2018 EM Experts' Q&A

BlueBay Emerging Market Debt Team

As we approach 2018, most forecasters remain positive on the outlook for emerging markets: we share this view. Between 2009 and 2016 global growth was subject to headwinds caused by bank deleveraging, fiscal tightening, a sovereign credit crisis in Europe and a collapse in commodity prices. The final removal of these headwinds has resulted in us seeing a year of stronger global growth, and we logically expect that to continue. We address the pressing topics that we believe will likely shape 2018 and the emerging market investment landscape.

Nationalist/populist leaders rule in the world's most densely populated countries – can they avoid conflict?

Polina Kurdyavko, Partner, Co-Head of Emerging Markets, Senior Portfolio Manager

Nationalist leaders are in power in the US, China, India, Russia, Turkey, North Korea, Iran and Saudi Arabia. Their interest in maintaining the global conflict resolution architecture, which has been in place since 1945, seems to be waning. Can this all be ignored for another year? North Korea seems to us the first place where it could all go wrong, and arguably where the ramifications for global risk sentiment (and hence impact on US Treasuries) could be most pronounced. Equally, a potential change away from the 'old guard' in Russia, South Africa or Venezuela could translate into meaningful upside for investors.

Will global inflation remain low?

Nick Shearn, Senior Portfolio Manager

The key macroeconomic surprise of 2017 was the combination of stronger growth and lower inflation. We believe that global labour markets and global product supply chains mean, on a secular basis, that inflation is becoming more of a global rather than an idiosyncratic national phenomenon. Having said that, we do not believe that the Phillips Curve is entirely redundant. Headline CPI is beginning to rise in Eastern Europe and Asia. Wages are showing sustained, if gradual, pick up in the US. Any sense that central banks need to react quickly to rising inflation pressures could derail the appetite for all risk and potentially challenge the thesis for long interest rate duration positioning in some of our core conviction markets.

Do we still need to worry about the protectionist threat?

David Dowsett, Partner, Co-Head of Emerging Markets, Senior Portfolio Manager

Compared to fears at the beginning of the year, protectionism was 'the dog that didn't bark' in 2017. Global trade actually witnessed its strongest year of growth since 2010. That is not to say that we should discount this risk though. NAFTA negotiations are not yet concluded and proving troublesome. Trump's disdain for multilateral trade arrangements is unlikely to change. We believe that if he experiences any domestic setbacks, the risk of him lashing out on trade cannot be discounted, and the knock-on effect on the US dollar in particular could have far-reaching consequences for emerging market currencies in particular.

What will be the effect of China's growth transition?

Alan Siow, Portfolio Manager & Zhenbo Hou, Junior Strategist, EM

Post the party congress, there is some evidence that China is moving from an 'offensive' growth strategy, with excess focus on a certain GDP target, to a more 'defensive' one based on deleveraging, poverty reduction and environmental protection. This is sensible for China, and we would not overemphasise the slowdown, but it does raise questions for other China-sensitive regions (North Asia, Western Europe). Furthermore, against the backdrop of deleveraging, we are beginning to see some signs of cracks in the high yield segment of the Chinese corporate market, so a key watch-point for 2018 will be the extent to which we may see this weakness manifest itself in higher default rates in the region.

Will the Saudi/Iran proxy war intensify?

Tim Ash, EM Senior Sovereign Strategist

The conflicts in Yemen, Kurdistan and Syria, and the political spats involving Qatar and Lebanon are all best understood as part of a larger struggle for power between the leading Sunni and Shia regional powers. The support of the US, Egypt and Israel for the Saudis is matched against Russian and Turkish support for Iran, which makes the conflict especially dangerous. At an asset class level, given the MENA concentration in corporate indices (investment grade in particular), this is where we would expect to see the most direct impact. Though if we were to see any meaningful escalation in tensions sending oil prices higher, it could make this more a global concern.

Can an outsider win the presidency in Brazil?

