bear market has led to an improvement in valuations and to some positive policy inflexions, with Argentina becoming the latest country to embrace change.

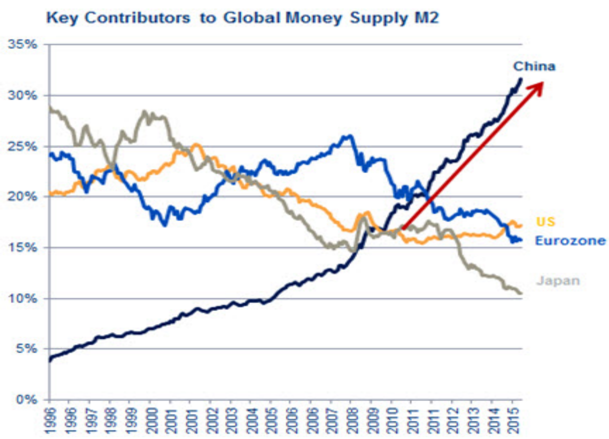
However, the pockets of value in emerging markets (EM) should currently be seized with caution, flexibility and a particular focus on liquid assets. While local currency bonds in countries such as Indonesia, India, Russia, South Africa, Argentina and Brazil could perform reasonably well in 2016, other sectors of the market should be avoided. This is particularly the case in EM hard currency debt (i.e. US dollar-denominated sovereign and corporates) which remains the next shoe to drop for the EM re-pricing cycle to be complete.

Outlook clouded by Fed actions and China growth

The US Federal Reserve (Fed) finally initiated its monetary tightening cycle in December. This decision to hike rates was widely anticipated and is long overdue. The key concern now is that this slow process of monetary normalisation may have started too late and in an already unfavourable environment of depressed global credit conditions, persistent deflationary pressures and decelerating global growth.

While the Fed has started to tighten, other key central banks (European Central Bank, Bank of Japan and People's Bank of China) are continuing to pursue activist monetary policies but with very limited impact so far on global economic activity. Judging by the continued elevated level of capital flight from China, we are particularly concerned that the recent measures implemented by Chinese authorities appear to be failing to restore confidence in the country's economic outlook. Therefore, China's deflating credit system remains the most serious structural threat to global financial stability. The chart below highlights China's contribution to global money supply. This shows the extent to which China's credit cycle remains dangerously overextended.

