EM Outlook 2018

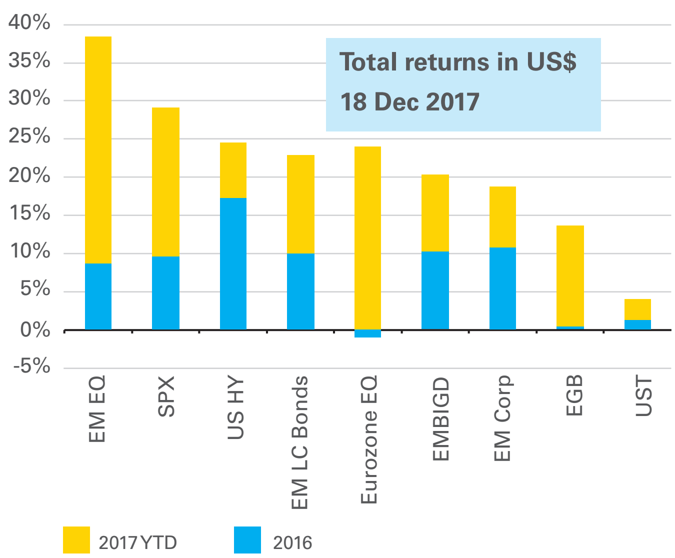
What challenges do emerging market bonds face after two strong years?

Simon Quijano-Evans is an emerging markets strategist at LGIM, focused on allocation and macro strategies for the EM fixed income funds

With the European Central Bank and US Federal Reserve set to be in tightening mode throughout 2018, emerging market (EM) assets have a tough act to beat. 2017 will go down positively in history as the 'big surprise' for most emerging markets pundits, with flows into the asset class well above expectations after an already strong 2016. And, all this happened in spite of clear challenges from an imminent shift in US domestic and foreign policies (Figure 1).

Looking into 2018, US policies will remain one of the biggest focal points for EM assets, even if it has felt like 'waiting for Godot'. EM local currency assets will closely watch the effects of US tax cuts, given possible US-dollar strengthening pressure from a more 'introvert' US economic policy. EM hard currency assets, on the other hand, will be focused on a more 'extrovert' US foreign policy, as partly reflected in the 'political spread' (or 'p-spread') that separates countries like Mexico, South Korea and the GCC (Gulf Cooperation Council) from their EM peers (Figure 2 overleaf).

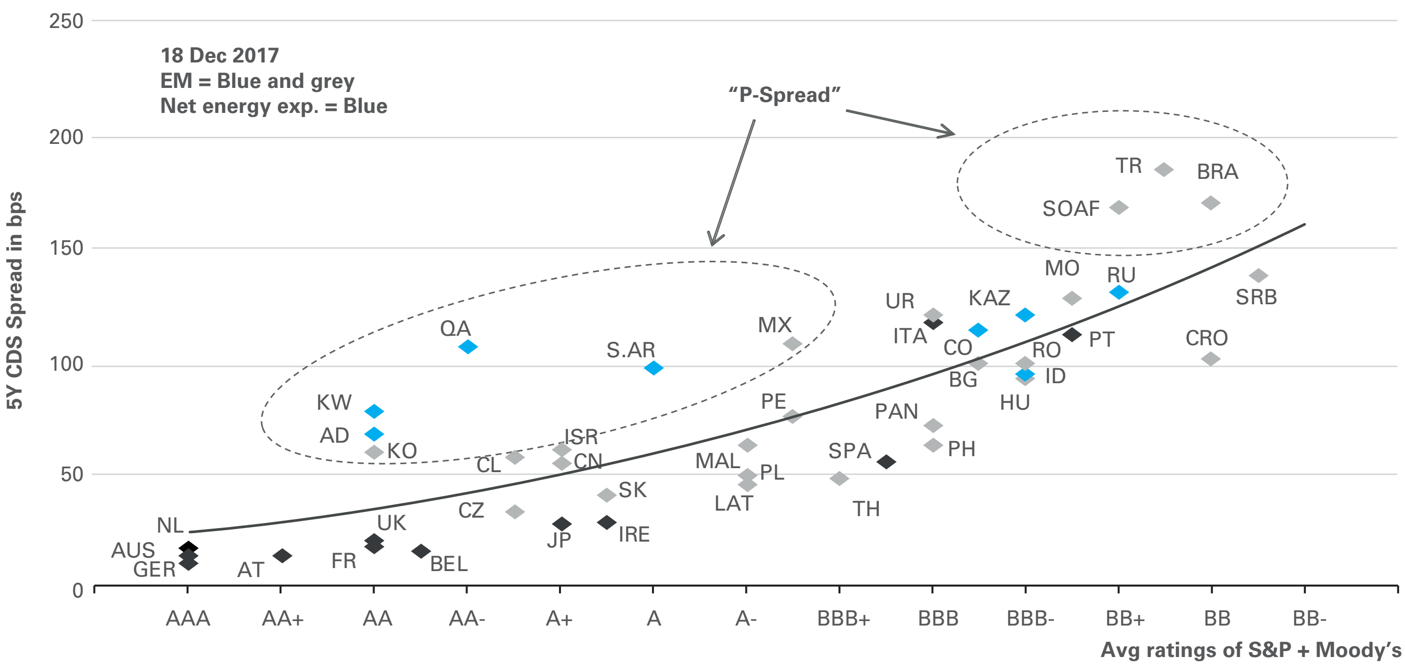
Figure 1. Strong returns for emerging markets in 2016 and 2017



