

VIEWPOINT

Commonly Asked Questions
on Emerging Markets Today

PENELOPE D. FOLEY, DAVID I. ROBBINS | DECEMBER 22, 2015



Penelope D. Foley
Group Managing Director
Emerging Markets

Ms. Foley is a Portfolio Manager for TCW Emerging Markets. Prior to joining TCW in 1990, Ms. Foley was a Senior Vice President of Drexel Burnham Lambert where she was involved in the management of DBL Americas Development Association, L.P. and in the provision of investment and merchant banking services in Latin America. Before Drexel, she was a Vice President in Citicorp's Investment Bank and was responsible for Eurosecurities, project finance and private placements in Latin America and Canada. Previously, she was an Associate in the Corporate Finance Department at Lehman Brothers. Ms. Foley attended Northwestern University and holds a BA from Hollins College.



David I. Robbins
Group Managing Director
Emerging Markets

Mr. Robbins is a Portfolio Manager for TCW Emerging Markets. Prior to joining TCW in 2000, Mr. Robbins invested in private equity. From 1997-1999, he was with Lehman Brothers where he was responsible for global emerging markets trading in the Fixed Income division. Prior to that, he worked at Morgan Stanley from 1983-1997 where he was head of Emerging Markets Trading. Mr. Robbins received a BA in Economics and History from Swarthmore College.

The past year has been challenging for emerging markets for various reasons, including external imbalances, a continued sell-off in commodities and fears of a sharp slowdown in China.

Growth in emerging markets has slowed from about 7% in 2009 to an estimated 4% in 2015, with drivers of this contraction being both structural and cyclical. In addition, the growth differential between emerging markets and developed markets has narrowed from six percentage points in 2009 to a little over two percentage points in 2015.

While these are clear risks for emerging markets credit, differentiation remains key, considering 1) divergent growth rates (i.e., India at 7.5% versus Brazil and Russia in recessions) and 2) varying impacts of the decline in commodities (importers versus exporters). In addition, an adjustment process has been underway since the "taper tantrum" in May 2013. Domestic demand has decelerated, currencies have depreciated sharply and current account balances are improving. As emerging market countries move through this period of adjustment, we are already seeing a number of interesting investment opportunities for next year.

Below are five questions we frequently hear from investors and our views on these issues.

Where are we in the credit cycle for emerging markets?

David Robbins:

We think we are approaching the bottom of the credit cycle fairly quickly. We're seeing this in the significant spread widening in many emerging market credits. At the same time, we have seen a positive response by countries in addressing external imbalances and by corporates in addressing balance sheet issues.

The de-leveraging process has certainly begun, both at the sovereign and the corporate level. And whether we've seen asset sales, cuts in capital expenditures, or liability management operations, we're continuing to see management focus on the balance sheet.

Naturally that doesn't mean that spreads can't go wider over the near term. But in our view, the stronger credits, which are the ones pursuing positive policy dynamics, are likely to outperform over the longer term.

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Penny Foley:

Also, while corporate liabilities have increased substantially over the last three to five years, about a third of that has been a refinancing of shorter term bank debt. So the liquidity of corporate balance sheets in those cases has actually improved over this period.

Secondly, we really think that the risks are idiosyncratic. They are heavily weighted toward sectors that have been punished in terms of price volatility for their products, such as commodity companies, or domestic firms with local currency revenues that have borrowed in dollars and are vulnerable in a stronger dollar environment.

So, again, we think it's an idiosyncratic issue, not a systemic one. However, we do expect that default rates will increase this year to reflect where we are in the credit cycle. EM default rates should come in around 3.5% in 2016, up from this year's 3% and in line with the 3.0-3.5% expected for U.S. high yield. And in our view, we'll be at or close to the bottom of the credit cycle once we see corporate defaults accelerate.

Emerging market hard currency debt has been one of the top performers globally the last two years, whereas EM local currency debt has significantly underperformed. When would you recommend moving more into local currency debt?

David Robbins:

That's right. EM hard currency has outperformed most fixed income asset classes in 2014 and 2015, despite higher rates and wider spreads. That's mainly due to its high carry as well as significant spread tightening in several idiosyncratic situations, such as Ukraine, Argentina and Russia which are all up around 20-40% this year. We still see value in this market, with average emerging market sovereign and corporate spreads over 400 basis points.

