



Emerging Markets: What Forces Are at Work?



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Recently, the increased risk in Emerging Markets (EM) has led to questions about what forces are at work and where the opportunities may be going forward. In this Q&A, **Portfolio Manager Robert Abad** offers insight into what may be influencing the behavior of EM and how this could be built into investment considerations.

Q: Investor opinion on emerging markets (EM) appears to be mixed with economic, political and social risks flaring up in various parts of the world. Why do you see EM as a compelling investment option at this time given heightened market risk?

A: There are several reasons to be constructive on EM. From a fundamental perspective, the need for continued monetary accommodation to support a still fragile global economic recovery is a positive catalyst for EM. Continued, unfettered access to low-cost capital allows the more vulnerable EM economies, such as the “Fragile Five”, as well as stressed EM corporate credits, more time to shore up their liquidity needs and balance-sheet strength, which in turn helps buoy their creditworthiness. From a technical perspective and after an impressive four-year run, the sharp normalization of valuations across EM sovereign, corporate credit and local markets over the past year has now made each of those segments much more attractive when compared with fixed-income markets in the developed world. Given these forces, it shouldn’t be surprising to see EM performance and inflows year-to-date surpassing the pessimistic forecasts most market analysts touted as we entered 2014.

This confirms our thesis that market participants have become more attuned to risks in EM and are willing to weather volatility-inducing situations such as the political turmoil in Turkey, World Cup-related woes in Brazil, and the Russia-Ukraine crisis. As we noted in our [EM Perspectives commentary](#)² last July: “for those with a positive, long-term fundamental view on EM, these will be the moments to set aside the tired rhetoric of ‘gloom and doom,’ and strike.”

Q: With risks in EM growing in complexity, should investors be concerned about risk or valuation models having the unintended effect of amplifying market volatility?

A: In a [2010 white paper](#)³, Western Asset’s Chief Risk Officer, Ken Winston, noted that one of the key principles of investment risk management is that “Hazards that defy quantitative analysis must be anticipated.” Currently, due to the central bank intervention noted earlier, market volatilities are quite low. This leads many risk models to anticipate continued low volatility. As the statistician George Box noted, “Essentially all models are wrong, but some are useful.”⁴ Risk models are useful when the consumer of the model understands its assumptions and the implications of those assumptions. No experienced risk manager and no experienced portfolio manager blindly follows risk models; they use the risk model as guide to intuition, while simultaneously evaluating “hazards that defy quantitative analysis.”

¹ “Fragile Five” refers to Brazil, India, Indonesia, South Africa and Turkey

² “[Emerging Markets Perspectives: Time to Embrace Volatility](#),” Western Asset, July 2013.

³ “[Principles of Investment Risk Management](#),” Western Asset, October 2010.

⁴ *Empirical Model-Building and Response Surfaces* Box, George E. P.; Norman R. Draper (1987)

EM valuation and risk management models are by definition complex due to the dynamic nature of this market, given the analysts and developers wrestling with the age-old challenge of assigning proper weights to quantitative and qualitative risk factors. With this in mind, we would pay less attention to the impact of EM models on market volatility and more on the assumptions that EM asset managers use to support their investment decisions. It's the degree of divergence between expected and actual outcomes, and the timing of the latter (which is unknowable), that generate the bouts of sharp and sudden volatility in our market.

Q: To what extent has “herding behavior” impacted risk differentiation in EM?

A: Herding behavior has always been evident in EM, but the drivers of this market phenomenon have changed since the 2008 financial crisis. Pre-crisis, analysts had a relatively easier time differentiating between strong and problematic credits. Markets were smaller in size and number, and new issuance was less frequent, allowing sufficient time to perform due diligence. On the back of that work, market participants would “herd” to and from a specific country based on what they could exploit from idiosyncratic risks (e.g., Argentina debt crisis in 2000-2001) or systemic risks (e.g., Russia/Long-Term Capital Management crisis in 1998).

The QE programs initiated by developed world central banks in 2009 muddled this dynamic. With each successive QE announcement, the strong demand for EM assets suppressed market volatility further, creating the illusion that EM idiosyncratic risks were relatively contained. This eventually spawned a more pernicious form of herding behavior whereby investors began to focus more on QE-related factors to justify their investment decisions rather than relying on traditional, fundamental EM risk factors. It wasn't until tapering fears surfaced in May 2013 that this behavioral cycle hit a wall, helping to restore some common sense back into our market.

Q: What role did exchange-traded funds (ETFs) play in last year's EM market volatility?

