2019 Market Outlook: Emerging Markets Debt

Emerging Markets Look Forward to 2019

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After a challenging year for risky assets, in emerging markets (EM) fixed income in particular, we hold a constructive outlook for 2019, driven by attractive valuations, a benign global backdrop of moderate growth/subdued inflation and a U.S. Federal Reserve Bank (Fed) that is likely approaching the end of its tightening cycle. We believe these factors and growing twin deficits in the U.S. limit the scope for material U.S. dollar appreciation, further supporting EM fixed income assets.

Our historical analysis indicates that EM fixed income tends to outperform when EM economies are closing negative output gaps and converging toward potential growth. Local currency strategies should benefit from already adequately tight monetary policy in key EM economies, and steep yield curves providing investors with excess term premium. Furthermore, overall EM foreign currency (FX) cheapness should supplement local currency returns from carry/duration, particularly if our expectation of a declining U.S. dollar and hawkish EM central banks were to materialize.

Among credit, the JP Morgan Emerging Markets Bond Index Global (EMBIG), a proxy for U.S. dollar external debt, screens as cheap versus both its historical average and traditional comparables such as U.S. high yield. In addition, our sovereign spread model indicates that there is about 40 basis points spread compression potential from a fundamental perspective. When coupled with already high carry (the highest since 2008), EM external sovereign debt at these valuations may offer attractive investment opportunities. The same holds true for the JP Morgan Corporate Emerging Markets Bond Index (CEMBI), a proxy for U.S. dollar corporate debt, where absolute and relative spreads have sharply underperformed other credit markets such as U.S. and European high yield in 2018, despite generally improving fundamentals that are reflected in a similarly (low) default profile.

In the absence of synchronized global growth or loose monetary policy, and while trade tensions and geopolitical risks are on the rise, we believe investors should approach this more challenging investment landscape with caution. Furthermore, opportunities in EM will demand a discriminating approach to country/asset selection. We will focus on countries providing what we consider to be attractive valuations, with strong macroeconomic fundamentals to help withstand external shocks and/or political dynamics that could lead to enhanced economic frameworks and thus provide interesting alpha-generating opportunities for those comfortable with the risks of investing in emerging markets debt.

A stable-growth/moderate-inflation global backdrop supports EM assets

The consensus thesis of steady, synchronized global growth in 2018 played out differently than envisioned, challenged by heightened market volatility from U.S.–China trade tensions, geopolitical risks, and relentless U.S. monetary policy normalization causing material dollar strength. Furthermore, U.S. growth-boosting tax policies implemented at 2017 year end, coupled with a slowing China and growth disappointments in Europe further undermined the thesis of synchronized global growth. Against that backdrop, EM has suffered significant capital outflows, forcing externally imbalanced economies to strengthen policy frameworks to reign on macroeconomic imbalances.

Our global outlook for 2019 is one of moderation both on the inflation and growth fronts. The impact of Fed tightening, the end of the European Central Bank (ECB) bond-buying program by year end (and, possibly, rate hikes as early as the second half of 2019), as well as the sizable global disinflationary shock thanks to the latest round of oil price weakness underpins our subdued global inflationary outlook. Furthermore, those factors should offset the inflationary impact of a potential expansion of U.S. tariffs to all Chinese imports. The inflation picture in EM should be qualitatively similar to that of developed markets (DM), anchored and moderate in aggregate, barring some more idiosyncratic cases such as Argentina and Turkey, and at a much lower level, in Central and Eastern European economies where monetary policy is arguably too loose.

Growth in the developed world is bound to slow. Key to this projection is a deceleration in U.S. growth on the back of Fed policy normalization, a fading impulse from last year’s fiscal stimulus (and limited scope for a new one post-midterm elections) and an economy that has expanded for almost a decade. Furthermore, rising uncertainty over trade should dampen investment and thus growth. This is also the case in the open economies of Europe, where, in addition to fading ECB support and lingering political risks (Italy, Brexit, Germany’s leadership transition, among others), the pace of growth will likely diminish.

