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A gentle rebuttal to Carmen Reinhart

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Harvard economist Carmen Reinhart thinks Emerging Markets (EM) are more vulnerable today than they were in 2008 crisis. We disagree. In this Weekly we offer a rebuttal to her main arguments.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	11.1	–	0.13%
MSCI EM Small Cap	11.4	–	0.97%
MSCI Frontier	10.3	–	-2.73%
MSCI Asia	11.8	–	0.52%
Shanghai Composite	10.8	–	-2.25%
Hong Kong Hang Seng	7.2	–	-1.54%
MSCI EMEA	9.4	–	0.79%
MSCI Latam	11.1	–	-4.54%
GBI-EM-GD	6.45%	–	0.92%
ELMI+	4.51%	–	0.39%
EM FX spot	–	–	0.38%
EMBI GD	6.17%	323 bps	1.28%
EMBI GD IG	4.80%	186 bps	1.16%
EMBI GD HY	7.72%	479 bps	1.41%
CEMBI BD	5.90%	300 bps	0.35%
CEMBI BD IG	4.86%	197 bps	0.46%
CEMBI BD Non-IG	7.17%	427 bps	0.22%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	15.4	–	0.33%
1-3yr UST	2.40%	–	0.22%
3-5yr UST	2.65%	–	0.51%
7-10yr UST	2.82%	–	1.07%
10yr+ UST	3.00%	–	2.04%
10yr+ Germany	0.26%	–	2.43%
10yr+ Japan	0.03%	–	0.41%
US HY	6.39%	351 bps	-0.01%
European HY	3.41%	410 bps	-0.63%
Barclays Ag	1.99%	-83 bps	0.56%
VIX Index*	15.77	–	2.69%
DXY Index*	94.80	–	1.13%
EURUSD	1.1554	–	-1.91%
USDJPY	108.63	–	-2.05%
CRY Index*	201.81	–	-3.88%
Brent	75.2	–	-5.53%
Gold spot	1304	–	0.99%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

Emerging Markets

Harvard economist Carmen Reinhart recently commented that EM is more vulnerable today than in 2008.[1] Her comments are clearly timed to match a sudden and quite severe pullback in EM asset prices after the two-year relentless rally, which followed the first Fed hike in December 2015.

In this brief note, we evaluate Reinhart's main points and offer a six-point rebuttal. Our conclusion is that her comments epitomise the kind of punditry, which often accompanies pullbacks in EM markets and which lead many EM investors into making serious Type I investment mistakes, that is, they end up wrongly inferring that a crisis is happening when in fact it is not. Our own view is that the ongoing pullback in EM asset prices was primarily triggered by a sharp reversal in EURUSD. Remember that EURUSD rallied at a faster than sustainable pace of more than 15% in 2017. When European growth and inflation disappointed in Q1, this led to a revision of expectations of ECB monetary tightening, which in turn provided a strong rationale for profit-taking. The resulting vicious Dollar bounce then prompted EM investors also to take profits after a sizzling 26% USD-return in EM local markets in just two years (2016-2017). We do not share Reinhart's view that the pullback materially changes the medium-term outlook, which to us continues to look very strong. As such, we view the pullback as the first opportunity for investors to re-enter the asset class at the best valuations for more than two years.

Having made our view clear, let us address Reinhart's specific points about alleged EM vulnerabilities. We think her view of EM woe and misfortune reflects observations about EM about a quarter of a century ago, when EM countries were still in the grip of destructive Cold War economic and political dynamics. Her observations seem outdated, have little relevance to circumstances prevailing today and in some instances sound downright bizarre. Let us examine each of her points in turn.

