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EMERGING MARKET DEBT OUTLOOK 2017

Could 2017 be a Replay of 2016 for Emerging Markets Debt?

The year in review

2016 was a strong year for emerging market (EM) fixed income, with markets reflecting an inflection point in EM fundamentals, after several years of deterioration. Overall in 2016, external debt was the best performing segment in EM (up 10.15% - JPM EMBI GD), followed by local debt (up 9.94% - JPM GBI EM GD) and corporate debt (up 9.65% - JPM CEMBI BD).

The year started with concerns about China and its ability to avoid a hard landing. The global search for yield also continued throughout the year, amid the still expansionary G-3 monetary policy regimes.

BREXIT was a non-event for EM, with the additional stimulus into the bond market from the Bank of England turning out to be supportive. The risks coming from the European Union (EU) were largely ignored by the market during 2016 – the recapitalisation of Italian banks, the Austrian presidential elections, the Italian constitutional referendum, the migrants' crisis and the Hungarian referendum about EU refugee quotas.

The rally from mid-January to 8 November was also punctuated by a lot of political noise in EM countries – the 1MDB corruption scandal in Malaysia, an attempted coup in Turkey allegedly infiltrated by the Gulenists, political fighting between Jacob Zuma and Pravin Gordhan in South Africa, the corruption scandal and impeachment of Dilma Rousseff in Brazil, and devaluation in Nigeria.

Despite creating much dispersion within EM sub-indices, none of these events were viewed as systemic risks. Each time the market ignored the short-term negative headlines, instead focusing on the expected medium-term turnaround of EM economies, and so inflows stayed strong.

2016 was shaping up to be one of the strongest years on record for EM fixed income returns and flows. However, this was halted when the US Presidential election disrupted the party. The unexpected outcome seems to have altered these supportive dynamics for EM fixed income, as we move into 2017.

New challenges for EM fixed income

Indeed, three aspects of US policy that could potentially create an issue for EM fixed income in 2017 are:

- Pro-growth fiscal and infrastructure spending leading to higher interest rates
- Greater protectionism, trade barriers and custom tariffs negatively impacting EM trade with the US
- A change in the geopolitical scene disturbing the current existing order.

A significant driver of the EM recovery in 2016 was the widening of the EM-DM growth differential, after almost five years of tightening. We believe that this is likely to continue into 2017/2018, but at a slower pace if President Trump's economic policies are fully implemented. On the EM side, China will continue to moderate, with most of the improvements expected to come from Latin America, after a weak 2016.

We do not see inflation being an issue, as output gaps still appear to be large, with a majority of EM central banks expected to remain biased toward easing interest rates or keeping them on hold. We expect the easing cycle to pause until US Treasury yields and the US dollar peak. Stronger monetary easing should come from Brazil, Colombia, Russia and India, where disinflation, weak growth and high real rates are providing enough of a cushion for further interest rate cuts.

Fiscal policy uncertainty

On the fiscal side, EM should continue to consolidate while DM is expected to be more expansive. We do not see this EM-DM fiscal gap helping the EM-DM growth differential, however it should make a tighter EM-DM rates differential more sustainable, which should indirectly support growth in EM.

Concerns about the renegotiation of US trade agreements are expected to impact growth in the more open EM economies like Mexico and some Asian countries like Korea, Malaysia and Thailand. How this transpires could also have some implications for China. Until some clarity emerges around President Trump's trade policies, business and consumer sentiment in many EM countries should continue to be undermined by this uncertainty.

President Trump also expressed reservations about NATO during his political campaign, in which currently 70% of the budget is provided by the US. Only five countries (out of 28) currently exceed their treaty commitment of contributing more than 2% of their GDP to the organisation. In our view, the necessary re-balancing of contributions would put a strain on most European budgets (except Poland and Estonia in the EM space).

On a more positive note, better relations between Russia and the US could increase the likelihood of sanctions being lifted. This would represent an upside risk for Russia, as it has already adjusted, more than any other crude producer, to lower oil prices.

A repeat of last year?

Apart from the potential disruption of President Trump's presidency on EM, 2017 could be a replay of 2016 in many ways.

While China's growth has stabilised, its debt problem looks far from being fixed, with the country still heavily dependent on credit. We believe that China has a lot of policy leeway (fiscal and monetary) to support liquidity and bail out part of the financial system, and state-owned enterprises, if needed. Nevertheless, we would expect any financial stress to have an impact on local credit distribution and growth, which could also negatively affect global risk aversion, just like we saw at the beginning of 2016.

It is likely that populism will continue to rise in Europe, as was witnessed last year. The political backdrop in Italy is still uncertain, and we have important elections in the Netherlands, France and Germany. We don't expect any negative surprises at this stage, but these events could, at some point, challenge and test the cohesion of the Eurozone, potentially leading to market volatility and temporarily lower economic expectations for the region.

As in 2016, we expect the US Federal Reserve (Fed) to continue increasing interest rates. However, it will likely be a dovish tightening, with currently two rate hikes expected by the market for 2017. Given markets have had plenty of time to prepare themselves, this should help to limit any negative impact.

We see commodity prices continuing to support emerging markets in 2017. It must be remembered that the drop in commodity prices between 2014 and early 2016 was a key contributor to the EM deceleration, particularly in commodity-exporting economies. Since the second half of 2016, the rebound in commodity prices (especially oil) has provided a lot of support to the EM cause. This should continue in 2017, with our analysis showing a better balance between supply and demand going forward.

We expect that commodity prices (including oil) to increase gradually, which should considerably ease the financial stress on EM commodity producers. This in turn should restore growth, confidence and investment, which could remove the floor put under interest rates after years of instability and uncertainty.

A better outlook for EM

After a few years of macro-economic consolidation, EM economies now appear to be more robust than before. The 'Fragile 5', a term coined in 2013 by a Morgan Stanley research analyst to represent emerging market economies running high current account deficits with a heavy reliance on foreign investment – namely Brazil, Turkey, India, South Africa and Indonesia – seem to have narrowed their external imbalances substantially.

In most cases, this improvement looks to have been accompanied by the implementation of structural reforms and greater productivity – the natural conclusion of this adjustment being a resurgence of investment into EM. In our opinion, investment has been the missing component of EM growth over the past few years (except for China), with our analysis showing that after years of almost zero contribution to GDP growth, it may have a significant role to play in 2017.

Although we expect that China won't be a source of acceleration for EM growth in 2017, the rest of EM should be. Russia and Brazil (the two largest EM economies that went into recession in 2015 and 2016) should slowly recover from their downturns going into 2017. In Russia, strong disinflation now allows its central bank to begin cutting interest rates aggressively to stimulate growth. In Brazil, the reform agenda pushed by the Temer Administration could benefit business confidence further in 2017 and continue to attract investment in the economy.

Finally, political risk in EM should subside. What could potentially play out as the most interesting and positive surprise in EM is in South Africa, where a new ANC president will be appointed toward the end of the year. We see the new ANC leader as the natural candidate for South Africa's next presidential elections and this could significantly reduce the country's perceived political risk.

In summary

We remain positive about EM in 2017, with local debt expected to outperform hard currency debt in the year ahead. Local debt is starting the year with a much higher carry (6.79%) and we forecast interest rate cuts for several large high-yielding EM economies.

In contrast, we expect that external debt should be negatively impacted by Fed hikes. EM currency performance versus the US dollar should also remain modest. EM currencies should benefit from better commodity prices and EM growth, but the US dollar should benefit from President Trump's reflationary policies and Fed tightening.

If we add up the carry, plus a modest currency appreciation and contribution from duration, EM local debt performance for 2017 could be very close to 2016's achievement.

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