# EM's next growth drivers

By Jan Dehn

**EM's long-term growth dynamics remain entirely intact but they are now likely to receive tailwinds from increasingly benign cyclical drivers. Following the giant global portfolio shift induced by QE policies, EM countries now look attractive both in terms of valuations and fundamentals while the rallies in the QE economies look spent. External rebalancing has been profound in EM which will help growth via net exports. Latin America looks very promising as does China. With the start of the Fed hiking cycle now in the past, perhaps the single most important tailwind helping EM right now is the waning momentum behind the Dollar. Global capital follows currencies. If capital begins to flow back to the asset class – which we believe is already starting to happen – then a series of further enhancements to EM's growth prospects will follow.**

## EM's long-term structural growth drivers remain intact

Over the long term, Emerging Markets (EM) growth is rooted in the dynamics of economic convergence – the processes whereby capital tends to flow to countries with lower capital-labour ratios and technical advancements can be adopted at lower cost. These dynamics will remain strong for decades to come, because per capita GDP in EM is still less than ¼ of that of Developed Markets (DMs).

Economic convergence has been particularly strong since the end of the Cold War due to greater local political accountability leading to better economic policies. The basic dynamic at play here is simple: EM electorates are still constrained in their ability to smooth macroeconomic volatility so they tend to strongly prefer governments that deliver stability and growth – and to punish mercilessly those that fail to deliver either. EM economies are also steadily increasing their share of global trade despite recent falls in commodity prices.

This political and economic reality will not change over the next few decades and should ensure that EM countries grow much faster than DMs. The IMF, for example, expects EM countries to grow 4.9% per year on average between 2017 and 2021, while DMs are expected to grow only 1.9% on average over the same period. Given population growth trends, this means that per capita GDP in EM will rise 25% over the next five years – nearly twice as much as per capita GDP in DMs. This, in a nutshell, is why one should invest in EM.

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## The short term EM growth picture has been challenging for some time

The good news is that the recent headwinds have largely been external and financial in nature, not structural, and therefore ultimately temporary. Many of these headwinds are now turning into tailwinds, partly because they naturally abate – for example, commodity prices eventually find a floor, bond yields eventually top out and currency realignments eventually exhaust themselves. EM countries have done the rest by adjusting to the new conditions.

This tendency for economic systems to adjust is now turning into a positive for EM countries because in addition to their long-term growth drivers the EM growth story will now benefit from a number of additional powerful shorter term dynamics, some specific to EM countries, others emanating from developments in DMs.

Specifically, we expect strong returns in EM this year due to high yields against a backdrop of now improving cyclical fundamentals in many EM countries. In addition, return prospects are looking poorer in DMs, where pre-existing growth challenges that were temporarily masked by monetary easing now appear to be re-manifesting. That, in turn, makes for a more benign currency environment, which is critical to the direction of capital flows.

## The giant global portfolio shift

To understand how we arrive at this positive view of EM for 2016 it is necessary to go all the way back to the Developed Market Crisis (DMC) of 2008/2009. This was a financial crisis. The defining characteristic of a financial crisis is that financing that was previously available in abundance suddenly disappears. Policy becomes aimed almost solely at restoring financing, as soon as possible, by any means possible.

The preferred tool for restoring financing following the DMC was asset purchases (Quantitative Easing or 'QE'). As of early 2016, the combined asset purchases by the Fed, BOE, BOJ and the

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ECB had reached USD 13trn, which is more than 10% of all outstanding corporate and sovereign bonds in all DMs. Financial repression and zero-interest rates policies also played a role in the restoration of financial flows to DMs, but they were marginal in comparison to QE.

The impact of QE on global asset prices has been enormous, but highly uneven. QE central banks did not buy a single EM asset; they only bought their own country's assets. Institutional investors jumped on the QE bandwagon, financing their purchases in the QE markets by reducing exposure to the non-QE markets, including EM.

The result was a giant portfolio shift whereby capital flowed into US equities on a bullish view of that country's recovery, into European bonds on the view that Europe will neither have growth nor inflation and out of EM on the view that EM would fall under tightening financial conditions.

The sell-off in EM was largely indiscriminate. By late 2015 EM currencies had fallen by more than 40% against the USD, dropping 10% per year for years on end. EM bond yields were pushed to levels last seen before the DMC when Fed interest rates were higher than 5%. Local currency bonds and high yield segments of EM fixed income were particularly badly hit.

### Is the EM sell-off a good basis for future returns?

After years of QE, the key question now facing investors is this: Was the sell-off justified? Do the enormous differences in valuation between DMs and EMs constitute an opportunity, or are high yields foretelling trouble to come?

Whether the so-called EM crisis of the last few years is a genuine fundamental crisis or an 'EM investor' crisis, i.e. a crisis of sentiment, is a classic relative value question: are the risks as high as yields would imply in EM and how does the risk-return trade-off in EM compare to the one on offer in DMs?