A context of softening U.S. growth and subdued inflationary pressures, as well as unsteady U.S. stock and housing markets, significantly undermines the case for further Fed hikes beyond current market pricing. Confirmation of our thesis, and its corollary of potential U.S. dollar weakness next year, should bode well for EM assets. U.S. dollar weakness is also predicated on valuations: We see the dollar overvalued in real terms by about 10% (both a Purchasing Power Parity (PPP) approach and our Behavioral Equilibrium Exchange Rate (BEER) model suggest similar levels of richness).

Meanwhile, aggregate EM growth is also likely to slow next year, mainly driven by the gradual but steady decline in Chinese growth. The downside could be slightly deeper as well, and will depend on the evolution of the trade conflict with the U.S., and the policy response from the Chinese government, which up to now has been restrained.

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1 Brent has fallen 26% since the October high as of November 30, 2018.

2 Some estimates put the impact on U.S. inflation from a full-tariff regime on China imports at 50 basis points.
However, the EM growth picture is more diverse than what aggregates convey. Several key EM countries are beginning to recover from years of contraction and adjustment, and barring negative disappointments on the policy front, should continue their upwards march toward potential growth. In Latin America, countries such as Brazil and Colombia are likely to fall in that category, whereas in Asia, we expect growth to be close to potential in India, Indonesia and the Philippines. On the other hand, EM economies in Europe are bound to decelerate: Turkey’s growth should disappoint as the economy continues to adjust to the self-inflicted crisis last summer. Meanwhile, the fast-growing economies of Central and Eastern Europe should decelerate gradually toward potential level as supply-side constraints become binding.

**EM-ex-China at recovery stage: good for EM fixed income**

To help inform our views on EM debt assets for the year ahead, we examined the historical performance of bonds, rates and stocks in EM at each stage of the business cycle, which we identified as follows: recovery, expansion, slowdown and contraction. First, we calculated the output gap for EM-ex-China and we defined each phase of the cycle based on the level of the output gap and the change relative to the previous quarter. **Display 1** shows that EM-ex-China growth is going through a recovery stage.

Then, we estimated the average quarterly returns for each asset class across the business cycle. As expected, we found that high-beta-to-growth EM equities outperformed both EM U.S. dollar hard currency bonds and EM FX during economic recoveries. U.S. dollar hard currency bonds have tended to post the best performance during expansion and slowdown while local rates fare best returns in a recession.

Since we identified the current stage of the EM-ex-China business cycle as recovery, and to the extent that historical performance provides useful information about future return potential, the analysis supports our constructive thesis for EM: all EM debt strategies have posted positive returns during the recovery phase, though they have failed to outperform EM equities. However, as we mentioned previously, due to a more challenging global scenario, we believe a nuanced approach to EM debt investing more heavily focused on idiosyncratic developments should outperform a more beta-driven strategy. We provide some more information about improving (and deteriorating) country-specifics in the sections ahead.

**Display 1**

Output gap estimates suggests EM-ex-China is going through a recovery phase...

![Output gap estimates](image1)

**Display 2**

...And EM assets have tended to outperform during the recovery stage

<table>
<thead>
<tr>
<th>ASSET CLASS PERFORMANCE</th>
</tr>
</thead>
<tbody>
<tr>
<td>EM USD HARD CURRENCY BONDS</td>
</tr>
<tr>
<td>Recovery</td>
</tr>
<tr>
<td>Expansion</td>
</tr>
<tr>
<td>Slowdown</td>
</tr>
<tr>
<td>Contraction</td>
</tr>
</tbody>
</table>

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. Past performance is no guarantee of future results. See Disclosure section for index definitions.

