Ashmore

The difference between Paraguay and Uruguay: Active management in the coming global monetary policy shock

By Jan Dehn

Introduction

The approaching shock caused by global monetary policy normalisation will strongly accentuate the differences between Emerging Markets (EM) countries. Knowing the differences between EM countries will therefore become critical to performance.

This poses a challenge to a market that all too often glosses over the differences between EM credits. The tendency to lump EM countries together is wrong today, but it will be positively detrimental to performance going forward.

Paraguay and Uruguay illustrate the importance of paying close attention to credit fundamentals perfectly. They are two relatively small countries with roughly similar-sounding names in the southern tip of South America; many investors probably casually group them together. Yet, Paraguay and Uruguay are very different countries and so has been their performance. Paraguay 2023 bonds today trade 43bps wide of Uruguay 2024s, but this spread was as high as 171bps just a year ago. Uruguay was last upgraded by the ratings agencies (to BBB-) in July 2011, but Paraguay has been upgraded no fewer than four times since then.[1] Paraguay and Uruguay, it turns out, may be similar in size and location, but they are very different in terms of their credit dynamics and performance.

The normalisation of global monetary policy will amplify further the already significant differences between EM countries. The resulting credit differentiation will strongly favour active over passive management, both to enhance returns and to reduce risk.

Revisiting the EM convergence argument

Darwin's Theory of Evolution is a good way to illustrate how and why global monetary policy normalisation will have an impact on EM. The highly complex yet conceptually simple process of evolution occurs when populations of species with pre-existing characteristics in environments of finite resources are exposed to random external shocks. Each shock alters the relative performance of individual species, either favouring or rendering obsolete their specific pre-existing characteristics. Over repeated life-cycles, the lucky species – those with the favoured pre-existing characteristics or those that are able to adapt quickly to the new circumstances – will expand by usurping the resources no longer usurped by those with obsolete characteristics or an inability to adapt to the new environment.

The analogy is not entirely perfect; EM countries will not merely be passive subjects in the process of global monetary policy normalisation. Being more than 50% of global GDP, EM economies and especially their central banks, will also help to shape the world of tomorrow. But regardless of the causality one thing is clear: Change is coming.

The coming shock: the return of conventional macroeconomics

In a bid to avoid a repeat of the Great Depression of the 1930s, developed economies responded to their debt crises with massive monetary and fiscal stimuli. The idea is to allow private sector deleveraging to occur without dramatic losses in current income. Deleveraging has temporarily frozen growth rates, inflation rates and policy interest rates at low levels, while zero-rate and QE policies have pushed up asset prices. Risk aversion, myopia, regulatory pressures and a preference for liquid assets have stimulated disproportionately the demand for developed market assets and their currencies relative to those of EM.

But the return of conventional macroeconomics is inevitable. Easy money will end, the global financial pie will shrink, debts will have to be reduced and reserve accumulation reversed. Debtor nations will soon come face-to-face with the difficult question of how to reduce their debt stocks, while EM central banks will no longer be able to ignore the challenge of how to diversify their reserves away from Dollars.

We think money printing and high debt levels in developed economies will inevitably push inflation rates higher than nominal bond yields, thus inducing pressures on developed country currencies to weaken, while the large external surpluses,

[1] Paraguay was last upgraded from BB- to BB in June 2014 (Standard & Poors' US dollar sovereign credit ratings).

stronger growth, lower debts and comparatively more conservative monetary policies in EM will push their currencies higher.[2] In short, the adjustment required in the real economy will eventually occur via profound changes in asset prices.

This means that the main actors in the EM space – EM investors from developed countries, EM central banks, public debt management officials and index providers – will find themselves playing a central role in propagating the coming global shock. How and why and when these actors move will largely determine how the shock unfolds. And the unique characteristics of individual EM countries as well as the foresight and policy flexibility of their policy makers will largely determine how they cope with the changes forced upon them by the markets.