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### Resilience

The first clue comes to us from the recent default history in EM. Despite the quadruple whammy of the Taper Tantrum, USD strength, collapsing commodity prices and the start of the Fed hiking cycle, there have been just two sovereign defaults in EM out of an index of 62 countries.[1] Corporate default rates in EM never rose above long-term average default rates since 2010 and currently track well inside default rates for, say, US corporates. Low debt levels, better demographics, better fiscal policies, far less leveraged financial systems, higher levels of reserves, more prudent monetary policies and a greater proclivity for reforms – all reasons why investors should consider EM in the first place – did their job in providing resilience to shocks.

### The growth delusion

The second clue is in growth rates. EM has in fact not suffered nearly as much as asset prices would imply. The latest data from IMF's World Economic Outlook from April 2016 shows that EM economies grew on average 5% per year between 2012 and 2015 – this growth rate is virtually identical to EM's long-term growth rate. Global growth rates have slowed in post-DMC, but this is mainly due to DMs, not EM. DMs grew only 1.6% on average in the 2012-2015 period despite enormous stimulus. This is more than 40% slower than the decade and half prior to the DMC. Seen over the post-DMC period as a whole, the real growth crisis has been in developed economies, not in EM.

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### EM's cyclical downturn

Averages can be deceptive. EM growth rates have in fact trended down over the period from 2010 to 2015. This slowdown is cyclical, however. The outflow of capital from EM, especially in local markets, pushed yields up and currencies down all in the context of low, stable inflation. As such, QE in effect inflicted a classic macroeconomic adjustment on most EM countries regardless of whether they needed it or not.

Real financial tightening and big currency moves encouraged resources to move to more productive uses within EM countries – people and capital moved from non-tradable sectors to the tradable sectors and from domestic demand towards exportables. This temporarily slowed growth, but it also sowed the seeds for a restoration of EM's competitiveness.

### Dramatic improvements in external balances

EM external balances are responding strongly to weaker currencies and depressed domestic demand. On average, EM countries have improved their current account balances by 3.5% of GDP in the past few years, despite sharply lower commodity prices.

Stronger current account balances contribute directly to higher FX reserves and higher growth rates via net exports, which enter positively into GDP. EM's share of global trade has been rising despite the headwinds.

### EM's new growth engines

2016 will be the first year since 2011 that EM's growth premium – the excess of EM growth rates over DM growth rates – rises. Moreover, the latest forecasts from the IMF suggest that EM's rising growth premium is not just a flash in the pan – it will continue. This is partly because EM economies are seen to

[1] Argentina and Ukraine.

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accelerate outright, but also because DMs are seen not to recover their former dynamism.

The IMF expects EM economies to accelerate to 4.1% growth in 2016, up from 3.9% in 2015, and rising to 5.1% per year by 2021. By contrast, DMs will slow to 1.9% in 2016 and to further decelerate to a rate of just 1.8% by 2021.

The strongest recoveries will be in Latin America, Africa and the Middle East. They have had the biggest downturns, the biggest FX moves and been hit the most by the drop in commodity prices.

### EM differentiation – don't make too much of it

Differentiation between EM countries is not new and can be overplayed. Investors largely pay lip honour to differentiation – when sentiment sours they forget about nuances and treat the asset class like an amorphous mass. Sure, structural differences matter. Clearly discernible groups can be identified, including undiversified single commodity exporters, countries with deeply binary political structures, EM countries still caught in the Cold War dynamics. However, ultimately, the actual risk of investing in any one country depends more on the quality of the policy response to shocks than the shocks or the country's fixed effects per se. The very different experience of Russia and Nigeria following the fall in oil prices is a case in point. The lesson from many previous examples of herd-like panic selling in EM is clear: the best strategy is to use spikes in risk aversion to add, because it locks in alpha potential.

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### Latin America – on steroids

Having said that, Latin America looks especially interesting right now. A number of populist regimes are on their way out and look set to be replaced by more sensible governments. Argentina, Brazil and Venezuela are large, important economies with influence across the entire region. These three populist regimes have either already fallen (Argentina), are in the process of falling (Brazil) or will likely do so in the foreseeable future (Venezuela). The Latin American recovery will therefore not just be a standard cyclical one – it will also be one where trend growth rates can be expected to rise due to better policies.

### China – don't be too myopic

China's gradual slowdown is due to reforms as the economy is weaned from export towards domestic demand led growth. This policy is forward-looking and is based on the view that debt fuelled demand in the West is over and that QE will weaken DM currencies. China has plenty of scope to increase domestic demand due to the country's 50% savings rate. But in the short term, China will have to liberalise interest rates, which creates uncertainty and raises default rates. It has to raise productivity, which means price liberalisation, SOE reform, judicial reforms, all of which put spending decisions on hold. It also has to open the capital account, which encourages speculation.