Source: Morgan Stanley Investment Management, Bloomberg as of September 2018. Note: Quarterly returns from March 1994 to September 2018 for U.S. dollar hard currency bonds and EM equities. For local rates, EM FX and corporate bonds the sample starts March 2003, June 2003 and March 2002 respectively. We use the JP Morgan EMBIG index for U.S. dollar hard currency bonds, the JP Morgan GBI-EM Global Diversified index for local rates, the MSCI Emerging market index for EM Equities, the JP Morgan GBI-EM Global Diversified FX index for EM FX and the JP Morgan Corporate EMBI Broad Diversified Composite Index for Corporates. We include the following countries to estimate the output gap: Brazil, Chile, Colombia, Czech Republic, Colombia, Hungary, Indonesia, India, Mexico, Malaysia, Nigeria, Peru, Philippines, Poland, Romania, Russia, Thailand, Turkey and South Africa.
All metrics agree that EM sovereign spreads offer value

All valuation metrics we reviewed suggest there is value in sovereign spreads. For example, EMBIG spreads look about 50 basis points cheap to their 10-year historical average. In addition, the Bloomberg Barclays U.S. Corporate High Yield Index-EMBIG spread differential, which had been positive for over a decade, has compressed to almost zero, despite the higher average credit rating of EM spreads (three notches, BB+ for EMBIG versus B+ for Bloomberg Barclays U.S. Corporate High Yield Index). Furthermore, our outlook of slowing U.S. growth and the recent outperformance of U.S. high yield versus EMBIG should prompt cross-over investors to consider re-entering relative value positions in EM sovereign credit.

Furthermore, our fair-value sovereign spread model, which relates spreads to fundamental domestic and external variables, suggests that spreads are cheap by about 40 basis points.

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As seen in Display 4, despite overall cheapness in EM sovereign spreads versus fundamentals, there is variation across regions and countries. The model points to cheapness in Africa and, to a lesser extent, Latin America, while flagging European sovereigns as expensive and Asian spreads as fairly priced. At the country level, we single out the following countries as having potential to generate alpha in the year ahead:

- **SOUTH AFRICA**: Marginally stronger growth in 2019, a credibly hawkish central bank and the potential for positive surprises on the fiscal front may spur spread compression across South African assets. While Cyril Ramaphosa is almost assured victory in the May presidential elections, the margin of victory will be a key signal of the degree to which he has a mandate to pursue reforms and tackle entrenched interests.

- **INDONESIA**: We have a positive outlook for Indonesian spreads, which should benefit from the recent decisive policy response by Bank Indonesia (BI) and the government, aimed at addressing a rising current account imbalance and threats to financial stability due to excessive Indonesian rupiah (IDR) weakness. A more stable currency next year that allows BI to replenish its stock of international reserves should provide further support for spreads, so should a successful re-election bid by President Jokowi, as it would guarantee market-friendly policy continuity.

- **UKRAINE**: Despite front-runner Tymoshenko’s populist campaign rhetoric, we hold the view that the electoral outcome will not lead to major policy shifts, given a widespread domestic consensus about the country’s Western orientation, and its reliance on multilateral funding to meet a steep increase in external debt redemptions starting next year. The recently passed International Monetary Fund (IMF)-compliant 2019 budget approval may cause spreads to compress, as it would likely lead to the IMF disbursing the first tranche of the Stand-By Agreement (SBA), as well as additional financing from the European Union and other multilaterals.

- **ZAMBIA**: We believe that sustained pressure on the currency may be a trigger for changes to the current political economy framework responsible for the current policy paralysis. If we see indications that the political calculus is changing, and we have a tangible chance of positive policy steps being implemented, we would see value in Zambian external debt.

- **TURKEY**: Lack of domestic demand for imports, declining oil prices and a stronger geopolitical bargaining position may alleviate external balance concerns and could support sovereign spreads. However, we remain cautious, as we see diminishing appetite from the government to pursue further orthodox policy and a potential reversal to fiscal and quasi-fiscal loosening before local elections in March. Such fiscal maneuvering could counteract the tight monetary policy stance and further exacerbate the economy’s vulnerability to external shocks.

