Q&A

Emerging Markets: Braced for the New World Order

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Research Analyst, 2006–

Citigroup Investment Banking
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Fiduciary Trust International
Investment Strategist, 1999–2000

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Merrill Lynch & Co.
Emerging Market Debt Analyst, 1991–1995

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*In this Q&A, **Senior Research Analyst Robert Abad** describes recent developments in the emerging market space, the risks that investors need to be aware of, and why Western Asset is well positioned to benefit from the changing dynamics within this market. In contrast to previous periods, external factors are increasingly driving risks within emerging markets. However, emerging markets have demonstrated an ability to weather broad market shocks, such as those that occurred in 2008.*

Q: Is interest in emerging markets waning with all of the recent volatility?

A: On the contrary, there's increasing interest in emerging markets by a large number of investors who recognize that this asset class is a solid long-term story. What do I mean by long-term? If you take a look at the state of today's world through the lens of economic history, the whole picture is now "upside down." In an incredible departure from the 1990s era of defaults and devaluations, emerging markets now sit in the position of "creditor," while the developed world has assumed the role of "debtor," an outcome that would have been difficult for me to imagine when I first started analyzing emerging market (EM) sovereign debt 20 years ago. A lot of this can be attributed to much of the EM world finally reaping the benefits of three critical inputs—labor, natural resources and capital—which brought tremendous power and influence to the Western world during the past 200 years.

This shift in the balance of economic power was reinforced during the depths of the 2008 financial crisis, when China's massive stimulus package played a huge role in restoring confidence across global markets. And this shift has forced even market veterans to reevaluate their understanding of emerging markets in the new world order. That said, the rising prominence of emerging markets in the global arena will not be smooth. Geopolitics can get very messy, and some countries will experience growing pains as they integrate further into the global economy. But if you study paradigm shifts in world history, you'll see that it takes a very long time for newly established trends, such as the reemergence of emerging markets, to bend or reverse.

From a market perspective, we can appreciate the skepticism or reservations some investors may have about adding what was traditionally a volatile, below-investment-grade asset class to a fixed-income portfolio seeking to generate income while minimizing volatility. But emerging markets, in aggregate, reached investment-grade status years ago, so that should render the latter characterization obsolete. Regarding "volatility," what does that term really mean when, in today's fractured markets, a closely watched risk barometer such as the VIX can compress to levels near historical lows, or the S&P 500 can drift to pre-2008 crisis highs while economic, political and social risks continue to escalate around the world? The breakdown between markets and reality is not sustainable.

We would argue that instead of trying to assess the merits of an asset class by studying backward-looking data of decreasing relevance—especially as we enter a new world order fraught with uncertainty—investment managers should aim to identify those fixed-income investments that are capable of weathering broader market shocks and delivering full payment of principal and coupons. If we look at emerging markets' performance during and after the 2008 crisis, we have proof that it can deliver on these two fronts.

Q: Can you put into context the risks in emerging markets today?

A: When we think about risk in emerging markets, we tend to focus, first and foremost, on any pressure points that could lead to extreme negative outcomes. The pressure points in the current environment actually stem from external factors to a much greater extent than from internal factors, and largely center on two potential market events: renewed quantitative easing (QE) in the US and full-scale financial meltdown in Europe. The implications for emerging markets from each event, though, are very different and can broadly be categorized as creating either country-specific risk, or systemic risk.

A decision by the US Federal Reserve to resume QE—on top of its "low rates through 2013" policy stance—would bring the dual threat of commodity price inflation and speculative capital inflows to bear on EM policymakers. And this, in turn, would have different implications for different countries—for example, a commodity exporter and a commodity importer—with both immediate and long-term consequences. In an environment where unilateral policy decisions can create such a heterogeneous set of risks across the emerging world, the importance of country research cannot be understated. It's the first line of defense for an investor's portfolio, and one of the areas we really focus on in emerging markets.

The sovereign debt problem escalating in peripheral Europe is much more concerning, from our perspective, as it's now affecting confidence around core European banks. Financial turmoil there, especially combined with a potential slowdown in the US, would be a serious short-term threat to emerging markets, as the fiscal position, growth dynamics and monetary stance across the developed world are much weaker today than they were in 2008–2009—leaving global growth much more exposed to downside risk than was the case in 2008.

