BlueBay Asset Management

Understanding the sell-off in emerging market assets and get ready to be greedy

The move higher in US interest rates and the US dollar was the catalyst for the sell-off in emerging market (EM) assets that began in April. It intensified as tighter external financing conditions exposed Turkey and Argentina's fundamental weaknesses. The sell-off will end when emerging markets have adjusted to the restricted availability of international capital and the risk transfer of emerging assets from potentially fickle 'search for yield' investors to those willing to bear the volatility associated with the asset class is complete. But it is a painful sell-off, not a systemic crisis and its conclusion will likely offer an attractive entry point for those investors willing to "be greedy when others are fearful".

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Author

David Riley
Chief Investment Strategist

RBC Global Asset Management

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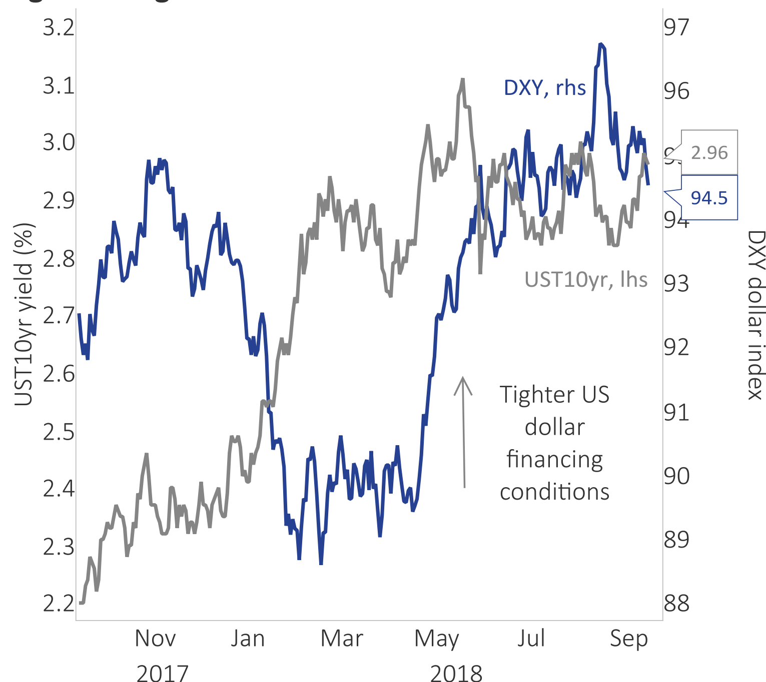
Anatomy of a sell-off

The boost to US growth from the tax cuts passed at the end of 2017 and the additional federal spending approved early this year shifted market expectations for US interest rates and Treasury yields higher. However, the first quarter of 2018 was also characterised by US dollar weakness and positive global investor risk appetite, more than offsetting the impact of higher US rates on external financing conditions for EM. But from the middle of April to late May, the US dollar (DXY Index) appreciated by more than 6% and even though the 10-year Treasury yield eased to around 2.85%, short-term interest rates continued to move higher and external financing conditions for EM began to tighten in earnest.

Fig. 1: Rising US interest rates & dollar



Source: Intercontinental Exchange (ICE), Macrobond Financial AB 13 September 2018

Tightening in US monetary conditions (including from the reduction in the Fed's balance sheet) provided the gunpowder for the sell-off in EM assets, but the vulnerabilities of Argentina and Turkey lit the fuse. Both countries rely on capital inflows to finance large current account deficits (in Turkey due to an unsustainable credit boom and in Argentina the counterpart of the government's budget deficit) while foreign exchange reserves were too small to provide a meaningful 'shock absorber' and their central banks' anti-inflation credentials were weak. Argentina did eventually hike interest rates dramatically but was still forced to seek external financing from the International Monetary Fund (IMF) while the Turkish central bank reluctantly raised interest rates but by too little and too late to prevent a currency crisis. [1]

Other major EM economies do not have the same degree of vulnerability to tighter external financing conditions, but the crises in Turkey and Argentina is forcing a faster and more painful adjustment to reduced availability of international capital. EM economies with external financing needs not mostly met by foreign direct investment will have to raise

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[1] Belatedly the Central Bank of Turkey raised its one-week repo rate by a greater than market expected 6.25% to 24% on 13 September, at least temporarily stabilising the Turkish lira.