With these coming challenges in mind, we recently reviewed the current state of EM's fundamentals and concluded that EM fundamentals are in a good state to handle global financial tightening.[3] We also reviewed EM's financial markets and concluded that EM countries have not gorged themselves on cheap money.[4] These are reassuring findings, but they will not prevent major differentiation in performance from occurring across countries going forward, in our view. Knowing the difference between Paraguay and Uruguay will matter a great deal.

What will EM public sector debt managers do?

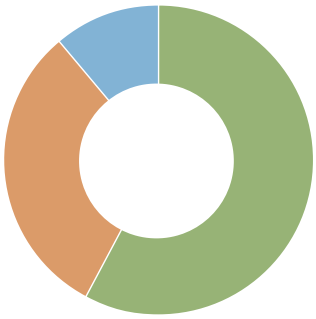
EM public sector debt managers in many EM countries are already fully aware that the global financial pie is about to shrink. They will be asking themselves a simple question: What is the best way they can maintain their share of international capital and secure continuing access to global markets?

One answer is surprisingly simple: Join an index! Passive money will allocate solely on the basis of index inclusion, while most active mandates track indices to various degrees. Joining an index is almost a sure way to secure access to global capital.

The more forward-looking EM countries already recognise the importance of making their markets accessible. For example, Mexico has consistently shown a strong commitment to free and open capital markets, Russia has recently moved all OFZ bonds to Euroclear, Brazil has reversed tack on IOF taxes, Colombia had reduced Withholding Tax and Nigeria joined the GBI Index not long ago. We think India and China could join the local bond indices in the next few years.

There is significant scope for more EM countries to increase their presence in various EM benchmark indices, particularly local indices. We expect Kenya to become the 62nd member of the EMBI GD index soon and for membership of this index to rise to 80 countries by the end of this decade. The EMBI GD currently has 61 member countries and the market cap of the index covers about 44% of total outstanding EM external bonds. On the other hand, EM local currency bond indices only cover a tiny part of the total local currency universe. We estimate the local currency government bond market will grow to about USD 8.4trn by the end of this year. The main index covers c. USD 1trn, or 11% of the total market (based on our projections) and only comprises 16 of the 165 EM countries in the world.

Fig 1: **The Big Fight for Finance: EM Local currency government bond market**



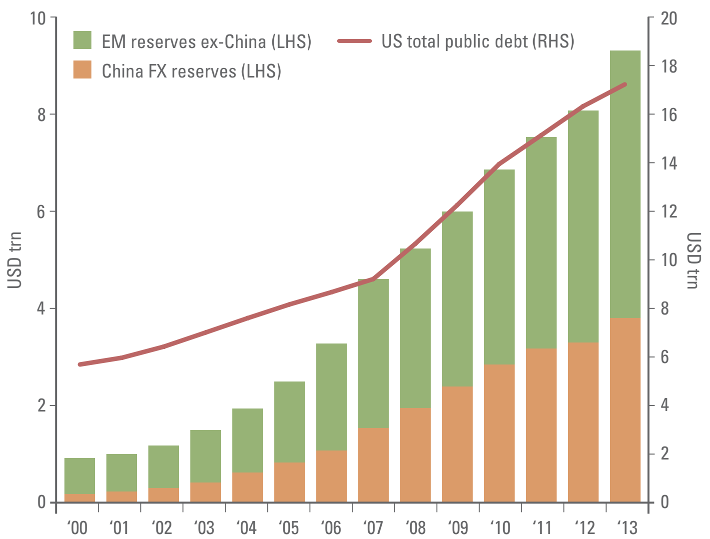
Source: Standard Chartered Bank, JP Morgan, BAML, Ashmore.

EM countries can overcome the formal requirements for joining indices by removing capital controls and streamlining settlement procedures, for example by allowing local paper to settle via Euroclear or Clearstream. But they may face greater challenges in overcoming the 'softer' subjective criteria used by index providers to limit membership (such as liquidity). Index providers have few incentives to cover markets where they do not have branches due to the cost of buying pricing data from third parties.[5]

What will EM central banks do?