Clearly, the systemic nature of such a crisis would create mark-to-market risk across the entire spectrum of EM assets. Keeping in mind emerging markets' solid fundamental positioning and their performance throughout 2008–2009, our focus is on trying to avoid those assets that would be most directly (and potentially permanently) impacted by such a crisis. In turn, this enables our portfolios to potentially fully realize the benefits of a bounce-back in EM asset prices.

Precisely because the transmission of risk from Europe to the rest of the world would flow directly through global financial channels, we have been underweight EM banks for some time. To mitigate broader market risk, we've continued to emphasize diversified investments in strong-balance-sheet countries and in securities with the greatest amount of liquidity by rotating across the three EM sectors: USD-denominated sovereigns, local markets and EM corporate credit. It's an investment philosophy that makes sense and that has successfully worked for our clients during these volatile times.

Q: How do you respond to the view that EM equities offer better value now?

A: Historically, investors have gravitated toward EM equity over EM debt because equity was perceived to be the most liquid and direct way to take advantage of the EM growth story. If you look only at data from the past decade, that thesis certainly appears to have some merit, as EM equities outperformed EM debt in absolute terms year after year. But again, I want to stress the pitfalls inherent in assessing an asset class using only backward-looking data, particularly when doing so in the context of a global paradigm shift. Are the factors that drove such spectacularly positive performance throughout most of the last decade still in place? While it's impossible to say with certainty, an environment characterized by a slowly deleveraging developed world certainly challenges this view. And this gets to the heart of what we think really separates EM debt from EM equity: consistently superior risk-adjusted returns.

With this in mind, the fundamental argument against the traditional growth-driven investment thesis for emerging markets is even more persuasive. Slower global growth, exacerbated by the massive public and private debt burden in the developed world, increases the probability of economic and sociopolitical risk globally, which eventually impacts market valuations. We've already started to see this.

What should matter more to investors going forward, then, is how their investments can be expected to perform over a very wide range of potential economic scenarios—or in other words, their expected risk-adjusted returns. The balance-sheet strength and financial flexibility currently enjoyed by many EM countries would be critical to weathering the shock of another protracted global growth slowdown or broad-based financial crisis, providing a floor for EM debt prices under even the most negative of scenarios. Conversely, the inability of EM countries to sustain the kind of growth rates seen in recent years under such a scenario would likely weigh very heavily on EM equity performance. As such, we would expect EM debt to continue to consistently outperform EM equities on a risk-adjusted basis.

Q: How is Western Asset positioned to take advantage of this evolving EM space?

A: Western Asset has been involved in emerging markets since 1993. As the EM investable universe has grown over the past 20 years, so has the depth of our collective experiences and our respect for what it takes to successfully navigate markets through smooth and turbulent times.

Western Asset's team culture and investment approach have really contributed to our success in emerging markets. Our more than 25 dedicated EM professionals are passionate about the countries and sectors they cover, and there's a high degree of communication and collaboration among colleagues across our global footprint, which covers New York, Pasadena, London, Singapore, Melbourne, Tokyo, Hong Kong and São Paulo. In this new world, having a top-down and bottom-up approach to global investing is essential, which is why the EM team benefits from the critical input of forums such as the Global Investment Strategy Committee and the Global Credit Committee and vice versa.

Emerging markets have been, are, and always will be a price-taker of global interest rates and FX risk. There is no doubt, with the events that we're seeing today, that a paradigm shift is underway in the global economy with potential change looming over the current international monetary order. The staying power of emerging markets will depend in large part on how the developed world addresses its structural problems. One half of the world simply cannot manufacture a sustained global recovery without the other half—the math doesn't work that way. You can therefore understand why I remain puzzled by people using terms such as "decoupling" or "safe haven" to characterize emerging markets and justifying emerging markets solely as an isolated growth play.

With this view of risk and reward, we really believe a global story is best managed by a global firm in terms of scale and scope, and by a process such as Western Asset's.