A: As discussed earlier, the QE side effect of volatility suppression across risk markets turbocharged new investors and sizable new money into EM sovereign, corporate credit and local markets. Double-digit performance starting in 2009 and expectations that this one-way momentum would continue for many more years led to a proliferation of new, low fee, passively managed EM ETF products. Many retail investors were lured by BRIC, MINT and other acronym-driven marketing campaigns which paid no respect to the importance of active portfolio management in EM, let alone to the laws of financial market gravity. While the sharp and sudden redemptions from EM ETFs last year certainly aggravated overall market volatility, the unwinding of the over-bloated ETF segment was a healthy development for EM as it removed an unwelcome layer of froth from the market and highlighted the risks of passively managed ETFs for retail investors.

Q: Does the current composition of EM benchmark indices represent another potential source of market volatility?

A: In late 2012, we were concerned that “with monetary policy in the G-3 remaining highly accommodative for the foreseeable future, the pace and quality of growth in EM—for example, the amount and type of issuance throughout the EM corporate credit space and the level of asset quality and leverage in EM banking systems—[bore] close monitoring to identify potential balance-sheet vulnerabilities percolating under the surface.”⁵ While last summer's correction went a long way toward reducing the pace of speculative issuance and reintroducing investment discipline and proper due diligence, unfortunately, we still need to be cognizant of the fact that investor memory skews toward the short term.

If you look at the JP Morgan EMBI Global Index, which asset managers and consultants have embraced as a proxy for the investable universe of EM sovereign debt, the number of country constituents has grown from 15 in the early 1990s to 61 thus far in 2014. The number of EM corporate issuers in the JP Morgan CEMBI Index, the most widely used benchmark for EM corporate credit, has tripled to almost 500 since 2008. Combined with a dearth of experienced EM

⁵ “Emerging Markets – Maintaining Perspective,” *Western Asset*, September 2012.

analysts on both the sell-side and buy-side, the explosive growth of the asset class has stretched the ability of market participants—and this includes the major rating agencies and the EM broker/dealer community—to fully process the myriad risks associated with all of these newer issuers. The job of EM asset managers, such as Western Asset, is to continue focusing on those stories that offer the best risk/reward proposition, while putting up the necessary firewalls to prevent the more speculative issuers—the “walking dead” in our space—from becoming a fire accelerant at the worst possible time.

Q. Russia, China, Brazil and Mexico have the largest country weights in JP Morgan's CEMBI Broad High-Yield Index. What are your views on each and how is Western Asset currently positioned in its EM High Yield strategy?

A: Russia: The consensus for near-term growth outlook remains unclear, given the increased uncertainty around the extent and impact of US/European-led economic sanctions that have aggravated an already fragile story. So far, we've observed a sharp depreciation of the Russian ruble, a depletion of international reserves, and an ensuing tightening of monetary policy to arrest a potential inflation spiral. It remains to be seen if the expected improvement in Russia's external trade position, on the combination of additional ruble depreciation and higher oil and gas prices (a by-product of the crisis), will be sufficient to offset the domestic contraction stemming from tighter monetary conditions as well as the marked slowdown in post-Olympics investment and consumption-related activity.

On the positive side of the ledger, Russia's relatively low public debt and fiscal position are expected to remain stable despite the economic turbulence, which supports our view of the country's ability to maintain its investment-grade ratings. Russia's large weight in the various benchmark EM indices, global investor familiarity with its sovereign and corporate credits, and the relatively high liquidity of its assets, are important technical factors that should continue to support investor interest; this is precisely what we observed with Russian assets during the market low of 2008.

It's also why we've used the recent volatility in Russian bond prices to raise our exposure in our EM High Yield strategy from underweight to neutral. Going forward, we would expect to remain broadly neutral in this space, assuming the absence of a meaningful change in valuations from current levels.

Brazil: Until a few weeks ago, sentiment toward Brazil had been steadily deteriorating. Market dissatisfaction with government interventionism, continued fiscal and current account deterioration, bouts of social unrest, public relations fiascos around the World Cup build-out, and fears of a sovereign downgrade precipitated a sharp decline in the Brazilian real in 2012, triggering a vicious cycle in equities that culminated in last year's sell-off in Brazilian sovereign and corporate debt. However, S&P's decision in April to assign a BBB- rating with a “stable” outlook marked an inflection point for investor sentiment, with the real and Brazilian assets rallying sharply from the lows.