Figure 1: China's credit cycle remains dangerously overextended

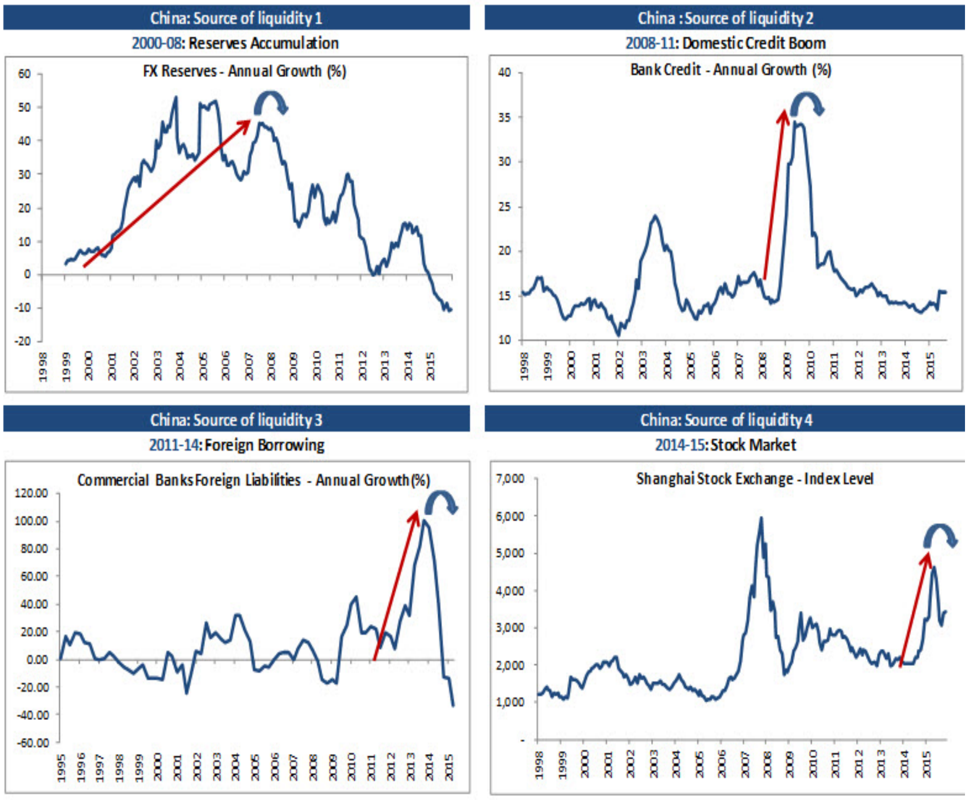


Source: Thomson DataStream; Schroders; Bloomberg – October 2015

We returned from our recent research trip to China with the view that some encouraging policy initiatives were starting to be taken in order to reduce inventories and excess capacity in some sectors of the economy. However, these initiatives are still at the early stages and remain underwhelming, especially given the extent of the credit problems which continue to accumulate. Total credit outstanding remains unsustainably high and is on the verge of exceeding 300% of GDP.

Following the market panic of August 2015, various monetary measures, financial repression, moral suasion and the tightening of capital controls led to some stabilisation in China's financial markets. This period of relief appears to be ending given the current renewed pressures on the renminbi and on the stockmarket. The charts below highlight how China exhausted, in succession, key sources of financial liquidity during the course of the last few years as well as the current difficulties faced in restarting these engines of credit creation.

Figure 2: Chinese sources of liquidity



Data sources: Thomson Datastream, Bloomberg, Schroders - December 2015

The deflationary pressures emanating from China, as highlighted by the charts above, have become widely publicised and a number of EM local debt markets have already cheapened accordingly. Key EM countries have also now adjusted, to some extent, to the new reality of collapsing demand from China.

While EM local debt has become cheap...

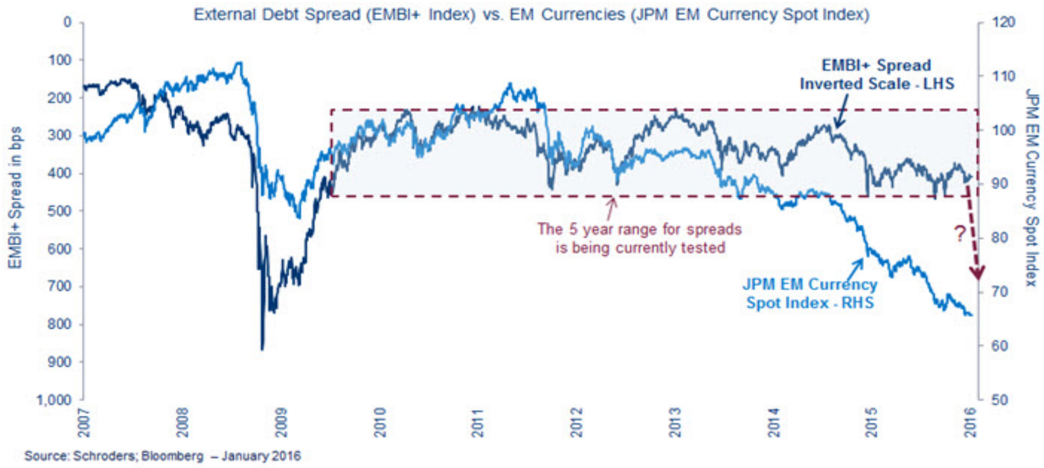
Currencies served as a shock absorber during the bear market of the last three years. These devaluations allowed most EM countries to improve competitiveness and to restore balance of payments sustainability. This can be seen in the improvements in EM trade balances (albeit mostly as a result so far of contracting imports) and in the lower reliance on short-term foreign capital

