Emerging Markets:

Does Reversal of Fortune Create Buying Opportunities?

At the beginning of 2018, "synchronized global growth" was a phrase commonly used in the financial press. Financial markets were hitting on all cylinders, with equity markets surging across the globe and the riskier segments of fixed income also providing strong returns in 2017. In fixed income, Emerging Markets Debt (EMD) led the way as illustrated in the figure 1.

FIGURE 1.

	2017 Returns
Bloomberg Barclays Aggregate	3.5%
Bloomberg Barclays High Yield	7.5%
JP Morgan EMD—US Dollar	9.3%
JP Morgan EMD—Local Currency	15.2%

As of December 31, 2017
Source: JP Morgan, Bloomberg Barclays

Mark Foust

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These strong returns came despite three interest rate hikes by the Federal Reserve in 2017 with more moves forecasted for 2018. Investors were aggressively moving money into emerging markets with the expectations of continued solid growth and further currency appreciation. The strong performance in local currency EMD continued in the first quarter of 2018 with returns of +4.4%. US Dollar EMD posted a negative return over the first three months, but this was mostly caused by the decline in US Treasury prices as spreads widened only modestly. It was during the first quarter that global synchronized growth began to fall out of sync, with the US outpacing many regions of the world, particularly Europe and Japan.

Investor sentiment abruptly changed for the worse in April and remained negative throughout the 2nd quarter. Higher growth in the US and a more aggressive posture from the Federal Reserve combined with weaker growth in most developed countries to push the dollar much higher. Countries such as Turkey and Argentina, with high current account deficits that require significant external funding, experienced collapsing currencies. The problems in these two countries, combined with higher US interest rates and the rising dollar, helped cause EMD to experience large declines in the 2nd quarter with local currency EMD returning -10% and USD EMD down -3.5%. After a brief rebound in July, EMD suffered further losses in August. For the first eight months of 2018, EMD spreads have widened by 89 basis points with yields higher by 132 bps. Not surprisingly, EMD is the worst performing fixed income asset class so far in 2018. The other segments of fixed income have held in better considering that the US economy is strong, inflation has been rising, and the Fed has hiked rates two times this year with two more expected before year-end. US Investment Grade fixed income has a small negative return while High Yield has a positive return with spreads 7 bps tighter for the year. Figure 2 is a table with returns through August 31, 2018.

FIGURE 2

	2018 Returns
Bloomberg Barclays Aggregate	-1.0%
Bloomberg Barclays High Yield	2.0%
JP Morgan EMD—US Dollar	-5.1%
JP Morgan EMD—Local Currency	-10.5%

As of August 31, 2018
Source: JP Morgan, Bloomberg Barclays

There are several issues that could continue to weigh on EMD, for both US Dollar and local currency. The main headwinds are:

1) The trade war instigated by the United States
2) Possible contagion to other EMD countries caused by Turkey's and Argentina's problems
3) Possible weaker economic growth in China
4) Higher interest rates in the US
5) Continued strength in the US Dollar
6) Local politics – Some strong-willed EM leaders (Russia, China, Turkey, Hungary, and Poland) may be overplaying their hands

Given what has transpired so far in 2018 and these headwinds, it is not surprising that EMD has declined, with valuations changing significantly. Our research always begins with our proprietary country credit and valuation models. Our models systematically analyze both the country credit fundamentals and the valuations of the US Dollar bonds in each emerging country. We do not use the output of our models to make portfolio decisions; rather, we use our models to highlight the countries on which our EMD team's research should focus to construct and make changes to our portfolios. The models are also very useful in gauging the overall attractiveness of the EMD asset class.

The output of the model at the end of December 2017 appears in figure 3. EMD spreads at year-end 2017 as measured by the JP Morgan Global Index were +311 bps over Treasuries with a yield of only 5.54%.

DCM EMD Model—December 2017

FIGURE 3.

Category	Under Valued	Fairly Valued	Over Valued	Index Weight
Mature	Mexico	Chile, China, India, Indonesia, Kuwait, Malaysia, Panama, Peru, Russia, Saudi Arabia, UAE	Hungary, Israel, Korea, Latvia, Lithuania, Philippines, Poland, Qatar, Slovakia, Thailand	50.1%
Stable	Argentina, Bahrain, Egypt, El Salvador, Jordan, Ukraine	Brazil, Bulgaria, Costa Rica, Cyprus, Dominican Republic, Ghana, Greece, Kenya, Mongolia, Namibia, Oman, Pakistan, Paraguay, Senegal, South Africa, Sri Lanka, Tanzania, Turkey	Bolivia, Colombia, Croatia, Guatemala, Kazakhstan, Morocco, Romania, Serbia, Trinidad and Tobago, Uruguay, Vietnam	39.5%
Risky		Angola, Lebanon, Suriname	Armenia, Azerbaijan, Belarus, Cameroon, Cote D'Ivoire, Ethiopia, Gabon, Georgia, Honduras, Iraq, Jamaica, Nigeria, Tunisia, Zambia	6.6%
Distressed	Mozambique, Venezuela		Ecuador, Belize	3.8%
Index Weight	22.7%	53.5%	23.8%	

As of December 31, 2017
Source: DuPont Capital Management, JP Morgan

At that time, only 23% of the index was undervalued and 54% was fairly valued. The percent for each country is based on the market weights of the JP Morgan EMBI Global Index. Overall, the market was not particularly attractive at year-end.