[1] For a summary see https://www.bloombergquint.com/markets/2018/05/16/harvard-s-reinhart-says-emerging-markets-worse-than-08-crisis#gs.xswlSqw

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Emerging Markets

1. Vulnerability due to high levels of Dollar debt

First, Reinhart claims that EM countries are vulnerable to higher US rates and a stronger Dollar because two thirds of their debt is denominated in Dollars. This claim is clearly false. A cursory glance at readily available data from the Bank of International Settlements (BIS) reveals that only 14% of EM fixed income is denominated in foreign currency (Figure 1). Based on the latest full-year data from BIS (end-2016), the total EM fixed income universe is roughly USD 20trn of which USD 3trn is denominated in foreign currency. In turn, this breaks into roughly USD 1trn of sovereign bonds issued by some 70 countries and USD 2trn in corporate bonds issued by hundreds of corporates of which about two thirds are investment grade. The balance of USD 17trn (86%) of EM debt is denominated in local currency of which half is government debt and half is corporate bonds.

In light of these numbers, it is very difficult to see where Reinhart gets her two-thirds Dollar debt number. One possibility is that she confuses the EM fixed income universe with the market cap of EM fixed income benchmark indices, which are known to be notoriously unrepresentative. EM fixed income benchmarks only cover 8% of the EM fixed income universe in aggregate, but USD-denominated bonds are better represented than local currency bonds. As Figure 1 shows, USD-denominated bonds account for USD 851bn of the total index market cap of USD 1,662bn. Even so, this still only amounts to 51% of the total EM index universe, i.e. well short of Reinhart's claim of two-thirds of the debt being denominated in Dollars.

Figure 1: **EM fixed income universe (as at end-2016)**

Component	Investment universe		Index universe	
	USD bn	Share of total	USD bn	% of universe
External sovereign debt	976	4.8%	445	46%
External corporate debt	1845	9.2%	406	22%
Local government debt	8341	41.6%	707	9%
Local corporate debt	8909	44.4%	104	1%

Source: JP Morgan, Ashmore, BIS.

2. Local bonds in foreign hands

Reinhart seems to believe that foreigners own most EM local currency debt. This means that she has failed entirely to appreciate the single most important development in EM bond markets in the past two decades, namely the emergence of domestic pension systems. Most established EM countries now secure the vast bulk of their financing within their domestic markets following concerted and largely successful efforts to build domestic pension systems over the last two decades. Reinhart seems to be obsessed about the foreign ownership of such bonds, which can certainly lead to short term volatility. However, she fails entirely to realise that most foreign investors are index huggers, which means that they tend to invest only in the 19 EM countries, which are represented in the JP Morgan GBI EM GD benchmark index. Sure, foreign ownership can at times be high in countries such as Indonesia and Mexico, but both countries have successfully coped with the resulting flow volatility during many previous episodes of volatility, including the Taper Tantrum, the European debt crisis, Trump's election and the Subprime Crisis. We see no reason to believe that the current volatility should sink them when previous bouts of volatility failed to do so. Meanwhile, in other EM markets, such as Brazil, the level of foreign ownership is down to about 12% compared to 30% in bull markets and exposure to local markets by foreign investors is generally low after years of outflows from EM during the height of Quantitative Easing (QE) policies in the developed world.

3. Failure to appreciate external adjustment

Reinhart appears to have forgotten the importance of currency and real exchange rate valuations to economic resilience. EM nominal exchange rates are today 40% lower than in 2008/2009 and EM real exchange rates are also very competitive. Indeed, as recently as Q1 2016 EM real effective exchange rates, which is the single best measure of a country's competitiveness, hit levels last seen in 2003 at the dawn of the last EM local currency bond market rally. EM real effective exchange rates are not just competitive due to lower nominal exchange rates. EM inflation has also declined precipitously from 5.3% to 3.2% over the last six years due to orthodox monetary policies and prudent fiscal policies. The result is that EM today has far stronger external balances than in 2008/2009 despite much lower commodity prices.

