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Traversing EM challenges in a world of low returns

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In a world of subdued global economic growth (both potential and realised), where interest rates are low and financial assets expensive, investors are looking for value wherever they can. In this environment, EMs are starting to attract attention after a painful three-year crisis which has brought severe pressure to bear on both currencies and equities. Given EMs' high risk-sensitivity to market uncertainty (which is currently being driven by Brexit fears), it is sensible for investors to adopt a more cautious approach.

However, the pace of flows (especially in equities) have been subdued this year. This, against the backdrop of sharp outflows in 2014-15, indicates that most investors remain reluctant to take a first step back into the asset class.

We have identified three factors in which investors need to have confidence in order progressively to rebuild EM sensitivity in their portfolios. These are stabilisation in: (i) the USD; (ii) the oil price; and (iii) the Chinese economy.

The three challenges

1. USD: To reengage with EMs, investors must feel confident that the USD has peaked. This does not mean that it has to drop for EMs to do well. But in a world where the greenback continuously strengthened, EMs would, due to their high levels of USD-denominated corporate debt, suffer from financial strains. In our view, the fundamentals no longer point to an ever-rising USD. Here, it is also important to differentiate between the risk of higher interest rates vs higher USD, as historically, the empirical relationship between US interest rates and EM asset pricing has been tentative at best and only works through its influence on the reserve currency (i.e. USD).

Indeed, real interest rate differentials, late economic cycle conditions limiting the Fed's ability to hike, as well as current account differentials indicate that the prerequisites are in place for stabilisation. These offer welcome relief for emerging assets. In addition, the USD plays a role in the Fed's reaction function, and its data-dependency narrative is generally designed to reflect that.

2. Commodity price stabilisation: The second decisive element needed is stabilisation in commodities, and particularly in energy goods. EMs tend to move in tandem. Thus, commodity producers suffering from the vicious cycle of lower prices, lower currencies, higher inflation and falling economic activity tend to weigh on non-commodity-dependent emerging economies and their assets.

The current rebalancing of energy prices following the destruction in US supply appears to be a good omen. Although OPEC (and particularly Iran) may create additional supply risk, we still believe that the real price-setters of energy commodities today are the US frackers. With fewer than 400 rigs operating in the US versus close to 1,400 only two years ago, it seems clear that significant production rebalancing is underway. This should prevent energy goods from falling significantly from current levels.

3. China risk factor: China's stability is the final factor. China is the second-largest economy in the world, with a huge import and export base. Thus, a financial meltdown of its economy would impact Asia, as well as much of the rest of the world. We expect Chinese data to improve rather than worsen over the coming quarters despite the many sharp imbalances in the country. We believe that the impact of policy loosening is yet to be fully felt. As such, credit risk in China should not translate into financial stress in the recent context of declining interest rates.

However, credit risk will become apparent when money is less available and its cost increases (i.e. rising interest rates). While the risk is not imminent, investors should bear this possible sequence in mind. Our conversations with Chinese policy makers in recent weeks have suggested that the authorities remain ready to use reserves (which are available in very liquid form) to backstop the system. This is especially the case as the equilibrium level is seen as being around the USD 2 trillion mark, compared to around USD 3.19 trillion currently. Last but not least, China is a net creditor to the world and runs a healthy current account surplus, which adds important layers of protection against a full-blown balance of payment crisis.

EM Exposure in a World of Low Expected Returns – Implementation Matters

Beyond the key challenges facing EMs, with risk premia expensive across the global asset spectrum in advanced economies, the search for yield is again being driven by key central bank easing. German 10-year bunds have been trading in negative territory in recent days, and the ECB's corporate buying programme has been stronger than expected in terms of the projected pace. Meanwhile, Japan is again gearing for additional easing in the coming months. Within the fixed space, the prospect of 6%+ yields is important as expected portfolio returns collapse. This is especially the case given the range of valuation metrics suggesting that EM currencies are undervalued as external rebalancing and EM growth profiles start bouncing from their cycle lows.

Here, the attractive valuation case also extends to emerging market equities where a number of value metrics appear to be near 2008/9 crisis levels.

However, accessing this risky risk premia requires implementation techniques (i.e. appropriate portfolio construction) to be reassessed. In bonds case, this is especially the case given the stressed micro liquidity backdrop spurred by regulation-driven damage to the financial sector's ability to intermediate in fixed-income markets. Here, our recommendation is to bring fundamentals transparently to the heart of the portfolio construction process and treat each EM country on its own merit. We also recommend breaking away from the status quo of using market cap-driven allocation schemes, which tend to reward the most leveraged borrowers.

Turning to equities, our recommendation is once again to move away from market-cap and focus on both nature and shape of value-add coupled with downside protection via a skill-driven high conviction approach.

Conclusion

Overall, we see clear signs of stabilisation in (i) the USD, (ii) the commodity complex (particularly oil) and (iii) the Chinese economy. We believe that these should be assessed when considering progressively building exposure to EM assets. This is especially pressing at a time when western interest rates look set to remain low for a long time, even in the US. They seem likely to provide an important benchmark for relative valuation and positioning compared with expected returns.

That said, we continue to recommend that investors undertake this search for yield in a prudent manner by bringing fundamentals to the core of their portfolio-construction process. This is especially pertinent given the damage to micro liquidity, which we believe is likely to be a more permanent feature of the fixed-income investment landscape going forward.

Turning to equities, as noted above, our focus remains on underlying valuations of emerging market equities in a world of generally expensive risk premia, where we are recommending using a high conviction approach to generate both alpha and provide downside protection.

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