EM central banks today sit on USD 9.4trn of reserves of which upwards of 80% is invested in US treasuries in some countries. This concentration of EM FX reserves in US dollar assets constitutes the main systemic risk in EM today; US treasury yields are likely to rise and in addition we think the US dollar will head much lower once inflation returns in the US, probably sometime in 2016 or early 2017 when household deleveraging is over.

Fig 2: **EM FX reserves: At the heart of global imbalances**



Source: Bloomberg, US Federal Reserve, Ashmore.

[2] In *"A pleasant fiction"*, Emerging View, September 2013 we discussed the path for US monetary policy normalisation.
[3] In *"The High Income Trap"*, Emerging View, June 2014 we showed that EM fundamentals have improved for structural rather the cyclical reasons leaving EM in a relatively strong position to withstand a reduction in global liquidity.
[4] In *"Financial Divergence*: Emerging View, May 2014, *How ready are Emerging Markets for global financial tightening?"*
[5] For a discussion of the major market failures in the provision of benchmark indices in EM see *"Are Emerging Markets bond indices public goods?"* Occasional View, 21 May 2014.

EM governments care greatly about their FX reserves. They are an important part of the bulwark against external shocks, so EM central banks will take steps to preserve their purchasing power. EM central banks will be guided in doing so by their strong preferences for liquidity. Diversification efforts will therefore first take them in the direction of the EUR, the second most liquid currency in the world, then into other G10 currencies and then finally towards the currencies of larger EM countries, including Mexico, Brazil, Russia, Turkey, India, Indonesia, South Korea, Thailand and of course, China. This is bullish for local bond markets in these countries.

They import deflation via currency appreciation and their growth rates slow, prompting central banks to respond by cutting rates. This means that local bond markets will be the right place to be in large EM countries once global imbalances begin to unwind.

By contrast, small EM countries will experience less appreciation, because their less liquid currencies will not be targeted by diversifying central banks. Dollar weakness and better US growth will push up commodity prices. This is bullish for equities in such smaller economies, including frontier markets. In general, stocks with exposure to domestic demand should perform better than stocks exposed to exports, so small cap should do better than large cap, though individual large and mega-cap stocks can offer upside, but should be managed extremely actively.

What will foreign investors in EM do?

The single biggest drawback for EM as an asset class is its volatility, not its actual riskiness (i.e. the risk of permanent capital loss). There are few large permanent losses in sovereign space and default rates for corporates are on par with those in developed countries, while investors are paid substantially more for the risk. And the underlying EM fundamentals look a lot stronger in our view.

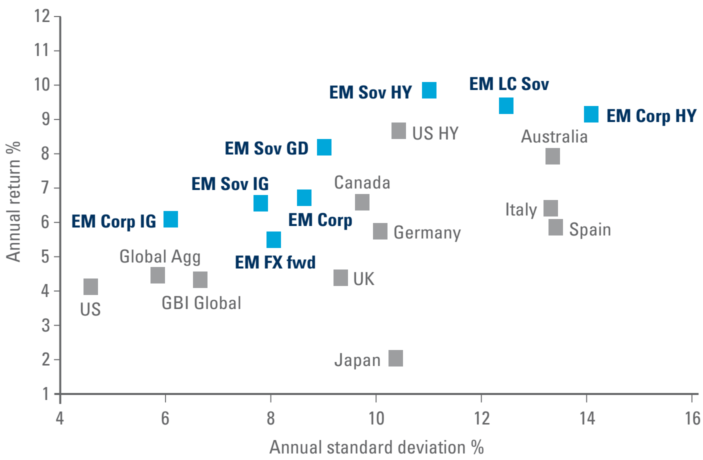
The deep irony is that the excessive asset price volatility in EM is largely caused by investors, not the riskiness of EM per se. Rule of thumb trading is rife; almost any eruption of uncertainty on the global investment horizon triggers kneejerk selling of something EM and equally mindless buying of something in the developed world, usually US dollars and US Treasuries. Each episode in turn creates price volatility and reinforces pre-existing perceptions about EM's alleged riskiness among investors that still, wrongly, use price volatility as a proxy for risk.