- **MEXICO**: Despite attractive valuations, we remain cautious in Mexico as recent policy decisions such as the referendum and cancelation of a long-planned airport suggest a potential change toward a populist agenda, raising concerns about fiscal discipline and the stability of the current policy framework.

**Value in local rates on high EM-DM real rate gap, steep curves, amid U.S. dollar weakness**

EM real rates, though off the highs of the last five years, still look compelling, at 2% levels. Similarly, the real yield differential with DM remains attractive at ~300 basis points and has spiked as of late due to more hawkish monetary policy stances by Central Banks in economies facing capital outflows such as Indonesia, Turkey and Argentina, among others. Meanwhile, real yields in DM remain in sharply negative territory, despite a less accommodating monetary policy stance. We expect real rate differentials to remain at elevated levels next year as the Fed approaches the end of the tightening cycle and other DM Central Banks cautiously remove monetary stimulus, global inflation remains subdued, and EM...
Central Banks tread carefully and maintain a hawkish bias in the face of persistent external risks.

Display 6 shows the output gaps versus real yield to help us identify countries that may provide interesting value opportunities next year. In particular, economies located in the upper-left quadrant (that is, positive real rates and economic slack) offer higher carry, and could also provide adequate cushion to accommodate adverse shocks. Among the high-yielders, Russia, Indonesia, Mexico and Brazil stand out. On the other end of the spectrum, Central and Eastern European economies feature nearly closed output gaps (except for Romania, whose output gap is more significantly positive) and negative real rates.

In addition, we believe that sizable steepness in several EM curves offers attractive opportunities for extending duration. For example, Peru, which features the steepest curve in EM, looks particularly compelling given the sovereign’s longstanding fiscal rectitude and FX stability. Furthermore, Brazil local yields have the potential to outperform next year, provided that the incoming Jair Bolsonaro administration delivers on campaign promises of social security reform and fiscal consolidation. In Central and Eastern Europe, Poland’s yield curve looks attractive, underpinned by a solid fiscal position and potentially higher demand for Polish government bonds in the second half of 2019 as the pension system’s third pillar becomes operational. Yields in Russia could outperform next year, anchored by a prudent fiscal stance and an orthodox Central Bank of Russia, on the condition that geopolitical tensions (sanctions) remain unchanged. Finally, we avoid long-duration positions in Mexico, given heightened policy uncertainty under the incoming AMLO administration and low-risk premium relative to the potential fiscal risks.
A combination of U.S. dollar weakness and broad-based cheapness on the FX side may add to carry/duration returns in local currency yields. In fact, both our medium and long-term valuation models (BEER and PPP, respectively) are in agreement that a large subset of EM currencies screens as cheap, thus potentially improving the return profile of exposure to local currency yields.

**Valuations in EM corporate debt look favorable relative to default expectations**

We see the sharp correction of EM corporate spreads, particularly in high yield, since the turn of 2Q18 as excessive given our assessment of credit fundamentals.

Our confidence in EM credit is grounded in improving metrics (credit, management actions, etc.). The improvement has been supported by the behavior of EM corporates since the end of the global financial crisis, as well as the more recent period following the severe downturn in energy and commodity markets in 2015/16.

The general stabilization and turnaround in corporate fundamentals registered over the course of 2018 derives from the same conditions that have supported credit in developed markets. EM corporates have benefited from the prolonged period of easy money and exploited favorable funding opportunities to strengthen their balance sheets through active liability management. This is evidenced by a meaningful uptick in calls, early tenders and buybacks and clear evidence at the aggregate level of a lengthening of debt maturities and an overall improvement in debt service.

**DISPLAY 8**

*Cheap EM FX can enhance carry/duration returns potential in local currency yields*

Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Source: MSIM, Bloomberg, Haver. Data as of November 23, 2018. CZK, HUF, PLN are modeled against the EUR.