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Global backdrop

4. Fundamental resilience

Reinhart appears to ignore the fact that EM countries have just successfully weathered external shocks, which are far worse than anything they face now. Between 2013 and 2015, EM countries had to cope with the largest capital flight episode in modern EM history (Taper Tantrum). EM also faced a 45% rally in the Dollar, the halving of commodity prices in 2014 and a rise in local bond yields to levels higher than those, which prevailed when the Fed had 'normal' Fed funds rate of 5.25% prior to the 2008/2009 crisis. Most EM countries came through these shocks without defaults, without balance of payment crises and even without IMF support. Indeed, bouts of global volatility have not caused a single EM default for the past twenty years and default rates in the most risky part of the EM fixed income universe, corporate high yield bonds denominated in Dollars, are about half of those of US high yield bonds.

5. The debt problem

Reinhart exaggerates the EM debt problem, in our view. Gross general government debt to GDP in EM countries has gone up from a modest 36% in 2008/2009 to 48% today. However, while debt has clearly increased, EM debt levels still average less than half of debts in developed economies, whose debt to GDP ratio has shot up from 84% in 2008/2009 to 104% of GDP today. Bear in mind that EM debt to GDP ratios were also pushed higher by materially slower growth rates and much higher debt service costs between 2010 and 2015 as investors pulled money out of EM. As noted below, EM growth rates are now picking up and we see no general evidence of notable worsening in the fiscal stance across EM. By contrast, developed economies will clearly grow more slowly in the coming years. IMF predicts that the average growth rates in developed countries will decline outright from 2.3% in 2017 to just 1.5% by 2023. Slower growth will certainly push debt to GDP ratios significantly higher in developed countries in the coming years, not least because countries such as the US and Italy have also embarked on major late cycle fiscal expansions.

6. China, again

Reinhart harps on about China's alleged debt problem. Yet, analysts have cried wolf about Chinese debt for more than a decade now without any evidence to support their claim that a crisis is imminent. Indeed, China is now deleveraging, while continuing to liberalise its economy and growing very fast in the process. China's debt stock is actually by far the lowest among the member countries of the SDR basket (issuers of global reserve currencies) and credit growth is well-funded by domestic deposits, which are extraordinary high due to very high savings rates in China. Chinese bonds have actually massively outperformed developed markets bonds in the past twelve months and should continue to perform well as Chinese markets make their way into the global benchmark indices. This will, of course, increase rather than reduce China's access to foreign capital.

7. Meaningless extrapolations

Reinhart does what so many other pundits do, namely extrapolate from a few idiosyncratic basket cases within EM, such as Turkey and Argentina, to the entire universe of nearly 80 readily investible EM countries most of which actually have solid fundamentals. This is quite cynical. Reinhart knows that most individual investors do not know the difference between individual EM countries, so it is extremely easy to paint them all with the same brush. Each year, two or three EM countries screw up, but to write of the entire asset class for this reason seems inane. In fact, EM fundamentals are quite solid at this point in time. It is not just us saying this. The IMF issued very conservative forecasts for EM growth in April of this year. IMF expects that EM growth rates will rise steadily in absolute terms and especially in relative terms compared to developed countries every year from now until 2023. Commodity prices are also gently rising, which will certainly support African issuers and oil producers, though it should be noted that two thirds of EM GDP now consists of non-commodity specialists.

8. Valuations

Reinhart does not appear to know very much about valuations. Today EM sovereign debt spreads sit around 330bps over US Treasuries. This compares to 170bps in 2007 and 220bps in 2010. Moreover, the external debt asset class is twice as diversified today as in 2008/2009, because the number of index members has more than doubled from 32 countries to 67 countries today. Based on the past relationship between yield and index volatility the fair value of EM external debt today is about 200bps over Treasuries. Moreover, a simple analysis of yield, volatility and correlations shows that today the optimal allocation to EM external debt is 99% versus the USD-hedged Global Ag.[2] EM sovereign bonds now offer a higher yield than US corporate high yield bonds. The former asset class has delivered 20% better returns with lower volatility than the S&P 500 over the past 25 years with an average risk-free spread of some 359bps over Treasuries over this period.[3] By contrast, the annual average default rate for US corporate high bonds has averaged 4.48% since 1998.[4]

[2] For more details see *'Chinese bonds in Developed Markets bond portfolios'*, The Emerging View, 18 May 2017.
[3] Spread after subtracting all default-related losses.
[4] Based on data from BAML.