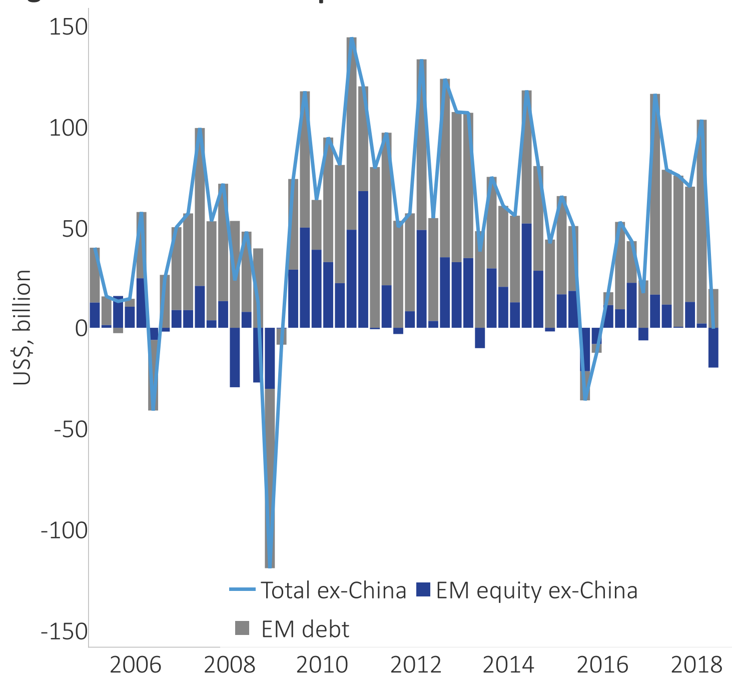
interest rates and allow their currencies to weaken to reduce their reliance on foreign portfolio capital. The more credible the central bank and the greater their foreign exchange reserve buffer, the less costly the adjustment will be in terms of growth and asset values. Investors must navigate carefully through this adjustment period, but not flee in fear of a systemic emerging market crisis characterised by sovereign defaults.

In aggregate, EMs are more resilient than during previous episodes of Fed tightening, and the current volatility in EM assets does not in our view presage EM-wide systemic crisis.[2] Flexible exchange rates, sizeable foreign exchange reserve buffers held by central banks and greater reliance on local markets for financing have significantly reduced the vulnerability of EM external debt to financial shocks. However, the burden of adjustment to tighter external financing conditions will fall more heavily on local debt markets and exchange rates.

The end of QE and investment flows to emerging markets

A necessary condition for EM asset appreciation is the reduction in excessive positioning by non-dedicated cross-over investors as well as retail inflows and in the near-term, this will likely mean a period of much lower or even negative portfolio capital flows to EM. The QE-era that characterised developed market (DM) monetary policies and underpinned the global 'search for yield' since the turn of the decade is coming to an end. US monetary policy normalisation and the gradual scaling back of monetary accommodation by the European Central Bank (ECB) and Bank of Japan implies a reversal of capital flows 'pushed' into EM and other risk assets during the QE-era. IMF estimates suggest Fed policy normalisation could reduce non-resident portfolio capital flows to EM to USD35 billion per year over the next few years (annual net portfolio flows to EM over the last several years averaged around USD270 billion).

Fig. 2: Net non-resident portfolio flows to EM

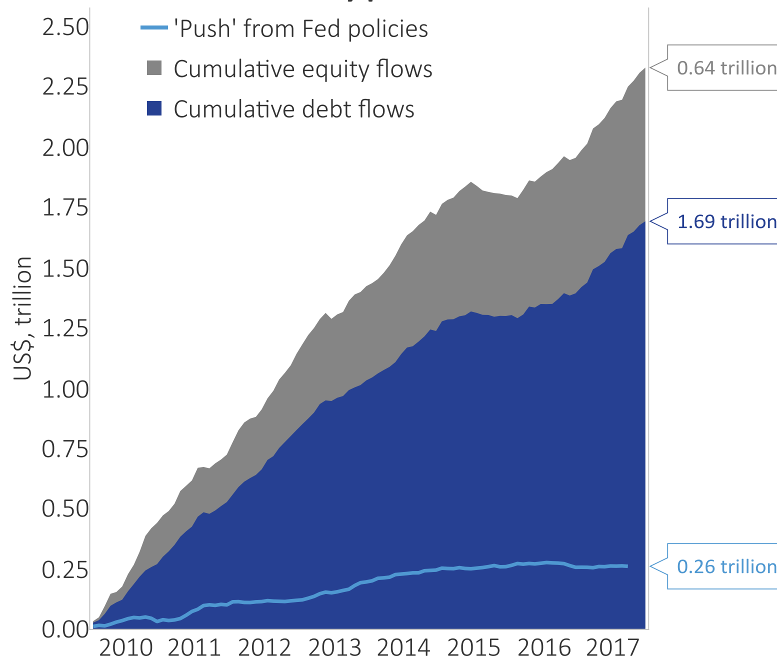


Source: Institute for International (IIF); last quarter Q2 2018

[2] *This is not an EM-wide crisis – yet,* Financial Times Opinion beyondbrics, by Tim Ash, a BlueBay senior sovereign strategist, 7 September 2018

The IMF estimates attribute around USD260 billion of portfolio capital flows to EM since 2010 to the 'push' of unconventional monetary policies by the Federal Reserve.[3] Although meaningful, IMF estimates of QE-induced flows to EM should be set against the context of total net portfolio capital inflows into EM economies of around USD2.5 trillion since 2010. Much of the growth in US dollar value of capital flows is due to the expansion of global investor portfolios and the share of EM in the world economy rather than the funding of large current account deficits (capital inflows were also used to accumulate an additional USD1 trillion of foreign exchange reserves by EM ex-China central banks).

