A Bond Boost for Developing Markets?

Western Asset Management’s Keith Gardner believes that stronger fundamentals in emerging economies bode well for their debt markets

These days, emerging-market debt is delivering some of the biggest yields in the bond market—and at substantially lower risk than just a few years ago, says Keith Gardner, head of developing markets for Western Asset Management. Gardner says this is because economic fundamentals for many emerging countries are stronger than ever. “The world is upside down right now, with the fundamentals in emerging countries better than [those in] developed countries,” he says. He believes that emerging markets should fare relatively well under most future economic scenarios. “Under almost any environment, we've seen emerging market debt perform very well,” he says. Gardner recently spoke with Morgan Stanley’s Tara Kalwarski about the opportunities in emerging-market sovereign debt, corporates, and even local bonds. The following is an edited version of their conversation.*

Tara Kalwarski: What’s your outlook for emerging markets?

Keith Gardner: The landscape continues to be positive. Most emerging countries have strong fundamentals, and growth in most cases is still strong. We have seen some lowering of growth expectations. But relative to developed markets, emerging countries look strong: The fiscal and external balances in the emerging markets are under control. And emerging countries also have much lower debt and have built up their reserves to significant levels—to the point where they could provide a significant cushion if the environment gets worse. Given the better fundamentals, emerging countries have the ability to use countercyclical monetary and fiscal measures.

Kalwarski: Where are you seeing governments take action?

Gardner: The shift we've seen has been more in monetary policy. At the end of last year, central banks had more of a bias to raise rates. Most now are more cautious, with a bias to ease because of concerns over the global economy. Several central banks have cut rates recently: [those in] China, Brazil, Korea, South Africa and Columbia. We'll potentially see more rate cuts in these and other countries.

On the fiscal side, China—along with Brazil and Malaysia—recently announced a stimulus package. I think emerging countries are well placed to take advantage of the good fundamentals, if necessary. That is, if things do deteriorate on the global economic side, they have tools that the developed economies don't have the luxury of using, because their fiscal balances are much more negative and their debt levels are much higher.

Kalwarski: How have the debt markets in these countries developed?

Gardner: We've seen a significant change in the structure of emerging-market debt. What was traditionally a U.S. dollar-denominated sovereign-bond market has developed into one with three distinct sectors. In addition to dollar-denominated sovereign debt, there are well-developed corporate markets now, and the local markets also have developed in terms of liquidity and demand.

Historically, the trend was that we saw issuance by sovereigns in the U.S. dollar market. Then, as fundamentals improved and investors became more comfortable with these
credits, the countries were able to issue in their own currency—which is very important, because now these countries don't have that currency mismatch. They also have access to funds in a market where the demand is growing substantially.

The issuance shift on the sovereign side—from dollars to local currency—opened up the U.S. dollar-denominated market to corporates. Initially, you saw very high quality corporates come to market. As the market has become more comfortable with these credits, we've seen some of the lower-rated credits come to the market as well.

[Again] there are three distinct sectors: dollar-denominated sovereign debt, dollar-denominated corporate debt and local market debt. In terms of supply, the corporate market is now close to the size of the sovereign U.S. dollar market. And in terms of issuance, this year in the corporate market [it] has exceeded that of the sovereign market. The biggest growth we've seen has been in the local markets, because of the increase in demand from pension funds, local banks and foreign investors. The issuance in the local markets is extremely high. If you add all the sectors together, it would be bigger than the U.S. investment-grade market or the U.S. high-yield market.

Kalwarski: Where are you finding opportunities?

Gardner: In the dollar-denominated sovereign markets, spreads have narrowed a lot already, and we don’t necessarily see a huge amount of room for further tightening. Right now, we see better value in the dollar-denominated corporate market [and in] local markets. In the corporate markets, spreads are attractive, and there are lots of really good credits with strong balance sheets. We're buying not only quality corporate bonds but also [corporate bonds] in sectors we feel comfortable with and in countries we feel comfortable with.

Kalwarski: How are the valuations?

Gardner: The valuations in the corporate market are attractive. We're also comfortable with the local markets as a long-term investment.