**DISPLAY 9**

*EM vs U.S. high yield spreads*

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Sources: Morgan Stanley Investment Management, J.P. Morgan as of November 2018.
To the credit of EM business managers’ prudence, it has only been in the last 12-18 months that we started to see a pickup in investment activity and only after evidence of a recovery in revenues and EBITDA (earnings before interest, taxes, depreciation and amortization) over 2016/17. Importantly, nominal debt levels have remained in check despite the availability of cheap money. Gross and net leverage ratios have fallen while revenues, margins and profitability have improved, signaling to us that EM has moved past the bottom of the credit cycle and into a more sustained period of stability.

These improvements are best illustrated in default expectations, which now look likely to end the year well below the 2.5% forecast we set at the beginning of the year in spite of the rise in idiosyncratic negative developments in countries such as Argentina and Turkey.

Looking ahead to 2019 we view the spread widening of EM high yield as particularly noteworthy given expectations that default rates in EM will likely remain low and in line with U.S. high yield next year.

In investment grade credit, we also believe the weakness in spreads is somewhat countervuitive given fundamental improvements in EM credit quality (which should continue to see upgrades outpace downgrades over the coming 12-18 months), versus in the U.S., where the combination of debt-financed stock buy-backs, and merger and acquisition (M&A) activity may put pressure on credit ratings in 2019.

**DISPLAY 10**
EM corporate credit metrics and recent trends

<table>
<thead>
<tr>
<th></th>
<th>GLOBAL</th>
<th>ASIA</th>
<th>EM EUROPE</th>
<th>LATAM</th>
<th>MIDDLE EAST &amp; AFRICA</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GROWTH</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue</td>
<td>-7%</td>
<td>13%</td>
<td>-8%</td>
<td>12%</td>
<td>22%</td>
</tr>
<tr>
<td>EBITDA</td>
<td>0%</td>
<td>13%</td>
<td>-4%</td>
<td>12%</td>
<td>20%</td>
</tr>
<tr>
<td>Gross debt</td>
<td>1%</td>
<td>4%</td>
<td>0%</td>
<td>5%</td>
<td>11%</td>
</tr>
<tr>
<td>Net debt</td>
<td>1%</td>
<td>2%</td>
<td>-3%</td>
<td>3%</td>
<td>2%</td>
</tr>
<tr>
<td>Capex</td>
<td>-15%</td>
<td>7%</td>
<td>-12%</td>
<td>12%</td>
<td>16%</td>
</tr>
<tr>
<td><strong>RATIOS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross leverage</td>
<td>3.0x</td>
<td>2.7x</td>
<td>2.9x</td>
<td>2.7x</td>
<td>2.5x</td>
</tr>
<tr>
<td>Net leverage</td>
<td>1.9x</td>
<td>1.7x</td>
<td>1.6x</td>
<td>1.4x</td>
<td>1.7x</td>
</tr>
<tr>
<td>EBITDA margin</td>
<td>20.0%</td>
<td>19.9%</td>
<td>17.3%</td>
<td>16.8%</td>
<td>21.8%</td>
</tr>
<tr>
<td>Interest coverage</td>
<td>6.4x</td>
<td>6.5x</td>
<td>8.5x</td>
<td>8.3x</td>
<td>6.7x</td>
</tr>
<tr>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Source: J.P. Morgan, Bloomberg; as of September 2018. Analysis utilizes an evolving set of external bond issuers with debt outstanding and excluding 100%-quasis, financials, real estate and defaulted companies. Capex stands for capital expenditures.

**DISPLAY 11**
EM versus DM default rates

Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

Sources: Morgan Stanley Investment Management, J.P. Morgan. EM default rates include distressed exchanges as of September 2018.
Risks and opportunities

Despite our overall constructive tone for EM debt next year, we acknowledge several risks that could undermine our thesis. The main risk, as widely flagged, concerns a worsening of U.S.-China trade relations. Though the recent truce reached at the G-20 meeting on December 1 is a step in the right direction, a final settlement of the ongoing disputes seems elusive in our view, as U.S. grievances involve issues that are critical to China’s development model, and that Chinese authorities may be reluctant to compromise on. Despite the obvious negative implications of trade wars for the global economy, we note that a tariffs/counter-tariffs regime may also generate shifts in trade flows and relocation of supply chains to other countries, which could benefit several economies in EM (for example, Brazil/Argentina could increase their market share of soybean exports to China, or low-cost Asian economies may gain as portions of the supply chain relocate to avoid trade restrictions). Geopolitical concerns could resurface in the form of Russia sanctions, though the impetus to impose further punishment has diminished after the U.S. midterm elections.