Source: Bloomberg

Legal & General INVESTMENT MANAGEMENT

Figure 2. The 'P-Spread' or political spread that differentiates the EM bond space



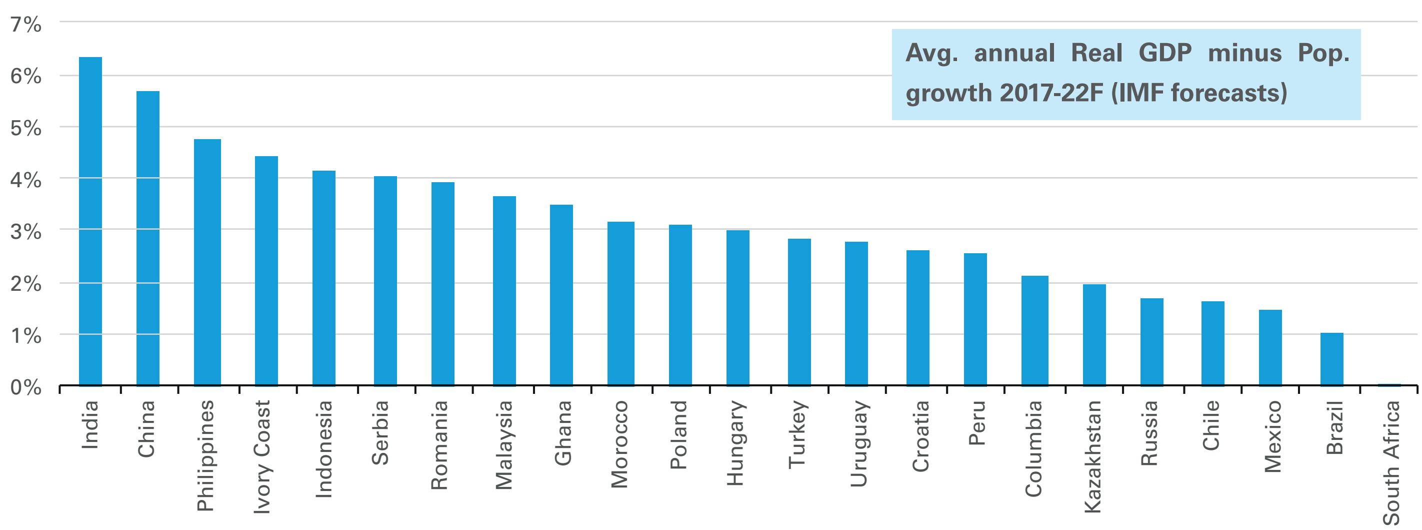
Source: Bloomberg

INCREASINGLY IDIOSYNCRATIC EM RISKS

One can't obviously 'blame' everything on developed market (DM) challenges, but EM-specific risks have become more idiosyncratic and less systemic over the past few years as the EM world gradually 'matures', supported by G3-driven central bank liquidity. Prime examples are Brazil and South Africa, whose domestic politics have pulled down their respective countries' economies, at a time when the rest of the world is in recovery mode (Figure 3).