We think that over time, capital flows will drift in the direction of countries with better fundamentals. And that [will] put pressure on currencies to appreciate. We also think that interest rates are at levels where we can see additional rate cuts. So the combination of the performance [potential from both currency and rates [is likely to] be attractive over a longer period.

We also have had to be sensitive to the risk side of the equation—particularly in the local markets. Currencies can be volatile. So we may be a little more tactical in terms of our investments in local markets. But from a long-term, secular view, we find them to be attractive.

Kalwarski: Are there any regions or segments that you’re avoiding?

Gardner: We're cautious in terms of investing in Europe. Countries such as Poland, Hungary and the Czech Republic obviously have close trade ties to Western Europe and some of the peripheral countries that are in the news. Some of the other countries in Europe—Turkey, Russia—their trade ties aren't as strong with Western Europe, but they are affected by what's going on.

We've been more constructive on Latin America and Asia—and have a greater preference for Latin America because the valuations are more attractive. If you look at the local markets, a lot of the countries in Asia have negative real interest rates, whereas in Latin America the rates tend to be positive.

Kalwarski: What are the biggest risks that investors face when taking on exposure to emerging-market debt?

Gardner: Right now, the external environment [is a concern]. How sustainable are the current levels of growth in the U.S. and worldwide? Second would be the issues in Europe, which don't appear as if they're going to go away any time soon. The third risk would be China—whether it can sustain a soft landing as opposed to a hard landing. And then, of course, there are wild cards like the situation in the Middle East.

But we don't think the risks are in the fundamentals of any specific emerging market. We really think it's the [broad] environment that creates that risk in the market.

Kalwarski: Describe how different economic scenarios would affect this asset class.

Gardner: Emerging-market debt has performed well in different environments over the past couple of years. If Treasuries are improving, emerging-market debt tends to do well because these dollar-denominated bonds trade at spreads over U.S. Treasuries. And if you have an environment where Treasury prices are going down—which
would indicate that the global economy is doing better—
generally emerging-market spreads tighten vs. U.S.
Treasuries. So in one scenario you get the benefit of
Treasury prices increasing, and in the other scenario you get
the benefit of the spreads narrowing to Treasuries.

The best case is where growth is at least moderate and
interest rates are very low. That's the environment that we've
been in with the Fed having targeted low interest rates for a
long period. This gives emerging countries access to
liquidity and provides the best environment for bonds.

The worst environment is one where there's a global
economic meltdown—another crisis like [the one] we saw in
2008. Emerging-market debt would be considered riskier, so
they suffer in that environment. But with every new crisis,
the effects on emerging-market debt become less and less
[severe]. And I would argue that even in this environment—
because of the stronger fundamentals in emerging countries
and their ability to use countercyclical measures—they
probably would perform okay on a relative basis.

Kalwarski: How does emerging market debt fit into a
broadly diversified portfolio?

Gardner: I think emerging markets [can be] a good long-
term investment [for appropriate investors], and they provide
some strong diversification characteristics in a broader
fixed-income portfolio. You have the fundamentals that we
talked about. The valuations are attractive, particularly in the
corporate and the local markets.

When you're dealing with a market where fundamentals and
technicals are strong, valuations are attractive, and cash
flows are coming into the market—people who hadn't
previously been involved are getting involved. But I think
the market has developed enough where it's not just an
opportunistic add to a fixed-income portfolio. The
diversification characteristics are good.

Kalwarski: How do you see the landscape of this asset class
evolving over the next decade?

Gardner: You are going to see countries develop to the
point where they leave the emerging-market index. And
we're seeing more and more frontier markets join the
emerging markets. It's an evolving universe. You are going
to see countries continue to improve. Moody's recently
indicated that it may upgrade Mexico. I think we're going to
see more of these upgrades over time because these
countries are doing so well.

Kalwarski: How would you adjust your exposure if the
global economy took a turn for the worse?

Gardner: Typically, in an environment like that, there
would be a flight to quality into the U.S. dollar. We would
reduce our exposure to currencies in the portfolio, continue
to focus on good-quality credits and move away from the
lower-rated credits.

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