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Global backdrop

Finally, we wish to point out that EM did not actually have a crisis in 2008/2009. The crisis in 2008/2009 began in the US and markets everywhere were impacted, including EM valuations. EM countries started from a position of strength, so very few countries defaulted. Since then, EM countries have been forced to make major adjustments. This was not due to 2008/2009, but rather due to the negative impact, which QE policies in developed countries caused to the allocation of global capital to EM. These adjustments have rendered EM countries better placed to weather tighter global monetary conditions than in 2008/2009. We therefore wonder why Reinhart has issued such damning and unfounded commentary about EM at this precise point in time. As far as investors are concerned, we recommend that they look more to the facts than to Reinhart's opinion. Markets right now are serving up the first and best opportunity to re-enter the EM asset class for at least two years, in our opinion. To sell now, as Reinhart would have investors do, would be the epitome of investment folly.

Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	-2.16%	-1.20%	14.73%	6.92%	4.77%
MSCI EM Small Cap	-1.49%	-1.42%	14.67%	3.72%	3.78%
MSCI Frontier	-8.26%	-6.75%	7.10%	3.72%	4.43%
MSCI Asia	0.03%	1.39%	18.71%	8.13%	8.21%
Shanghai Composite	2.00%	-4.90%	3.02%	-10.40%	8.79%
Hong Kong Hang Seng	-1.14%	4.12%	19.71%	-1.36%	6.26%
MSCI EMEA	-3.31%	-6.38%	6.02%	2.76%	-0.47%
MSCI Latam	-13.88%	-8.07%	1.97%	3.26%	-4.02%
GBI EM GD	-4.69%	-3.40%	1.26%	2.69%	-2.16%
ELMI+	-2.17%	-1.59%	2.50%	1.92%	-0.82%
EM FX Spot	-3.33%	-4.14%	-3.29%	-3.57%	-7.25%
EMBI GD	-0.44%	-3.60%	0.10%	4.56%	4.03%
EMBI GD IG	0.00%	-3.67%	-0.18%	2.70%	2.90%
EMBI GD HY	-0.89%	-3.60%	0.29%	6.70%	5.32%
CEMBI BD	-0.65%	-2.42%	0.68%	3.75%	3.76%
CEMBI BD IG	-0.28%	-2.38%	-0.16%	2.52%	3.10%
CEMBI BD Non-IG	-1.11%	-2.44%	1.90%	5.53%	4.60%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	2.97%	2.58%	14.90%	10.81%	12.82%
1-3yr UST	0.21%	-0.12%	-0.20%	0.39%	0.51%
3-5yr UST	0.28%	-1.09%	-1.42%	0.52%	0.79%
7-10yr UST	0.20%	-2.88%	-2.87%	0.44%	1.01%
10yr+ UST	0.17%	-5.01%	-0.84%	2.14%	2.97%
10yr+ Germany	2.02%	2.03%	2.05%	2.31%	5.47%
10yr+ Japan	0.28%	1.18%	1.81%	4.75%	5.06%
US HY	-0.01%	-0.22%	2.47%	4.91%	4.71%
European HY	-0.84%	-0.70%	2.08%	4.02%	5.75%
Barclays Ag	-1.17%	-1.43%	1.72%	2.54%	1.32%
VIX Index*	-1.00%	42.84%	60.75%	18.48%	8.91%
DXY Index*	3.23%	2.91%	-2.71%	-2.17%	13.32%
CRY Index*	-0.09%	4.10%	10.88%	-8.65%	-29.41%
EURUSD	-4.34%	-3.76%	3.49%	5.17%	-10.72%
USDJPY	-0.65%	-3.60%	-2.37%	-12.50%	7.38%
Brent	0.00%	12.41%	43.76%	14.66%	-26.61%
Gold spot	-0.87%	0.08%	2.82%	9.52%	-6.39%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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