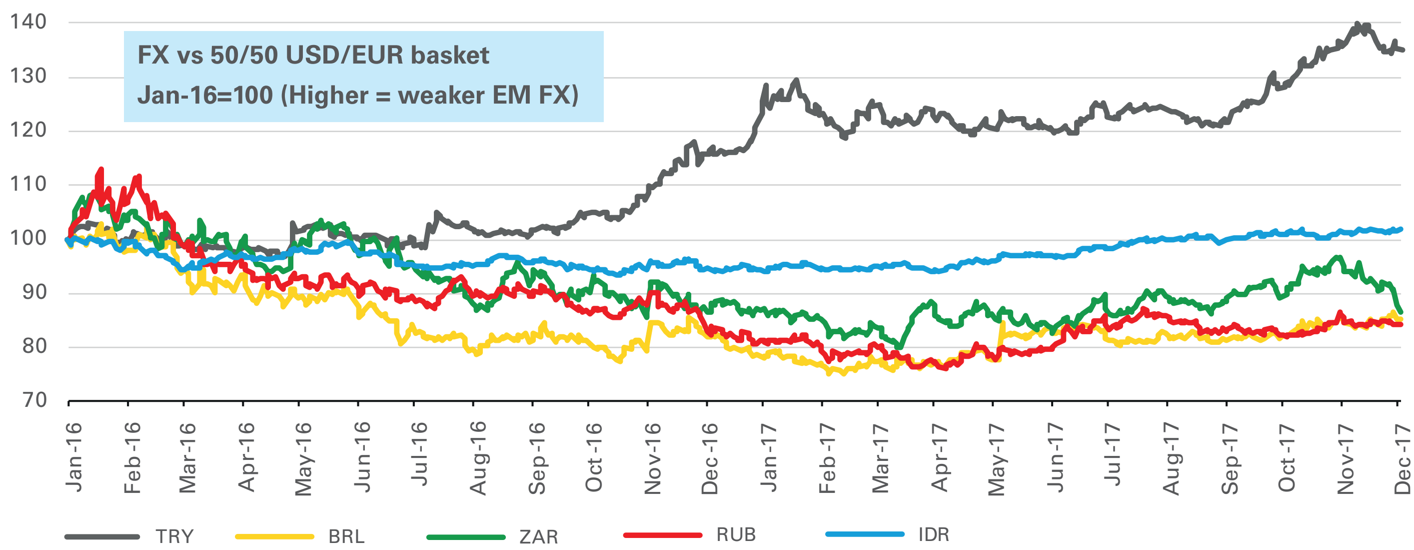
Fortunately though, central banks in most of the EM world have played a much-needed stabilisation role, as seen in the outperformance of both the South African rand and the Brazilian real versus the Turkish lira, which continues to struggle with its own politically challenged central bank (Figure 4). Indeed, the move to a more flexible exchange rate policy in much of EM, coupled with the increase in central bank credibility, has been a confidence booster for EM assets over the past few years.

Figure 3. Domestic politics have been a drag on growth in Brazil and South Africa



