EM Local Currency: Five Conviction Points

March, 2019

2019 has so far been positive for emerging market (EM) assets but returns have not been equally spread.

Local currency assets have lagged behind hard currency so far this year, with the JPMorgan GBI-EM Global Diversified Index for local currency government bonds returning 3.66% versus 6.60% for the JPMorgan EMBI Global Diversified Index for hard currency government bonds (returns to 19 March).

This performance differential has prompted us to re-examine our constructive medium-term bias toward local currency assets, and EM FX in particular.

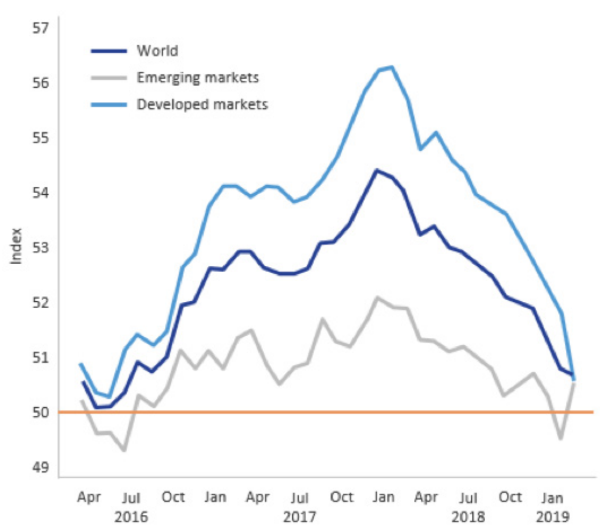
Is the investment case still positive? We believe so – here are five reasons why.

1. Stronger-than-expected Growth Impulse from EM

While global PMIs have continued to decline (dark blue line on chart 1), EM PMIs have shown a bounce (grey line), albeit from a low base, while developed market (DM) PMIs have fallen (light blue line).

The slowdown in DM growth (mainly Europe) is one of the main drivers of the global growth slowdown. However, we believe the 22 March European PMI print represents an outlier rather than the norm for the region. Most other recent European data – both hard (industrial production) and soft (Ifo and ZEW surveys) – has been better than expected, providing an early suggestion of a possible stabilisation in global growth.

Chart 1: Business Surveys, Manufacturing PMI, SA

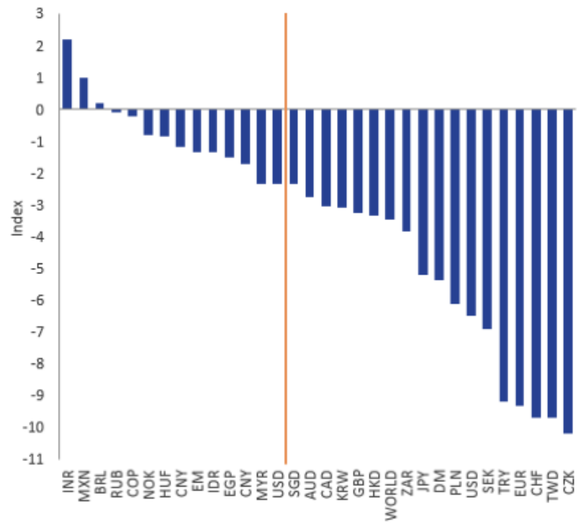


Source: Markit as of March 2019

Interestingly, EM PMIs are above DM PMIs for the first time in the past three years. This fits with GDP forecasts that suggest EM-DM growth differentials are expected to widen in EM's favour this year.

If we look at where PMIs are holding up well, chart 2 shows that a number of high yield EM currencies have seen stable or slightly higher PMIs since 12 months ago – namely the Indian rupee, Brazilian real, Russian ruble, Colombian peso, Mexican peso, Egyptian pound and Indonesian rupiah.

Chart 2: 12-Month PMI Change



Source: Markit as of March 2019

Hence, while we think global growth concern is something that we need to be aware of, we should also be discerning of where the weakness in global growth is coming from. Europe and North Asia are currently weak, but high yield EM is holding up reasonably well.

We are selectively focusing on countries where we believe the growth prospects are still reasonably attractive. We are positioned long Brazilian real, Colombian peso, Chilean peso and Indian rupee while being more circumspect on the offshore Chinese renminbi, South Korean won and New Taiwan dollar.