Yet, EM asset prices tend to bounce back relatively quickly after eruption of global risk aversion, which means that the realised return of a diversified EM fixed income portfolio, even when adjusted for volatility, tends to be consistently higher than most developed fixed income markets.

A key question going forward is whether foreign investors in EM markets will continue to behave as irrationally in the future as they have done in the past. If so, the flows in and out of EM will continue to be very volatile and structural allocations into EM will be lower than justified by EM fundamentals. On the other hand, if investors are learning from past experiences then the asset class can become more efficient, which is likely to speed up structural allocations.

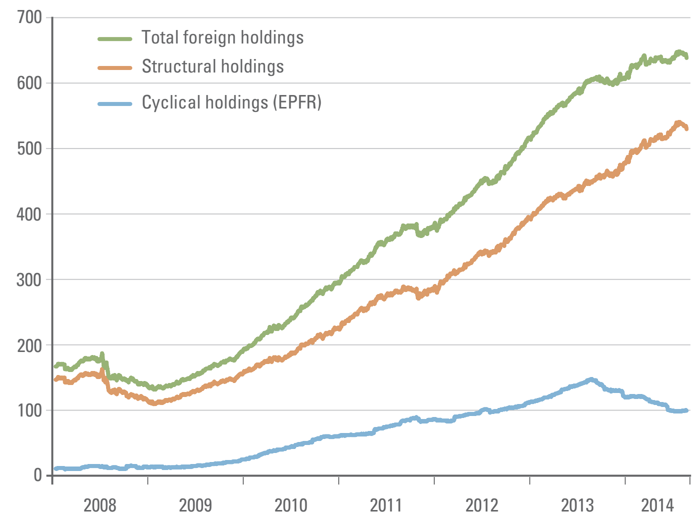
We think investors are learning. For example, closer inspection of the behaviour of foreign investors in EM local markets during the 2013 sell-off shows that different groups of investors behaved radically different in response to the US Fed's announcement of tapering. As figure 4 (below) shows, selling was heavy by US mutual funds, but total foreign investments into EM local markets actually increased, because institutional investors continued to add, despite the temporary volatility, or indeed, because of it. The chart shows that US mutual fund flows are unrepresentative of foreign investors in EM. In fact, EPFR flows (which capture US mutual funds) only represent about 17% of total foreign holdings in EM local markets. Given the strong recovery in EM assets so far this year, it would appear that those institutional investors that added into weaker markets last year will have done better than those that sold into weakness.

Fig 3: **Volatility adjusted 10-year returns for global and EM markets: EM outperforms**



Source: Ashmore, JP Morgan, Bloomberg as at 31 March 2014.

Fig 4: **Behaviour of EM investors in 2013 (USD bn): Cyclical versus structural investors**



Source: Standard Chartered Bank, Ashmore.

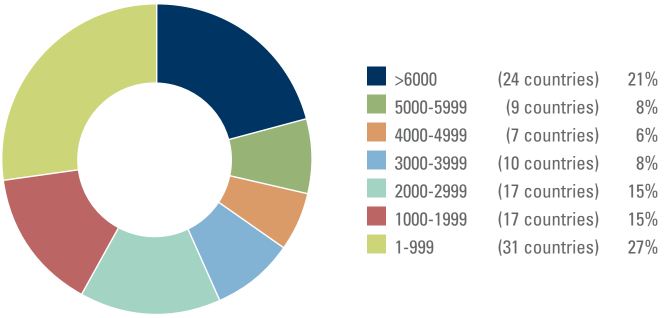
We think all foreign investors in EM will continue to learn, not just about EM countries, but also about the peculiar inefficiencies of EM markets that make episodes of volatility so misleading as guides to actual risk. As it slowly becomes clear that kneejerk selling of EM is irrational we would expect the volatility of the entire asset class to decline, thus alleviating the largest single drawback for foreign investors in the asset class. If this happens, we may be on the cusp of much larger allocations.