Source: IMF WEO

Figure 4. TRY sticks out by far

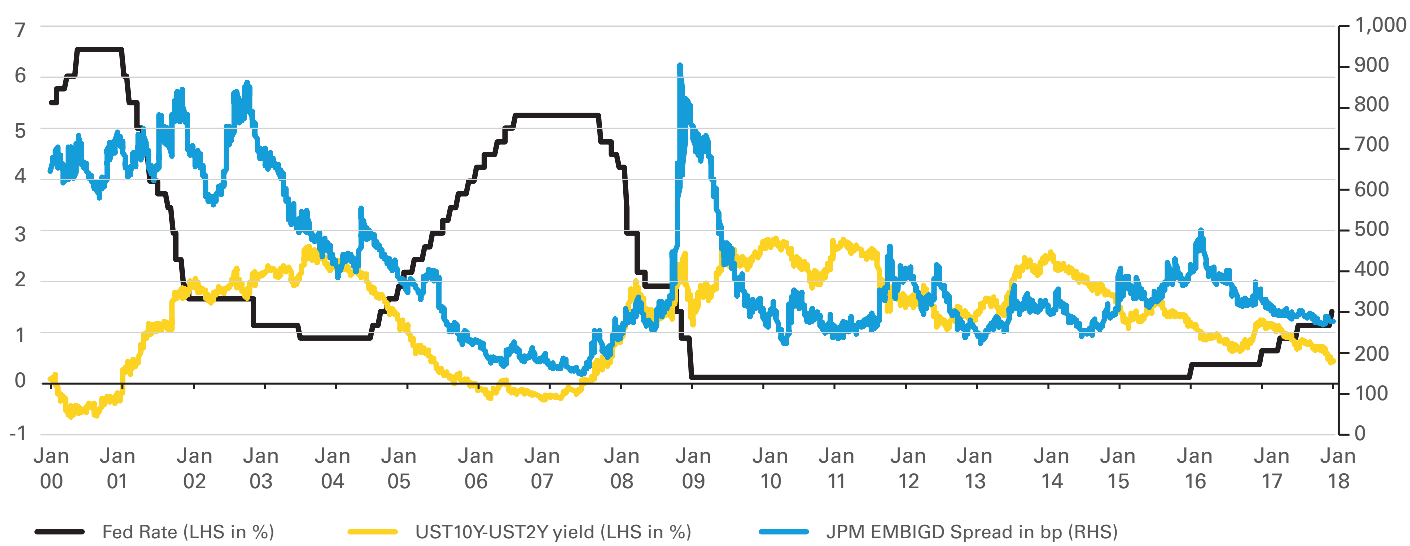


Source: Bloomberg

OIL PRICES CHALLENGE 2018 INFLATION

This brings us to the question of inflation. While the US Federal Reserve continues to deal with its Taylor rule conundrum and the issue of why low inflation could be with us for longer, the market is pricing in around 50 basis points of US rate hikes in 2018. EM spreads have been happy with the ensuing US treasury yield curve flattening, in a similar way to 2007 when spreads reached their all-time lows (Figure 5). And, while curve flattening may raise some concerns about where we stand in the global economic cycle, global pension funds seem likely to continue their quest for higher returns further down the individual yield curves. In the last 12 months, that has passed through into an unprecedented amount of 30-year bond issuance out of single-B rated sovereigns in emerging markets, such as Nigeria and Argentina, with the latter even managing to issue a 100-year US dollar bond.

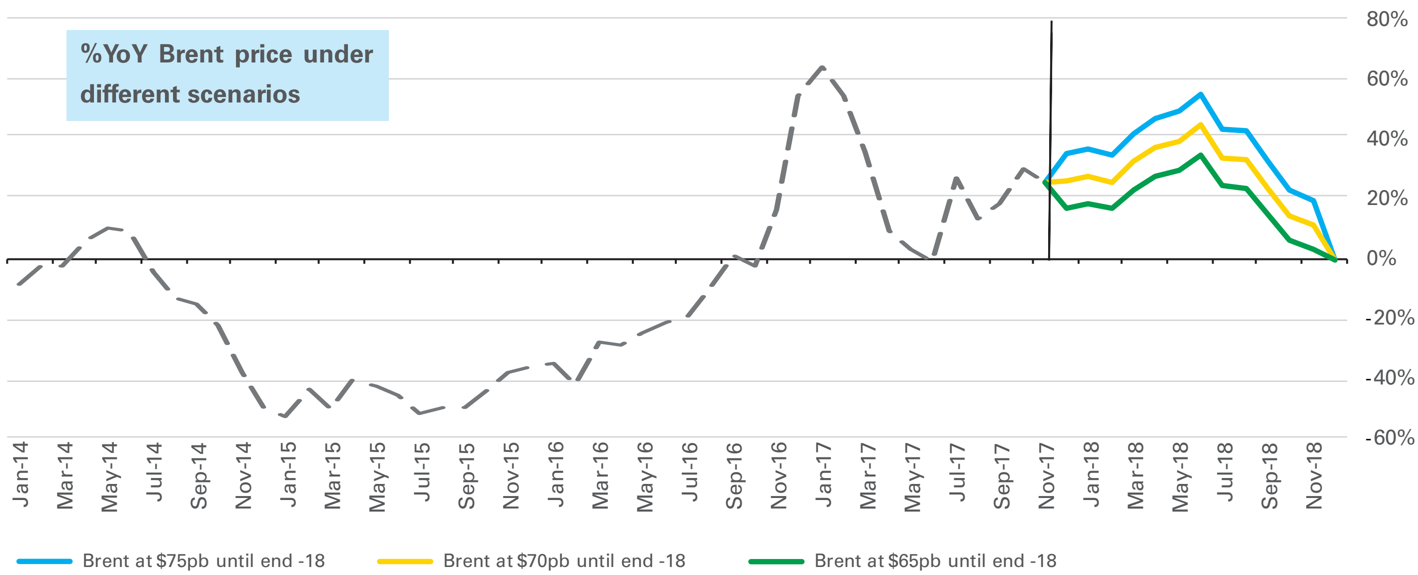
Figure 5. EM spreads like the US curve flattening