The Fed tightening by more than what is currently priced in the market could deliver a negative surprise, though as we mentioned earlier, we hold the view that disinflationary forces at play should more than offset any threat of rising prices brought about either by additional import tariffs and/or further labor market tightness.

It will also be important to monitor supply technicals in the credit space with more than an estimated $200 billion in EM corporate debt set to mature in 2019. While we do not expect financial conditions to tighten to an extent that poses broader refinancing risks to the corporate segment in general, any front loading of supply could serve as a headwind to performance at the beginning of the new year.

Finally, idiosyncratic risks (and/or opportunities) may arise from politics. Spillovers from political turmoil in Europe should be monitored closely as they could drastically alter ECB plans to normalize monetary policies. Among these risks, we highlight: Brexit, European Commission versus Italy budget disagreements and leadership changes in Germany’s ruling party. Meanwhile, next year, elections will be held in several EM economies. In Nigeria, we expect a competitive February presidential election, pitting the incumbent president against a former vice-president, with no broad differences in economic policy approaches between the two candidates. In Indonesia, we see President Joko Widodo securing a second term in the April elections, thus ensuring policy continuity. Ukraine’s presidential race remains wide open, with former Prime Minister Yulia Tymoshenko leading in the polls. We think that a heavy external repayment schedule in 2019-20 and wide domestic consensus on Ukraine’s European orientation greatly limit the scope for undoing the reforms already enacted, regardless of which candidate prevails. In India, we expect Prime Minister Narendra Modi to win re-election in the April/May general elections as he resorts to populist policies to improve his chances. President Cyril Ramaphosa is almost assured victory in South Africa’s presidential elections, but the margin of victory will dictate his ability to pursue reforms and tackle entrenched interests. In Argentina, President Mauricio Macri’s re-election prospects have worsened as of late following the economic crisis, casting doubts on the sustainability of the IMF stand-by program. Local elections in Turkey could be a source of heightened volatility, particularly if the government decides to boost its chances by premature policy easing. Finally, major government transitions in Mexico (December 1) and Brazil (January 1) could have a sizable impact on asset performance. As we discussed earlier, we hold a cautious view on Mexico, while we believe that the new Brazilian government may be able to use the honeymoon effect to pass social security reform through Congress, alleviating concerns over debt sustainability.

* Under this agreement, US stays the impending tariff increase on $200bn worth of Chinese imports, while China commits to purchase substantial amounts of American farm, energy, and industrial goods. During that 3-month period both parties will negotiate over critical issues involving US access to the Chinese market, enforcement of IP rights, technology transfers, etc.
Risk Considerations

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INDEX DEFINITIONS

The Bloomberg Barclays U.S. Corporate High Yield Index measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody’s, Fitch, and S&P is Ba1/BBB+/BB+ or below. The Index excludes emerging market bonds.

The JP Morgan Emerging Markets Bond Index Global (EMBIG) tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the EMBI+. As with the EMBI+, the EMBI Global includes US dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million.

The JP Morgan GBI-EM Global Diversified Index is a market-capitalization weighted, liquid global benchmark for U.S.-dollar corporate emerging market bonds representing Asia, Latin America, Europe and the Middle East/Africa.

The JP Morgan CEMBI Broad Diversified Index is a global, liquid corporate emerging markets benchmark that tracks U.S.-denominated corporate bonds issued by emerging market entities.

MSCI Emerging Markets Index (MSCI emerging equities) captures large- and mid-cap representation across 23 emerging markets (EM) countries.

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