Fig 3: Foreign portfolio flows to EMs & impact of US Federal Reserve monetary policies



Source: Institute for International Finance and IMF; monthly data to September 2017

There is evidence that in the search for yield, funds that traditionally invested solely in DM fixed-income and credit meaningfully increased their exposure to EM. These investment flows as well as the increased importance of retail investors in emerging market ETFs may prove more fickle than from dedicated and strategic investors that are aware of and willing to tolerate episodes of volatility historically associated with the asset class. The transfer of risk from such investors as well as capital repatriation from EM will further exacerbate asset price volatility.

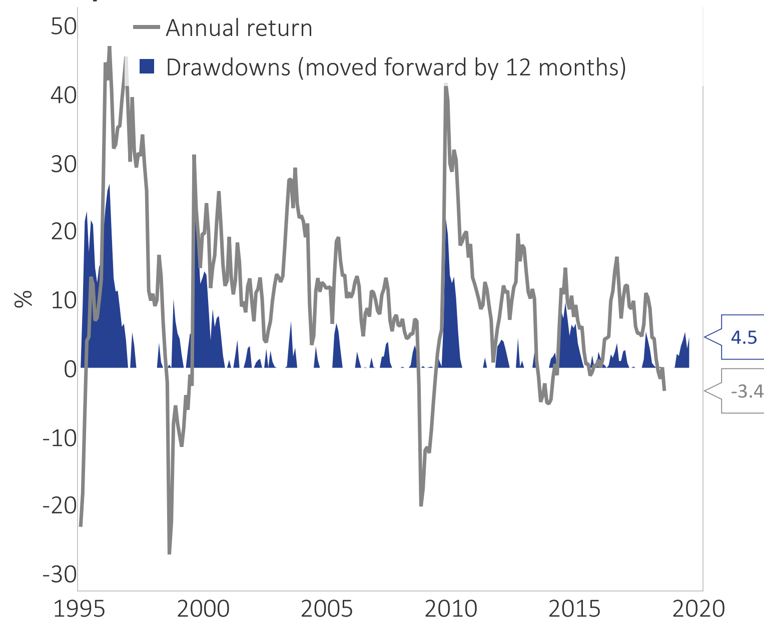
Sell-offs and entry points

Market sell-offs are of course painful but also offer attractive entry points for those investors able and willing to invest when others are too fearful to do so. In the case of EM, the 'home bias' of DM investors accentuates the typical over-shooting in asset prices relative to the change in underlying fundamentals. The greatest value resides in exploiting mispricing by selective investment in individual countries and companies, including those that may be at the epicentre of the sell-off. Nonetheless, we can also identify value at a broad market or 'beta' level from the historical experience of drawdowns at an index level.

[3] Global Financial Stability Report, October 2017, IMF

As Figures 2 & 3 illustrate, sizeable drawdowns are typically followed by higher than average annual returns (drawdowns are shown as a positive value and moved forward by 12 months – shaded blue – and plotted against the annual total returns – the grey line).

Fig. 4: EM hard currency sovereign debt drawdowns & subsequent annual returns



Note: JP Morgan EMBI Global Diversified index
Source: JP Morgan; Bloomberg; BlueBay calculations; latest month 08/2019, 08/2018

Fig. 5: EM hard currency coreporate debt drawdowns & subsequent annual returns

Note: JP Morgan CEMBI Diversified index
Source: JP Morgan; Bloomberg; BlueBay calculations; latest month 08/2019, 08/2018

Note: The forecast figures above are based on assumptions and are subject to change without notice. There are frequently sharp differences between forecasts and actual results. BlueBay Asset Management LLP disclaims all liability or responsibility arising from any use or interpretation of, or reliance upon these forecast figures.

The mean annual return following drawdowns over the history of the relevant EM asset class index and for the pre and post global financial crisis (up to 2008 and after 2010) periods are shown in the Appendix (including spread returns – the excess return over US Treasury notes – for EM hard currency sovereign and corporate bond indices). The history of returns on EM local currency debt following drawdowns is dominated by trends in the US dollar and is a much more volatile asset class. The trend appreciation of the US dollar from mid-2014 has meant that the EM local currency debt at an index level is yet to return to its pre-taper tantrum peak. Consequently, in the Appendix it is the mean annual return following 1-year negative returns that are reported.