Source: Bloomberg

That is not to say that the inflation ride is going to be an easy one for EM central banks in 2018. Indeed, they are likely to be faced with an increase in oil prices versus 2017, coupled with a corresponding rise in inflation expectations. Brent oil prices for example at USD65 a barrel until the end of 2018 would mean year-on-year (YoY) oil prices remaining at around 20% until Q3 and spiking at 35% in June (Figure 6 plots various oil price scenarios).

Figure 6. Various oil price scenarios and the YoY effect

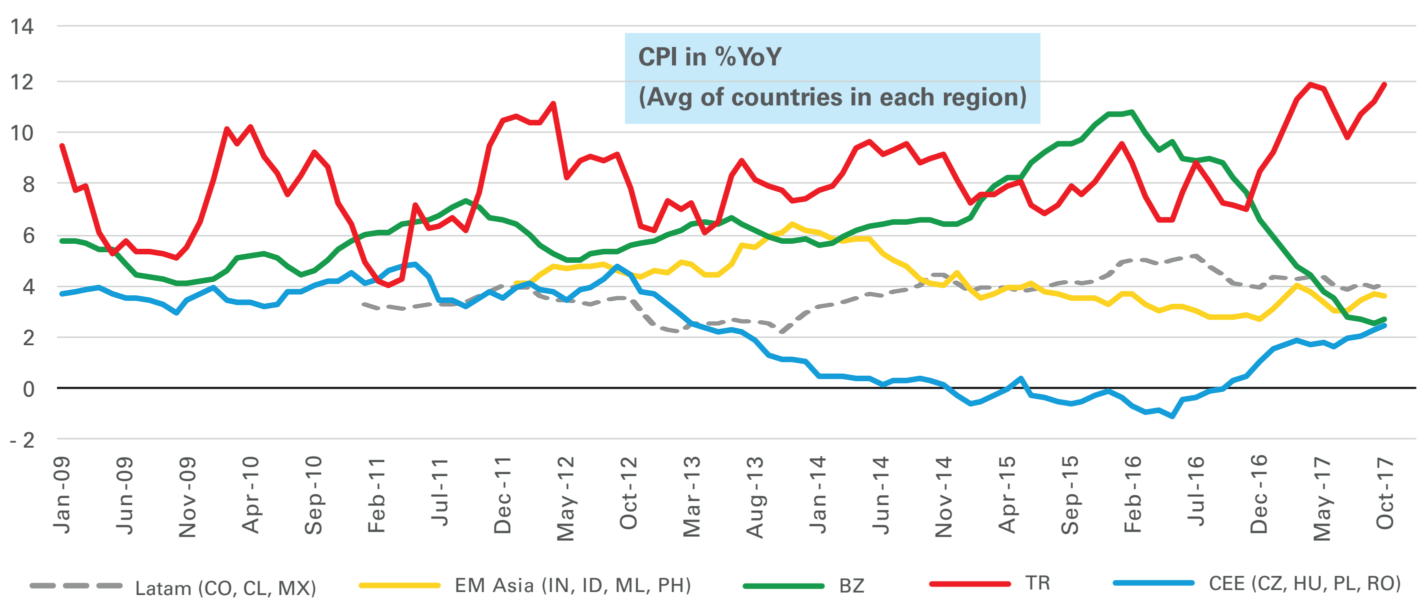


Data source: Bloomberg

Given that few expect this to be a multi-year trend of higher oil prices, EM central banks could be faced with a conundrum of their own, probably turning into a stop to rate cuts in 2018 rather than a big hiking spree (especially as regional inflation patterns still look benign – Figure 7).