What effect will EM country-specific factors have?

Public debt managers will seek index inclusion, index providers will face growing pressures to provide more comprehensive indices, central bank's will diversify and foreign investors will become better informed and more rational in how they manage their EM exposure. Even so, the single most important determinant of EM performance as global financial conditions tighten will be the characteristics of EM countries themselves.

EM countries are hugely different from one another – in terms of their resource endowments, their histories, cultures, the values of their populations, demographics, the state of their financial markets, income levels, locations in relation to trade routes, their systems of government, etc. Moreover, governments have different propensities to reform and their policy decisions may at any point in time temporarily override whatever the structural characteristics of the country would imply about its likely direction of development. Policy flexibility varies dramatically depending on local political conditions.

Fig 5: **EM GDP per capita (USD): A very diverse bunch**



Source: IMF World Economic Outlook April 2014.

Emerging Markets are well placed to cope with the challenges of tighter monetary conditions, however greater differentiation between the performance of the winners and the losers is inevitable. Active management is key.

A priori, we would expect the winners of tomorrow will be those that already now are actively preparing themselves for the unwinding of the global imbalances with productivity enhancing reforms. Among these countries we think China is the most forward-looking. China's economy is not slowing because China is paying for past sins, but because it is investing in its future. Other EM countries that are clearly pursuing very forward looking policies include Colombia, Uruguay, Peru, Philippines, the Baltic states, Malaysia, India and others.

By contrast, the losers are likely to be found among those countries that have very myopic policies, those inclined towards pro-cyclical policies, those less able to ameliorate external shocks due to shallow domestic markets and those burdened with less representative governments. Countries with strongly binary 'zero-sum' politics, such as Ecuador and Ukraine will struggle to build viable coalitions for reform unless they are led by enlightened autocrats. Countries that rely almost exclusively on a single commodity export tend to breed authoritarian governments, whose legitimacy will rise and fall with the value of that commodity. This renders them fundamentally more risky, though whether that risk actually materialises depends crucially on commodity prices (which we think will be well supported due to a weaker US Dollar). Finally, the recent experiences of Syria and Ukraine show that if countries are still under the yoke of Cold War politics they are prone to serious, even existential risks.

In between the expected winners and losers we find a large number of countries, whose current governments do not appear yet to appreciate the full gravity of the coming changes to the global environment. Many of these countries will however adjust once things become a little more acute, in our view. For example, Brazil and Turkey currently fall into this category. What is reassuring to us is that governments in these and similar countries are likely to come under intense domestic political pressure to do the right thing once their economic performance begins to wane materially.

Conclusion

Like biological systems, economies are subjected to a constant barrage of shocks. These shocks impact countries differently depending on their structural characteristics and their ability to adapt to changing circumstances. Chance favours the prepared and the lucky, who get to advance at the expense of others.

The global economy is heading for a major shock in the shape of a tightening of global monetary conditions. There will quite simply be less money available and the money will be more expensive. EM is well placed for this challenge, because EM countries have stronger fundamentals and EM markets are less addicted to cheap money than developed markets.

Even so, greater differentiation between EM countries is inevitable. Those countries that can lock in their share of the global pot of money, for example by joining indices, will be better placed to perform than those that cannot. Central banks will be critical to the speed and direction of the coming global currency realignment. And how well foreign investors improve their understanding of EM will have a big impact on the overall allocation of resources available to EM. Above all, the structural characteristics of individual EM countries and their policy flexibility will matter far more than they have done in the past. EM is not an amorphous mass. Forward looking countries are likely to do far better than countries stuck in intractable situations that render their policies myopic.

As we slowly move towards this future, the smart money will be active money. EM investors – regardless of whether they are EM central bankers or developed market institutions – will win if they understand the difference between Uruguay and Paraguay.

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