And the Weakest Links in Emerging Markets are…

By Naman Agarwal, June 8, 2018

Amid a backdrop of controversial tweets out of the White House, geopolitical risks and trade war angst, market volatility is surging and the potential outflow from emerging markets (EM) has heightened. In Signature's view, both these factors – which pose the biggest risks for EM investors – are being driven by tighter global financial conditions.

Structurally, two of the weakest links in the emerging markets (EM) universe currently are Turkey and Argentina. With low foreign exchange reserves, an uncertain path to meaningfully reducing fiscal deficits, structural current account deficits, heavy reliance on portfolio inflows and large dollar-denominated liabilities, both of these economies are highly vulnerable

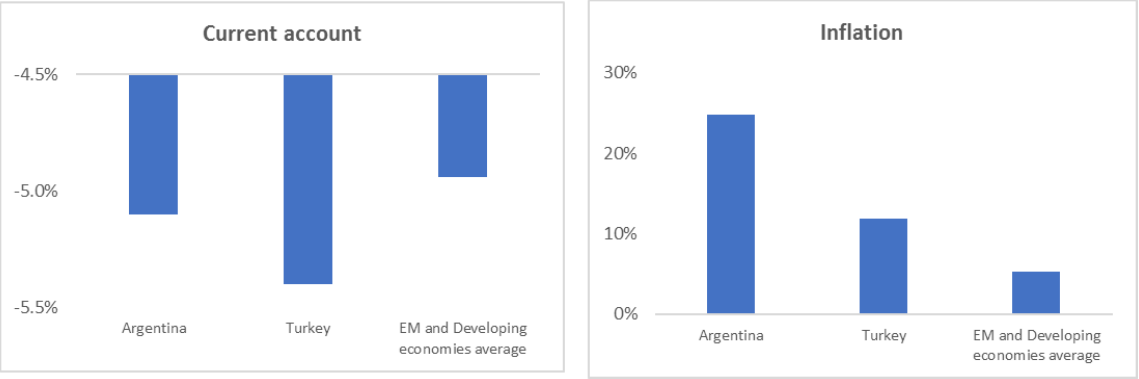
Tighter global financial conditions

The U.S.'s tightening monetary policy has led to 2-year and 10-year Treasury rates increasing 1.10% and 0.74%, respectively since September 2017. This in turn has strengthened the U.S. dollar, resulting in tighter global financial conditions and, consequently, a sell-off in risky assets, especially credit and EM assets.

EM central banks that have been pursuing expansionary monetary policies are turning cautious, even though inflation and growth across these markets remains subpar. Meanwhile, EM assets, including currencies, fixed income and equities, are under pressure. In addition, rising oil and energy prices are adversely affecting oil-importing countries like Turkey and Argentina, while pressuring sectors in other economies that are sensitive to higher fuel prices, as exemplified by the recent strike in Brazil.

Turkey, Argentina

Unlike the majority of emerging markets, Turkey and Argentina are struggling with rising inflation that they have been unable or unwilling to curtail, in fear of hampering growth. As a result, investors currently do not have much confidence in the central banks of these two countries. Not surprisingly, as global financial conditions marginally eroded since late 2017, these countries became the first among emerging economies to see investors leaving. The Turkish lira and Argentine peso, along with each country's external debt, have underperformed their EM peers year to date.



Source: IMF

In Argentina, the pro-reform government of Mauricio Macri represented a hope for change after coming to power in 2016. The issuance of a century bond in 2017 was seen as the EM investor's vote of confidence in Argentina's administration. Investors understood the political reasons behind the slow pace of reforms, but the policy misstep late in 2017, when the government was seen to be interfering with monetary policy, irked many investors. A deteriorating global financial backdrop further aggravated the tension and Argentina had to pay the price as the peso tumbled more than 25%. The administration was forced to react and showed dexterity in reaching out to the IMF for a line of credit, which helped contain the run on the currency. Due to uncertainties around the type and size of the IMF credit line, in Signature's opinion, investors will wait for the negotiations to run their course. In the meantime, investors will likely look elsewhere to trim their EM risk if the sell-off in risky assets intensifies.

That brings us to Turkey, where policy makers have displayed a lack of aptitude. Even though the central bank recently simplified its monetary policy in line with global counterparts, and raised its policy rates twice, Signature believes it is too late and probably insufficient to restore credibility in the country's monetary policy and regain investor confidence. Even if President Erdogan and his deputies are successful in stabilizing the currency, there is no evident path towards better fiscal dynamics in the country.

To express this view in the Signature Global Bond Fund, we have migrated our exposure in U.S.-dollar denominated 10-year Turkey bonds to 1-year bonds, consistent with our recent blog that shows short-term bonds having the best risk-reward trade-off. We are adopting the same strategy in Argentina, but given the reasons mentioned above, our underweight positioning in Argentina is not as extreme as that in Turkey.

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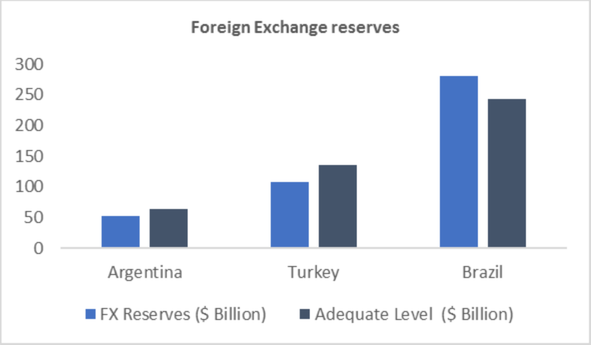
Brazil: Less distressed

Unlike Turkey and Argentina, Brazil’s EM economy is not as distressed. However, an unfortunate turn of events that include political uncertainties, and a truck drivers’ strike stemming from rising oil prices that brought the country to a standstill, have wreaked havoc on Brazilian assets. We continue to tactically trade Brazil bonds to take advantage of this volatile environment.



Source: IMF, Bloomberg

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