However, oil price dynamics do stand as an increasing interest rate risk if accompanied by a stronger US dollar and/or higher US treasury yields, bringing us back to the US policy challenges for EM.

Figure 7. Regional emerging market inflation patterns



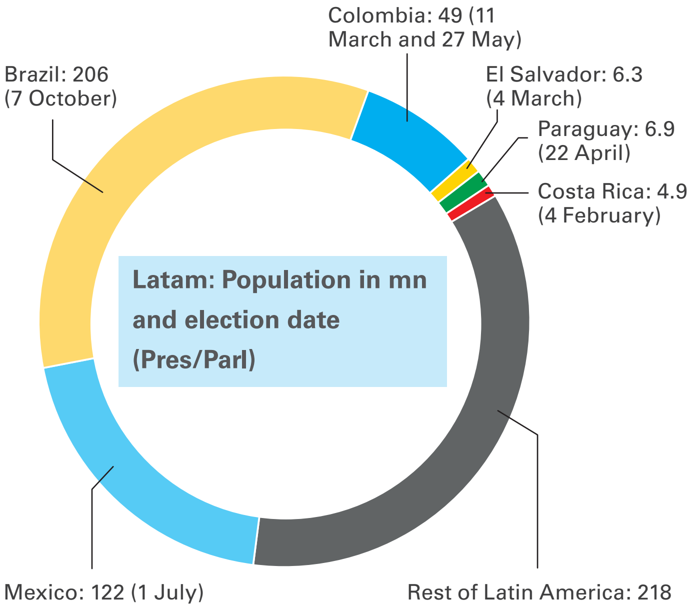
Source: Bloomberg

ELECTIONS VERSUS BOND SUPPLY

With multi-country elections in 2018, politics will remain an idiosyncratic risk for a number of EM countries, foremost driven by the presidential/parliamentary elections in Latin America (Figure 8 highlights the upcoming elections that involve around two-thirds of the continent's population). Brazil, Mexico and Colombia (which make up around 12% of the EMBIGD Index) clearly stand out as the three elections that could surprise in any direction, although opinion polls in Mexico already seem to point to a win by left-of-centre candidate Lopez Obrador. Significant 2018 elections elsewhere in EM include Russia (18 Mar), Egypt (before May), Iraq (12 May), Lebanon (May), Hungary (Q2) and Pakistan (likely Aug).