Sources of additional market volatility currently remain in place: Brazil faces a potentially protracted period of high inflation on weather-related food price pressures and the unwinding of costly public tariffs, and general elections this October. It remains to be seen just how much elected officials will tilt toward more market-friendly policies that help generate a more constructive balance between growth and inflation. A continuation of the current, unpopular measures would be a clear negative for Brazil.

In the interim, positive drivers of the Brazil story remain intact: the country's resilience to external shocks remains at a very high and comfortable level with international reserves accounting for more than 120% of its external debt; short- to medium-term debt service is low and more than offset by hard-currency reserves; the current account gap, which remains vulnerable to China's growth momentum, has been mostly financed by foreign direct investment, and monetary tightening has been underway for some time and appears to be reaching its final stages. Overall, our “against-the-consensus” view remains unchanged. We continue to see value in select Brazilian high-yield assets that have proven their resilience during the past year.

China: The new Chinese administration under President Xi Jinping aims to focus more on the quality of growth as

opposed to the quantity of growth. We're monitoring this balancing act closely. The combination of a \$4 trillion mega-stimulus package in the wake of the 2008 crisis and a regulated interest rate regime have fueled the rapid growth of the shadow banking system in the last five years. Moreover, as China's authorities embark on reforming the economy away from property investment towards consumption, the measures taken in the near term may have the unintended consequence of tightening financial conditions onshore at a time when there are increasing concerns over the rise of local government debt, corporate borrowings, and shadow banking related defaults.

To its credit, the Chinese government has demonstrated a long track record of navigating economic transitions, and risks associated with its plan to rein in financial excesses are mitigated in part by its fundamental strengths, which include a formidable stock of international reserves, a large productive work force, a closed capital account and a state-controlled banking system. That said, we remain broadly underweight the China high-yield space given the substantial new issuance pipeline and valuations (particularly in the property sector) which imply a more benign outlook than fundamentals would suggest.

Mexico: Investors began to lose faith in the Mexico story following the change in administration in late 2012. A series of policy missteps on housing (which led to an implosion of the largest public homebuilders), delays in infrastructure spending during the government changeover (the well-known "sexenio"⁶ effect), and healthy skepticism on President Enrique Peña-Nieto's ability to fulfill his campaign pledge of "groundbreaking" structural reform efforts only served to worsen the investment climate through the summer of 2013.

Since then, the turnaround in sentiment toward Mexico has been nothing short of impressive. Although recent growth has been underwhelming and is expected to remain weak throughout 2014, concrete progress in energy, telecommunications, labor and political reform as well as an incremental recovery in construction and manufacturing via renewed public spending (aided in part by a pickup in US manufacturing activity), sets the stage for stronger economic conditions in 2015. For these reasons, as well as Mexico's strong balance-sheet position, which was affirmed by Moody's single-A rating earlier this year, we maintain our healthy overweight position in Mexican high-yield debt.

Q. Have you observed any new trends developing in the EM debt space?

A: In our [EM High Yield \(EM HY\) primer](#) from April 2012⁷, we noted that: "from the perspective of developed markets, the emergence of an investable, EM HY market would seem a logical next step in the evolution of the asset class as a whole." Since that time, we've seen a meaningful bifurcation between the investment-grade and high-yield-rated segments of the EM sovereign and corporate credit space—a natural, evolutionary process in line with the growth of the US and European credit markets. We've also observed a push toward blended EM strategies that combine EM debt and EM equity—to take advantage of full capital structure arbitrage opportunities in the EM corporate space—and "unconstrained EM" mandates that allow full investment discretion across the EM spectrum.

In the same primer, we also noted that: "Driven in part by the realization that this segment of the asset class provides a more tailored way to participate in the secular credit improvement story of the emerging world, and in part by investors' need to obtain yield in an environment of low or negative real interest rates, robust issuance in EM HY over much of the past two years has been met by exceptional investor demand." We have every reason to believe that this trend should continue as more investors globally—EM-dedicated, distressed and cross-over money—look to this segment of the asset class for the diversification and total return potential it offers and as more EM sovereign and corporate issuers look to capitalize on attractive market conditions (relative to the financing sources available in their own local markets) for their balance sheet needs. Overall, we view EM HY and Unconstrained EM as key growth areas and one for which Western Asset is well positioned.

⁶ Refers to a four decade pattern of macroeconomic shocks in Mexico occurring either in the last year of the outgoing, or in the first year of the incoming presidential term

⁷ ["Emerging Market High Yield: Understanding an Evolving Asset Class"](#), Western Asset, April 2012.

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