Therefore, the recent collapse in EM currencies has probably gone too far. We believe that major EM countries have witnessed in succession what appears to be the final “overshooting” phase of their currency devaluation cycle. This was the case of India in 2013, Russia in 2014, Brazil, Turkey and South Africa at different points in time during 2015. We cannot yet say with strong conviction that this apparent domino effect is complete, especially given the risk of further dislocations which could result from the potential failure of Chinese authorities to contain the persistent pressures on the renminbi. However, the compelling valuations of selected currencies and the high yields on offer in a number of local bonds could lead these markets to generate US dollar returns in excess of 10% in the next 12 to 18 months.

…External debt remains the next shoe to drop

In contrast, expected returns in EM external debt are likely to disappoint. The challenging growth backdrop highlighted above and the deteriorating credit quality has yet to be fully reflected in the level of EM sovereign and corporate spreads, which remain far too tight (see chart below). A low exposure to EM external debt remains warranted, especially given the illiquid nature of this sector and the potential acceleration in outflows.

Figure 3: EM sovereign and corporate credits: the next shoe to drop?



Selected opportunities for 2016

Asia: India and Indonesia still offer the most attractive investment opportunities

India and Indonesia have not yet fully seen the rewards from their better policy frameworks, ameliorated external accounts and lower inflation. We retain small exposures to Indian and Indonesian local bonds (unhedged) and stand ready to increase these positions when they show more resilience to external shocks.

Valuations in most other Asian fixed income and currency markets remain unappealing and do not compensate investors against the downside risks emanating from China's economic woes. The main exception is the Malaysian ringgit, which has already experienced a substantial devaluation.

Emerging Europe Middle East and Africa (EEMEA): Russia and South Africa are our top 2016 picks

The recent Russian ruble weakness is challenging the outlook for additional monetary easing. Given the large gains already achieved by Russian local government bonds in 2015, it is now warranted to take some profits with the view to reinstate this position at higher yield levels in Q1 2016. Russia is experiencing a protracted economic downturn as a result of the collapse in oil prices. Authorities have shown a strong commitment to maintaining a tight fiscal policy and the central bank is likely to regain its ability to cut rates during the course of 2016.

In South Africa, the recent shocking mismanagement of the appointment of a new Finance Minister by President Zuma has been severely punished by the markets with a spike in bond yields and a currency collapse. These moves appear to be overdone, especially given the recent attempts of the leadership to regain some credibility. We are looking for opportunities to re-establish exposure to South African local rates (which recently paid 10.5% on 10-year bonds).

Latin America: Mexico and Chile remain strong; elsewhere, crisis is starting to bring change

Given the continued strong macroeconomic fundamentals of Mexico and Chile, the recent depreciation of their currencies appears overdone. This weakness should be used to accumulate positions in exchange rates of Mexico and Chile.

Recent elections in Argentina and Venezuela highlight that the region is moving away from left-wing populism. While Venezuela is still at the early stages of accomplishing this transition, change has already occurred in Argentina following the recent election of President Macri who is in the process of introducing market friendly reforms. This opening up and the recently announced devaluation of the peso should provide attractive multi-year investment opportunities in Argentina's local bond market.

Brazilian local bonds and currency have started to show some resilience in the face of escalating negative news headlines. This shows that the attractive valuations on offer (10-year government bond yield at 16.4%) are now providing an important cushion. We maintain a small core exposure to Brazilian local bonds and we stand ready to increase the position to significantly higher levels in 2016. We expect inflationary pressures to show signs of abating during the year. Political uncertainties, which remain another key concern for investors in Brazil, have already been discounted to a large degree.

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