INSIGHTS
INVESTMENT

Eric Stein
Vice President
Eaton Vance

Credit opportunities abound in emerging market debt amid headwinds

The global economy faces risks on three fronts, but compelling investment opportunities can still be found in emerging market debt.

First, the risks. At Eaton Vance, the team has identified three sets of headwinds: The interest rate environment in the U.S., rising oil prices and a slowdown in China.

"So, you have had the Fed, oil and China all being headwinds," said Eric Stein, a vice president at Eaton Vance and co-director of global income and portfolio manager in the firm's global income group. "That is part of the reason that you have seen some problems in emerging markets."

Of these, China presents the biggest long-term concern for Stein. Higher oil prices tend to help commodity-exporting emerging markets countries, though that has not happened this cycle.

"Usually, if I tell somebody the oil price is up, you would think it would be good for emerging markets," said Stein. "It has actually been bad for emerging markets, partially because it is hurting the importers seemingly more than it is helping the exporters." This may reverse in time. Additionally, other issues at work include supply disappointments that have affected the price of oil more than the demand picture.

The Federal Reserve tightening policy has clearly been a negative for emerging markets, and with a fourth rate hike expected this year, there may be more pain ahead in the short term. But rate hikes can't continue indefinitely, and there are indications, said Stein, that the Fed's view is starting to become less hawkish.

"At some point, six months from now, the Fed may be closer to being done than starting" with interest rate hikes, he said. "If the Fed ever has a dovish message at a meeting ... you could see a lot of dollar weakness and an EM rally on the back of that."

Where China is concerned, such silver linings are harder to identify.

TIGHTENING POLICY IN CHINA SLOWS ECONOMY

"China has had a very big domestic slowdown this year," Stein said. While there is a lot of focus on the tit-for-tat exchange of threats and tariffs with the U.S., "to us it is not entirely the trade war by any stretch," he said. The Chinese government has for some time been tightening regulatory and fiscal policies in an effort to reduce leverage and capital outflows, which had the effect of slowing its economy. Trade tensions with the U.S. have only exacerbated the situation.

To make matters worse, U.S. foreign policy does not look like it will soften around China, as it did around trade partners in North America and Europe. In fact, the opposite seems true, said Stein, who sees anti-China sentiments on the rise.

"U.S. trade policy is coalescing — both from what I call the trade warriors and from national security hawks — around anti-China," he said. This hawkishness has broad support in Congress from both parties and from many countries around the world. "I think the U.S. is realizing that we can't fight all countries at all times from a trade war perspective, so everything should be focused on China." Right now, "the U.S.-China relationship is clearly at a very, very low point," Stein said. "If you ask me what concerns me, even if anything more than Fed policy, it would be the U.S.-China trade relationship ticking another leg or multiple legs down from here."

With China's status as the world's second-largest economy, and one of the biggest consumers of commodities, this does not bode well for financial markets worldwide, especially for developing economies. But Stein still has reasons for optimism.

For one, broad valuations in emerging markets are "compelling," he said. This is especially true for many currencies. "Real rates in emerging markets versus developed markets" have a pretty wide spread, "so it is making EM local rates attractive," Stein said. What's true for currencies and rates also holds true for sovereign credit. "EM sovereign spreads have widened from the beginning of the year."

There is a lot of talk in the market about assets being overvalued, which may hold true for U.S. equity and credit markets that saw their last bear market almost a decade ago. Emerging markets, by contrast, have witnessed four broad sell-offs since the financial crisis: in 2011, in 2013 with the "taper tantrum," in 2015 with the oil price shock and the current sell-off in 2018. This latest downturn, sparked by Fed policy, trade wars and idiosyncratic issues within individual countries, has created an entry point "more compelling than many other assets," according to Stein.

Supporting this thesis is the micro-picture within individual emerging market countries, said Stein — specifically, "what countries have done from a policy perspective." Stein and his team spend a lot of time focused on macroeconomic and political analyses of countries, "looking at reforms, looking at policies, generally" to see how the reaction has been to the most recent sell-off. Here the signs are encouraging.

Stein mentioned interest rate hikes in Turkey and Indonesia, and fiscal consolidation in Argentina as examples of "the right kind of policy response to this little kind of mini-EM crisis we have seen over the last two quarters." While not all countries have reacted perfectly, and some have done better than others, in general, many emerging markets are in a better place than they were a year ago when there was a lot of complacency.

DIAMONDS IN THE ROUGH

Asked about specific opportunities, Stein mentioned Egypt, Serbia and the Dominican Republic as three markets that have defied the trend and performed well since the sell-off.

"Serbia is a country that we have been investing in for some time," he said. The Balkan nation until very recently received only scant attention from institutional investors in the West. That is changing. "They are getting more and more popular," Stein said. Serbia "is a good reform story. We still think it is a very attractive place to invest. Yields have come down a lot, but we still like it."

Egypt offers very high interest rates as a result of devaluing its currency in the past, but the current currency risk is "more than compensated for" with the high yields local Egyptian bonds offer. The Dominican Republic is somewhat similar. "Yields are lower," said Stein. "We expect the currency to depreciate a little bit, but not nearly as much as the yields would indicate."

These "smaller, frontier-ish countries" are examples of places where investors have been able to earn returns even in this difficult EM environment. There may be others. To find them, Stein and his team have a comprehensive approach that starts with analyzing individual countries — developing and emerging alike. The political equation is vital and often overlooked.

"I think anyone that invests in emerging markets has to analyze politics," he said. Indeed, this goes beyond emerging markets, as the examples of Brexit and Donald Trump's election in 2016 illustrate. "We are investing in the credit worthiness of an entity from a sovereign perspective, we are investing in the level of its interest rates, and we are investing in the valuation of its currency," Stein said. "All those are going to be variables that are heavily determined based on politics." ■

www.pionline.com/EatonVance_EM

P&I CONTENT SOLUTIONS GROUP

This sponsored Investment Insights is published by the P&I Content Solutions Group, a division of *Pensions & Investments*. The content was not produced by the editors of *Pensions & Investments* and *www.pionline.com* and does not represent the views of the publication or its parent company, Crain Communications Inc.