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Market Views: Fixed Income

Outlook 2017: Emerging market debt relative

2017 may prove a challenging year with consensus expecting a firm US dollar; however any change to this view could see a considerable rally and fundamentals for many emerging markets have improved.

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• Sector divergence between sovereign, corporate and local currency debt is likely to be greater in 2017 than 2016.
• Any US dollar weakness could result in a significant emerging market debt rally.
• Fundamentals are improving with brighter outlooks for several large emerging market economies, especially in Latin America.

The year has opened with a common presumption that global growth – especially US growth – will accelerate and that "reflation" will be a consistent theme. Though that scenario would bode poorly for many parts of emerging market debt, better growth prospects would make credit risk a good bet for global fixed income investors. Should the market change direction on the back of policy delays or disappointing data, local currency debt could be particularly compelling, in our view.

Greater sector divergence likely in 2017

In 2016, each of the sub-sectors of emerging market debt – sovereign, corporate, and local currency – returned around 9%. We expect considerably more divergence driven by developed market policies in the year ahead, and at this point there is no clarity on how those policies will play out.

We see several potential scenarios: stronger economic growth coupled with fiscal stimulus in the US would lead to potential outperformance by non-investment grade debt in both the sovereign and corporate sector. Investment grade debt, given its higher correlation to US Treasuries, would underperform in this scenario and local currency exposure would suffer assuming the US dollar gained strength on the back of a better US economic outlook, in our opinion.

Because the market spent the latter part of 2016 pricing in this scenario as a high probability, any disappointment would likely result in a swift reversal, and investment grade debt and currencies could then perform well.

Because the past three years have seen currencies weaken as a result of the soaring US dollar (with the exception of the middle of 2016), a weaker dollar could potentially result in a considerable rally. Dollar spreads, despite the growth optimism in the markets as of this writing, are near their tightest three-year levels against Treasuries so generous gains are less likely there if expectations reverse.

Key emerging market economies are recovering

Against that broad backdrop of global policies driving asset price returns, fundamentals continue to improve. Overall, emerging market growth is likely to be nearly double that of the developed world, as key countries such as Brazil, Russia, and Argentina continue to recover slowly from deep recessions.

Most countries have rebuilt foreign exchange reserves over the course of 2016, and because currencies have been weak over the past few years, external deficits by and large are modest.

Risks in Mexico and Turkey are largely priced in

The "problem" countries for EM are currently Mexico and Turkey, though asset prices in both have well priced in deteriorating scenarios.

Mexico has been held hostage to the anticipation of a tougher trade policy in the US ever since the election, and will have an uncertain outlook until greater clarity in that policy is revealed. A continuing risk will be a growth slowdown that leads to much brighter prospects for a leftist victory in 2018 elections.

Politics has also played a key role in Turkey as President Erdogan continues to consolidate power and is seemingly preventing the central bank from pursuing a more orthodox policy.

However, in both countries prospects for a true economic crisis remain muted, as weak currencies have played a role as a relief valve, and fiscal policies remain relatively prudent.

Encouraging outlook in Latin America

Brighter policy outlooks are in place across a broad swath of Latin America, including Argentina, Peru, and, to a lesser extent, Brazil. These countries should continue to perform well, we feel, especially if confidence boosting reforms continue into the New Year.

Despite the political noise swirling around Russia, the central bank is pursuing a completely orthodox policy framework: inflation is declining, and stability in oil prices is helping both fiscal and foreign exchange reserve accounts.

Higher EM yields offer diversification

In a global fixed income context, we think emerging markets generally remain attractive and the higher current yields in the asset class provide at least some measure of diversification against rising interest rate risk globally.

Even in a best case growth scenario, it is highly unlikely that developed market central banks would aggressively unwind the lenient policies of the past five years. In that context we would expect under most scenarios emerging markets should provide attractive return prospects above those of most other fixed income segments.

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