Graham Stock, EM Senior Sovereign Strategist & Meri-Luiz De Camargo, Credit Analyst

The corruption scandals over the past four years in Brazil should create fertile conditions for an insurgent candidate. The whole political class has been discredited. However, the establishment parties have significant advantages in terms of TV exposure and 'get out the vote' machinery. Brazil needs to avoid political volatility so that it can decisively escape the recession of the past three years. It is essential that investors have confidence that the next president will launch reforms that stabilise Brazil's precarious debt dynamics. This could also pave the way for much needed stability in the corporate sector too, where we have begun to see some fundamental improvements this year. Conversely, in our view a prolonged shift in sentiment could prove problematic for some of the more levered capital structures in the Brazilian corporate market.

Is AMLO for real in Mexico?

Graham Stock, EM Senior Sovereign Strategist

Andrés Manuel López Obrador (AMLO) has unsuccessfully run for the Presidency in Mexico twice before. Will he succeed at the third attempt? He faces a PRI candidate, Jose Antonio Meade, who is a technocrat and will struggle to overcome rejection of the traditional political establishment. Against the background of ongoing NAFTA uncertainty, inflammatory border rhetoric and an inefficient quasi-sovereign oil producer Pemex in need of significant reform, the charismatic and nationalist AMLO surely stands his best chance yet. Additionally, if he is elected, which path will he follow? Will he emulate Lula's 2003 move to the middle ground, or will he follow the leftist path of his friend Jeremy Corbyn? In either scenario, we anticipate the Mexican peso is likely to be volatile.

Will Putin win an easy re-election?

Brent David, Senior Portfolio Manager, EM Currency

The Russian presidential election is the one major political event that no one is focusing on, yet significant uncertainties remain; not least the question mark around whether opposition candidate Alexei Navalny will be able to generate any momentum or not. If we see protests similar to those prior to the 2012 election, there is a chance that Putin will become more defensive domestically, and therefore potentially more aggressive externally. The FIFA World Cup in the summer will also increase the spotlight on Russia. On the flipside, if we were to see more benign outcomes, one area that could look increasingly attractive is the local currency corporate market, which boasts near double-digit yields, in some places and a more positive liquidity profile than much of the market.

What will happen in Venezuela?

Anthony Kettle, Senior Portfolio Manager

The economic mismanagement of the Maduro regime continues to create a social tragedy. The infant mortality rate is higher than Syria, the average Venezuelan has lost 19 pounds in weight over the last two years and three million people have fled the country as economic refugees. Despite all this, the Bolivarian regime has a firmer grasp on power and the opposition has been worn down by the failure of this year's social protests. The Cubanisation of the country seems to be further advanced; this makes the prospect of any quick debt restructuring and economic turnaround a mere pipe dream. Despite its small weighting in bond indices, the low US dollar price still makes Venezuela a key call for emerging market bond investors. We feel that if we were to get greater visibility on the potential for political reform and/or a softening of sanctions, then there could potentially be scope for Venezuelan distressed assets to look attractive from the long side in portfolios at some point in 2018.

Will South Africa face up to its moment of truth?

Russel Matthews, Partner, Senior Portfolio Manager

We believe South Africa is now at a T-junction. Zuma's presidency has resulted in significant institutional and policy making deterioration. This can no longer continue. The country is teetering on the verge of a third junk rating for its debt and is showing no growth potential. Events of the next 12 months, beginning with the ANC Leadership Conference this December, will demonstrate whether politicians are serious about dealing with this challenge. But a turnaround is still possible. The election of Cyril Ramaphosa as ANC presidential candidate could unleash a positive confidence shock not unlike that witnessed when Dilma was deposed in 2016 in Brazil, but the situation is urgent. We view it as a fairly binary situation, but unfortunately markets are unlikely to afford South Africa the luxury of muddling through. We feel that risk on both the upside and downside is fairly balanced at this juncture, as is the likely path for the currency from here.