We are closely monitoring opportunities in local currency debt. Yields of around 7% for an almost entirely investment grade rated asset class appear attractive, but it could certainly get cheaper as long as currency volatility persists. In other words, we are first looking for stabilization in emerging market local currencies vis-à-vis the dollar. Right now, we are still in a period of consolidation in emerging market currencies. But emerging market foreign exchange has already depreciated significantly against the dollar – an average of

close to 30% over the last several years. With a stabilization in EM currencies, whether through stabilization in energy or other commodity prices and/or a rollover in dollar strength, the yield advantage that investors get in EM local currency debt will represent a very interesting opportunity. And there are certain high yield emerging market countries such as India where we expect relative stability on the currency side and therefore represent an attractive investment opportunity for a dollar-based investor today.

Penny Foley:

It's important to remember that in most government markets around the developed world, there is negative yield – in fact, nearly 70% of the global fixed income market trades with yields of 2% or lower – so whether you're getting high teens or mid-teens in Brazil or low teens in South Africa, there are some very attractive carry opportunities in emerging markets.

Given the number of challenges Brazil has encountered recently, is it still a country that investors should be watching?

Penny Foley:

Brazil is an interesting opportunity in the sense that the market has priced in a lot of the negative news. But there is still a lot of work to be done in Brazil in terms of policy changes to really improve the situation.

David Robbins:

As Penny mentioned, on the sovereign side Brazil really needs to solidify and improve its fiscal situation, which is a challenging prospect given the scandals facing the political and business arenas. As a result, we've seen continued spread widening in Brazil to the point where Brazil trades at cheaper levels than some single B credits.

Brazilian corporate spreads have widened out dramatically in some commodity names that used to be high quality investment grade credits several years ago. So we think that there are going to be tremendous opportunities on the corporate side in Brazil eventually.

It will take a while for stabilization in the political situation or an improvement in economic policy to really have a big impact on Brazil. Regardless, our sense is that Brazil is a credit worth watching as it could present significant opportunities next year as Russia did in 2015.

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How do rising rates impact emerging market debt?

David Robbins:

The Fed issued an overall consensus statement, a generally dovish hike, which was very well telegraphed. A lot of emerging market central banks have been preparing for this. And it's really a function of the path that they take from here. Emerging market debt offers a yield cushion, particularly relative to other developed markets, so similar to this year (2015), we think that should help mitigate the impact of rising rates. Plus the starting point for spreads is around 60 basis points wider than it was at the start of 2014. Also, if the Fed is responding to stronger growth, that benefits emerging markets, particularly countries like Mexico. But if they hold off on future hikes due to growth fears or deflationary concerns, the markets won't take that well.

What are the biggest risks to the market?

Penny Foley:

Some of the major risks in the market go hand in hand – Chinese growth and commodity demand for example. Chinese growth continues to be a significant driver of commodity demand and demand in general, so the pace of Chinese growth is a significant risk.

On that note, it is important to remember that oil is more of an operating input and therefore more responsive to changes in supply and demand dynamics. Oil prices are likely to be choppy in the next two to three months as Iranian exports increase. However, we do expect that we could see more strength around the oil price going into the second half of the year on the back of increased financing stress in the shale oil sector (particularly in light of the fact that some producers currently benefit from price hedges struck at higher prices in the second quarter of 2015 and which roll off in the early part of 2016).

We also think we will see a marginal improvement in growth on the demand side at some point over the next six months. So we see oil and oil-related credits as perhaps interesting investments as we move through 2016.

David Robbins:

In addition, liquidity and capital flows are critical issues going forward. On the liquidity front, the EM market is very broad, and includes both high-quality investment-grade credits and high-yield credits. There is ample liquidity in the high-grade portion of the market, but where you see the illiquidity generally is in the high-yield portion of the market. So it's important to consider individual credits carefully, in terms of position sizing and when to exit a trade. You can't always wait until your target price to sell and you have to be prepared for greater price volatility in light of smaller balance sheets on the street.

Given thin liquidity in various parts of the market, flows matter even more. And you have to pay attention not only to the direction of flows, but to who's invested where. We pay a lot of attention to the percent of foreign ownership in local markets and the strength of the local investor base. We also monitor U.S. high yield flows, as negative sentiment in that market can spill over into emerging markets. We, however, tend to find that those environments also present opportunities. If we feel like the market is getting frothy, we would generally look to ramp up cash levels and take advantage of technical-related selling. ■

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