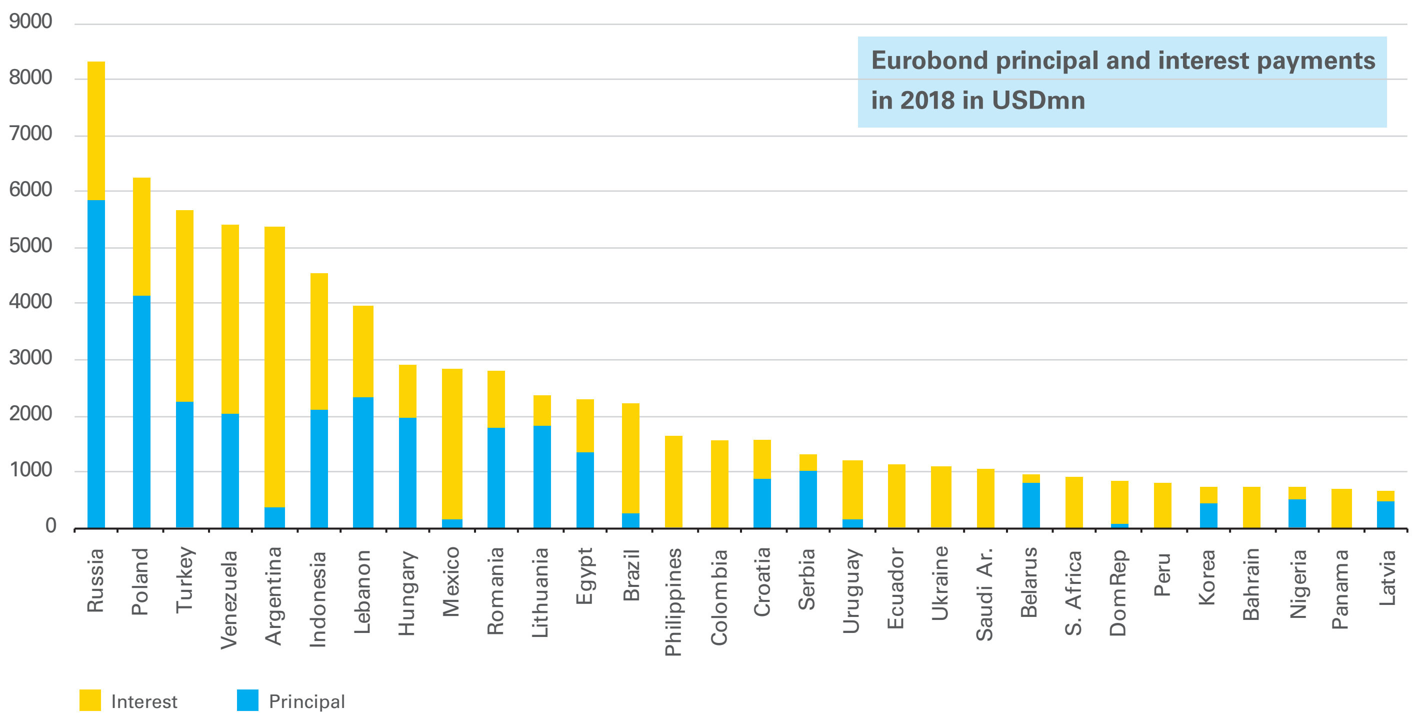
And, while politics continue to catch the eye of the EM investor, supply versus demand dynamics remain constructive. It is difficult to see 2018 flows into EM bond funds outdoing the 2017 record year, given a tighter US monetary policy backdrop with the Fed hiking rates and working its way through quantitative tightening or 'QT'. However, 2018 EM sovereign principal repayments are around US$4bn lower at US$32bn (Figure 9 shows the main sovereign repayments), sub-Saharan Africa still faces small amounts of redemptions, and all the 'over-issuance' in 2016 and 2017 provides EM sovereigns with an additional buffer. On the foreign exchange reserves front, though, the likes of the South African rand and the Turkish lira remain the most vulnerable.

Figure 8. 2018 elections for two-thirds of the Latin American population



Source: IMF WEO, parliaments, IFES, Reuters

Figure 9. The main 2018 sovereign repayments in emerging markets



Source: Bloomberg

BOTTOM LINE

2018 looks set to be a challenging but also engaging year for the EM fixed income universe. The risks: tighter G2 monetary policies and a more 'introvert' US economic policy, idiosyncratic EM political noise, a potentially uncertain EM inflation backdrop and, as always, any disruption to the Chinese growth story. The supporting factors: any continued US curve flattening and residual cross-over demand in the first half of 2018, sustained but visibly lower EM spread/carry pick-up and a benign EM external debt repayment schedule.

On balance, an environment that appears more conducive towards hard currency bonds in EM, with the EMBIGD Index offering a 5% yield buffer against any upside risks in US treasury yields and EM spreads (Figure 10 highlights the return matrix for various scenarios), while still allowing for exposure to individual higher-yielding picks that have a reform story to sell or are in the process of creating one. That includes the likes of Argentina, Ukraine, Nigeria and Angola.

Figure 10: The return matrix for various potential scenarios

Total returns in EMBIGD based on spread and UST yield changes

			EMBI GD spread							
			-75 bp 205	-50 bp 230	-25 bp 255	0 280	+25 bp 305	+50 bp 330	+75 bp 355
US 10yr yield	-75 bp	1.70	15.4	13.7	12.0	10.3	8.6	6.9	5.2
	-50 bp	1.95	13.7	12.0	10.3	8.6	6.9	5.2	3.5
	-25 bp	2.20	12.0	10.3	8.6	6.9	5.2	3.5	1.8
	0	2.45	10.3	8.6	6.9	5.2	3.5	1.8	0.1
	+25 bp	2.70	8.6	6.9	5.2	3.5	1.8	0.1	-1.6
	+50 bp	2.95	6.9	5.2	3.5	1.8	0.1	-1.6	-3.3
	+75 bp	3.20	5.2	3.5	1.8	0.1	-1.6	-3.3	-5.0

Source: Bloomberg, JP Morgan