2. Stable China

There is some tentative evidence from Chinese data that a stabilisation is underway. While we do not expect a major reflation (like in 2016), the credit impulse has turned positive and we retain conviction regarding an L-shaped recovery, with the economy bottoming out around these levels. This should push fixed asset investment higher and prove supportive for commodities and broader EM FX.

3. Dovish Turn by the US Federal Reserve (Fed)

In early 2019, there was a sharp shift in Fed rhetoric, particularly at the January FOMC meeting. The Fed policy stance shifted from 'normalisation' to 'neutral', putting further hikes into question.

Analyst expectations have quickly shifted from expecting three/four hikes this year to zero/one. This neutral stance was confirmed at the March FOMC meeting, where the baseline scenario was changed to no hikes for this year.

Additionally, an earlier-than-expected end to quantitative tightening was announced. Market pricing in US rates has reflected this – cuts are priced for this year.

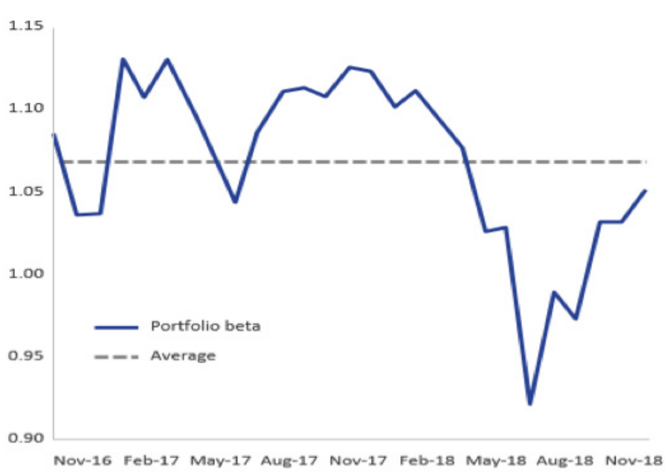
While this dovish shift should be supportive of carry trades and high-yield EM FX, we would argue that most EM currencies have not yet priced this in. For example, the JPMorgan EM FX index is close to flat since the January Fed meeting.

Hence, we believe there is significant scope for EM FX appreciation, as one of the main reasons for the lack of EM FX follow through – global growth concern – is now showing signs of green shoots.

4. Light Positioning

While EM FX positioning has built up since the start of the year, it remains relatively light on a historical basis. For example, fund factsheet data for benchmarked EM local managers suggests that positioning is still below the historical average, and much lower than the peak observed in early 2018.

Chart 3: GBI-EM: Portfolio Beta

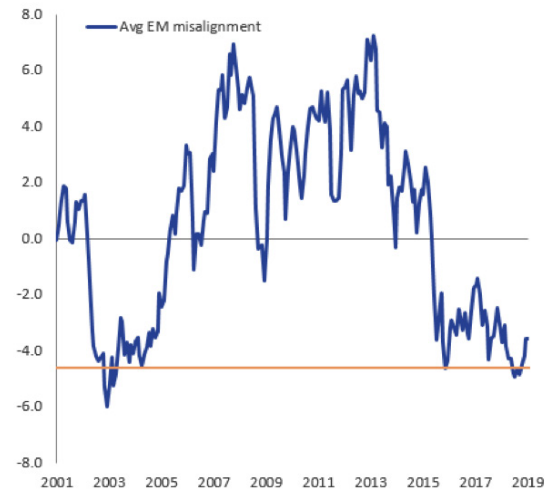


Source: Morgan Stanley as of March 2019

5. Attractive Valuations

Our Behavioural Equilibrium Exchange Rate (BEER) valuation framework – which models FX as a function of inflation, terms of trade and productivity – shows EM FX is at its cheapest level since 2005.

Chart 4: Average EM Misalignment



Source: BlueBay Asset Management as of March 14, 2019

Acknowledging the volatility in the data, we continue to believe in the theme of global growth stabilisation, noting that it could take one-to-three months for the stabilisation to become clear. If combined with the dovish shift from central banks (particularly the Fed), light positioning and attractive valuations, it argues for a constructive medium-term stance on EM local currency investing.

Global Asset Management

RBC Global Asset Management (U.S.) Inc.
Minneapolis | Boston | Chicago
800.553.2143 | **us.rbcgam.com**