The market's 'Death Star' perception of China is both myopic and outright wrong. China is trying to join the world economy, not destroy it. China's SDR inclusion will be completed this year and its markets will now join the main indices. By 2045 China's per capita GDP will be the same as that of the US, but China will be 4.5 times bigger than the US, so China's government bonds will replace US Treasuries as the global fixed income benchmark while the RMB will replace the USD as the most important global reserve currency. This means enormous benefits to China, especially to fixed income markets which already pay more than other SDR countries and have performed better than the US bond market, even in Dollar terms, since the start of 2014.

### What about China's debts?

China's debts are large, but so are its savings, which are the resources required to service the debt. EM countries in general have a positive relationship between savings rates and debt stocks and China is not far from the regression line. Moreover, much of China's debt has financed infrastructure investment, which will pay off in terms of growth. We expect China to remain the single most important source of global growth. Reserves will rise this year. Most corporates have refinanced their debt in RMB in the past year, so outflows will wane.

### What about the Fed?

EM markets priced in far more hikes than necessary ahead of the start of the Fed hiking cycle last year. So far, the market has been exactly in line with the previous similar hiking cycle in 2004. Local bonds are up double digits and corporate high yield bonds have strong returns too. EM is performing far better than DMs.

The Fed is likely to be constrained in raising rates, more so by low growth than rising inflation. The failure to reform since 2008/2009 has lowered trend growth rates to the point where the Fed cannot both hike and maintain decent growth at the same time. When inflation resurfaces, the Fed must choose between growth and price stability and it will opt for growth. The long-end of the US treasury curve will come under pressure, which will usher in more financial repression to keep the curve under control. As inflation rises amidst repressed nominal yields, real yields decline; and real yields drive currencies.

The exit from debt will be a process of inflation and currency debasement. Rotate currency exposure away from the USD towards EM FX once inflation resurfaces, probably late this year or early in 2017, provided the US avoids recession in which case the Dollar weakens sooner.

Even if we are wrong about Treasuries, EM bonds have a meaningful yield cushion. One way to express this is to look at how many years of carry investors will lose for a given move in yields. In EM today, the worst you can do is drop 1.8 years of carry if yields increase 150bps (in EMBI GD). In the US and UK, the equivalent loss is seven years of carry. In German bonds it is 19 years of lost carry. In Japan, carry is negative, so no amount of carry will compensate you for capital losses if yields rise.

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## DM – the declining opportunity cost of an EM investment

The outlook for DMs is becoming more troubled. The early success of QE restored financing to the crisis economies, prevented, for now, depression and above all, sent asset prices surging. Sadly, nothing else happened. Low interest rates and rising stock markets removed any incentives to deleverage and reform. The QE driven rally of the last few years was a sugar high. DMs are now expensive. US stocks had negative returns last year and weak performance has continued this year. Some 50% of European government bonds now pay negative yield. Investors should ask themselves: where will I get my next 10% return?

The economic problems are arguably worse today than in 2008/2009. Productivity is falling. Debts have gone up, not down. Asset prices are much higher than before the DMC, but today there are practically no conventional easing options left in case things go south. DMs are far more risky now. The next generation of policy tools – such as Helicopter Money, directed lending and FX manipulation – will be far less effective and have bigger costs, especially for investors.

## The rise of populism

The problems are not just economic. QE has increased inequality between those with a lot of their assets in financial markets and those that don't. This distinction also happens to closely match 'rich versus poor'. Rising disillusionment is now paving the way for a new crop of populist politicians. Their political appeal will not be matched by effective policies, if anything they will make things worse.

## The USD round trip

In the early years after the DMC the US welcomed the rising Dollar. The government was able to find buyers for its debt overseas and capital flowed back to America, because investors like to have their money invested in currencies that go up. But by now the strength of the USD has become a problem for the US as well. The Dollar rallied on expected growth and expected hikes, but it has now become so strong that it is hard for the US to grow and therefore made it hard for the Fed to hike rates. In short, the US Dollar has become a victim of its own success.

The significance of the moderation in the Dollar is hard to overstate. Following years of outflows and financial tightening that contributed directly to a cyclical slowdown in EM, capital is now flowing back into the asset class. The resumption of flows to EM will directly ease financial conditions, which means more credit for investment and consumption, thus higher growth rates.

A more stable Dollar should also provide a floor for commodity prices – this will help a minority of EM countries, but many of them trade at very distressed levels, so if commodity prices do go up from here there is a lot of money to be made.

The outlook for local markets is also supported by a strong technical picture. The two single largest consensus positions in the world today are long USD and short EM.[2] Even investors who have maintained exposure in local markets have generally not added to positions, so as their AUM has gone up EM has declined relative to other allocations. The main implication of a good technical picture is that current market dynamics could go on for longer than many expect.

[2] For example, a survey of global asset managers undertaken by BAML shows this (*BULLs3ye*, BAML, 13 April 2016).


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