As expected, annual returns tend to be higher the greater the size of the prior drawdown. Historically, drawdowns of between 2½ - 5% in EM 'hard currency' credit – the drawdown so far in the current sell-off - have been associated with an average return in the following year of around 10%. Sell-offs of at least 10% and in the post global financial crisis period 15% is the threshold for confidence that subsequent annual returns will be meaningfully positive.

Get ready to be greedy

Most EMs are well placed to absorb the tightening of external financing associated with the post-QE normalisation of global monetary policy led by the US Federal Reserve. Flexible exchange rate regimes, larger stocks of foreign exchange reserves and the greater reliance on local debt markets for funding has greatly reduced the currency and duration risks faced by emerging market borrowers and consequently the likelihood of a 1990s-style systemic crisis. International investors benefit from reduced sovereign (and corporate) credit risk, but face greater market risk from higher local interest rates and currencies as EMs adjust to tighter external financing conditions. It is for this reason that in BlueBay's multi-asset credit strategies, 'hard currency' debt is currently favoured over local currency debt.

The QE-era encouraged investors to embark on a global 'search for yield' and pushed capital flows to emerging market economies as well as into developed market risk assets. But the scale of QE-related investor flows into emerging markets accounts for a relatively small share of overall capital inflows. Nonetheless, the reversal of such inflows could prove disruptive if funds that traditionally invested solely in developed market fixed-income and credit markets indiscriminately cut their 'off-benchmark' emerging market holdings and that is a rapid reversal of retail investment flows. The completion of the risk transfer from these investors will mark the entry point for dedicated and strategic investors into the asset class. Asset market volatility invariably generates mispricing and relative value opportunities that can be exploited by active investors. The 'home bias' of investors also contributes to an overshoot to the downside in EM asset values during volatility episodes. The drawdowns in emerging market assets from their early 2018 peaks are close to levels that in previous sell-offs have typically been followed by above average returns for less fearful investors. Trade protectionism, populist governments in developed as well as emerging markets and the normalisation of US monetary policy after almost a decade of unconventional monetary policies all pose risks for emerging markets as well as for developed market economies. EM asset valuations are in the process of pricing these risks to a much greater degree than DM risk assets. There may be more pain before gain for EM assets, but strategic investors should get ready to be greedy.

Appendix: Drawdowns and subsequent annual returns for selected EM indices

EM hard currency sovereign debt total return (JP Morgan EMBI Global Div)

Drawdown from prior peak	1994 - Aug-18	2011 - Aug-18	1994 - 2007
None	6.7	3.4	10.2
0% - 2.5%	8.4	5.7	11.9
2.5+% - 5%	10.0	9.7	11.0
5+% - 10%	15.8	9.8	17.6
10+%	21.7	14.6	19.5
Average annual return over period	*8.9*	*5.6*	*10.9*

EM hard currency sovereign debt spread return (JP Morgan EMBI Global Div)

Drawdown from prior peak	1998 - Aug-18	2011 - Aug-18	1998 - 2007
None	1.3	-1.3	2.9
0% - 2.5%	2.4	1.9	4.4
2.5+% - 5%	4.8	4.1	6.7
5+% - 10%	3.0	9.5	5.1
10+%	22.3	16.2	19.4
Average annual return over period	*3.9*	*3.1*	*4.8*

EM hard currency corporate debt total return (JP Morgan CEMBI Div)

Drawdown from prior peak	2002 - Aug-18	2011 - Aug-18	2002 - 2007
None	6.8	5.3	7.3
0% - 2.5%	5.0	4.7	9.7
2.5+% - 5%	10.4	10.4	11.4
5+% - 10%	14.1	12.1	11.5
10+%	41.2	NA	NA
Average annual return over period	*7.4*	*5.2*	*6.3*

EM hard currency corporate debt spread return (JP Morgan CEMBI Div)

Drawdown from prior peak	2002 - Aug-18	2011 - Aug-18	2002 - 2007
None	3.6	1.5	4.7
0% - 2.5%	2.6	2.1	4.8
2.5+% - 5%	4.1	6.1	10.1
5+% - 10%	3.4	10.5	NA
10+%	19.7	16.1	NA
Average annual return over period	*3.6*	*3.1*	*3.6*

EM local currency sovereign debt total return (JP Morgan GBI-EM Global Div)

1-year % drawdown	1994 - Aug-18	2011 - Aug-18	1994 - 2007
None	7.5	3.2	9.5
0% - 5%	3.7	-1.7	14.7
5+% - 10%	8.0	-4.0	20.2
10+% - 15%	13.2	3.0	22.6
15+%	15.4	8.7	NA

Average annual return over period	6.7	-0.5	10.2

Note: From January 1994 to January 2003, JP Morgan EMLI+ index and thereafter joined to JP Morgan GBI-EM Global Diversified Index

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