Now, let us look at the model as of August 31, 2018, depicted in figure 4. EMD spreads widened to +400 bps over Treasuries with yields rising to 6.86%. Given the significant change in market prices in only an eight-month period, the changes to the output of the model were very significant.

DCM EMD Model—August 2018

FIGURE 4.

Category	Under Valued	Fairly Valued	Over Valued	Index Weight
Mature	Mexico, Russia	Chile, China, Croatia, Hungary, India, Indonesia, Israel, Kuwait, Malaysia, Panama, Peru, Philippies, UAE	Korea, Latvia, Lithuania , Poland, Qatar, Saudi Arabia, Slovakia, Thailand	51.6%
Stable	Argentina, Bahrain, Costa Rica, Eqypt, El Salvador, Ghana, Jordan, Kenya, Nigeria, Oman, Pakistan, Senegal, Sri Lanka, Turkey, Ukraine	Azerbaijan, Brazil, Bolivia, Bulgaria, Colombia, Cyprus, Dominican Republic, Greece, Guatemala, Kazakhstan, Mongolia, Morocco, Namibia, Paraguay, Romania, South Africa,	Serbia, Uruguay, Vietnam	39.5%
Risky	Ecuador, Lebanon, Zambia	Angola, Cameroon, Gabon, Suriname, Tajikistan	Armenia, Belarus, Cote D'Ivoire, Ethiopia, Georgia, Honduras, Iraq, Jamaica, Tunisia,	7.2%
Distressed	Venezuela	Mozambique	Belize	1.7%
Index Weight	44.0%	49.3%	6.7%	

As of August 31, 2018
Source: DuPont Capital Management, JP Morgan

At the end of August, 44% of the index was undervalued and 49% was fairly valued. The larger countries that moved to undervalued status included Russia and Turkey. Importantly, there were only a few changes to our model's overall credit scores of the countries (shown on the right-hand side). This is because overall economic growth has remained healthy in 2018, inflation in many countries did not rise materially, and commodity prices (especially oil) were generally supportive of the countries that rely on exports. Many emerging countries are arguably in a better financial position than they were during the Taper Tantrum a few years ago. Turkey and Argentina are the main countries experiencing declining fundamentals and have also seen the most significant declines in their bond prices. However, Argentina was aided in June by the IMF, which agreed to provide a $50 billion Stand-By-Agreement. As of the end of August, these two countries had not experienced credit downgrades in our model as their fundamentals have only been deteriorating over the last few months. Future credit downgrades are possible if the fundamentals decline enough to move their credit score below our rating threshold.

Our process is designed to try to take advantage of countries that are undervalued, and we believe the 2018 sell-off in EMD has increased the potential to add alpha and increase total return in our portfolios. The objective of our fundamental research is to understand why a bond is undervalued and to identify the key drivers for sustainable improvement of ability and willingness to pay.

The changes in the output from our models have led us to spend significant time on additional fundamental research on several countries, but with a particular focus on Jordan, Ecuador, and Turkey.

Jordan

1) Key military and political ally of US in the region. The Muwaffaq Salti Air Base is the largest US overseas military base expansion in 2018.
2) Jordan has low financial needs due in part to its bilateral and multinational supports.

We initiated a position in Jordan in June and are overweight compared to our benchmark.

Ecuador

1) Oil prices above $60 are very supportive – oil is the largest export and generates FX income for Ecuador.
2) Ecuador has made policy adjustments that are very market friendly.

We initiated a position in Ecuador in June. This purchase reduced our underweight.

Turkey

1) Significant short-term political and financial risks.
2) Low default risk for sovereign and quasi-sovereign credits.

We added to our position in Turkey in late August and our portfolios are slightly overweight compared to our benchmark. We continue to hold more cash than we typically do as we monitor the market and do additional research.

We believe the current valuations for EMD are attractive for long-term investors. Although our models highlight that the market has become much more attractive over the past eight months with increased investment opportunities, we have only modestly added positions to our EMD portfolios. The headwinds mentioned earlier along with the current negative market sentiment are making us proceed cautiously in taking a more aggressive stance. We continue to hold some cash as we monitor the market and do additional research. We will deploy more cash and take additional risk when we feel we are more appropriately rewarded.