J. STERN & CO.

The Value of Long-Term investing

Investment Insight

HAS THE SELL-OFF MADE IT SAFE TO RETURN TO EMERGING MARKET BONDS?

The Fed's tightening cycle and the subsequent strengthening of the US dollar have finally spurred a reversal in Emerging Market capital flows across the board. Whilst Emerging Market borrowers are feeling the brunt of the higher cost of funding, investors have a choice of higher returns.

In the context of a Fed acting more aggressively than most expected, additional headwinds came into the picture: slower global growth, trade disputes and geopolitics.

We have been commenting for many months about the lack of investment opportunities to deploy cash. However, following the recent sell-off which has taken average spreads to levels higher than early 2017 (see Chart 1, there are now opportunities to find both quality and value in Emerging Markets. This is reflected in our model portfolio which is now showing a yield to maturity of 7.5% with duration below 4 years.

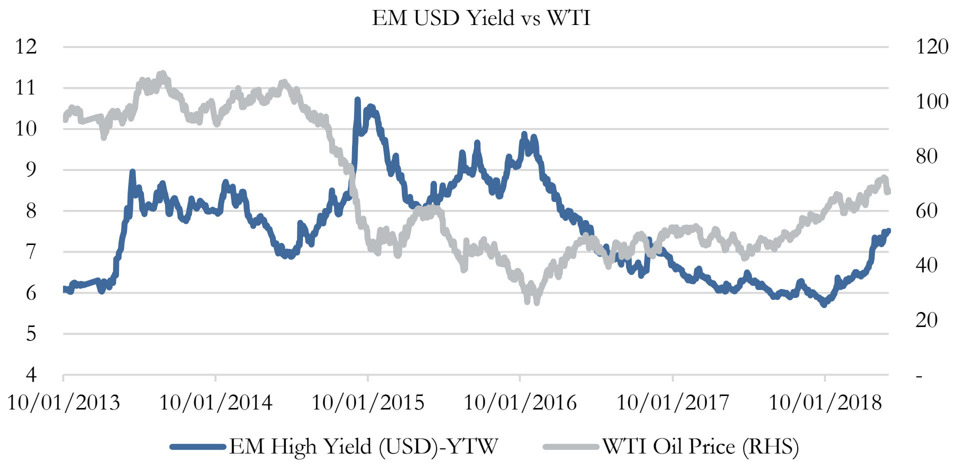

Chart 1. Source: Bloomberg

As Chart 2 below shows, the growth differential between Emerging and Developed countries is widening again, to the benefit of Emerging Market countries.

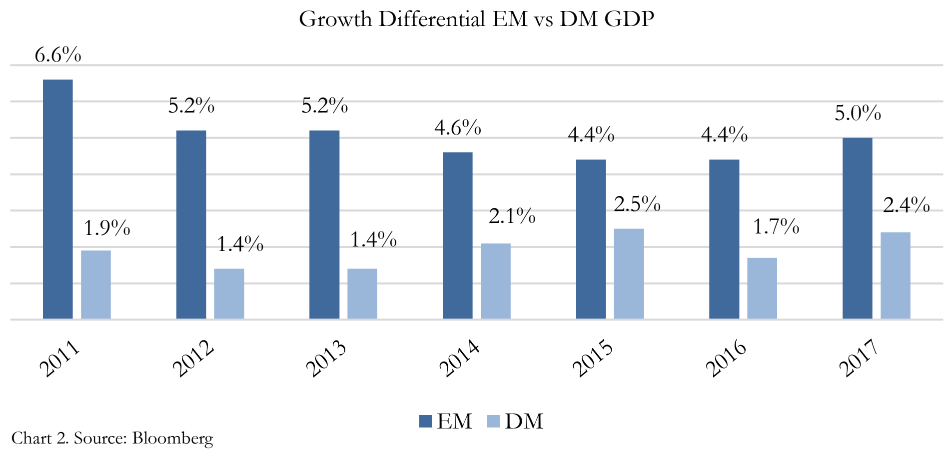

Chart 2. Source: Bloomberg

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Furthermore, for the first time in 20 years, we are seeing synchronised growth in Latam countries. Admittedly it is currently low at around 3%, but this is nonetheless a significant occurrence. The biggest challenge for EM governments is a fiscal one, as they contemplate how best to make growth persist while at the same time keeping budgeted expenses under control. Argentina and Turkey, two special cases on which we are dwelling further in this piece, illustrate very well the difficulty of the task.

Overall, whilst negative comments on Emerging Markets focus squarely on the rising levels of sovereign debt, the average amount of corporate credit in issuance as a percentage of GDP is much lower in Emerging Market countries than in the US. *

Most importantly, the level of debt amongst Emerging Market corporates has not risen as fast as EBITDA, resulting in a substantial decline in net leverage.

The two countries who have suffered the most in the recent sell-off are Turkey and Argentina. Below we analyse why the decline has been so brutal, and whether there are now some investment opportunities post the sell-off.

Turkey

When President Erdogan comes to London and blames the Central Bank for the country's pleas, it is certainly not going to appease foreign investors already spooked by the country's rising inflation figures. Turkey is clearly suffering from structural problems, made all the worse by the current political crisis.

Inflation

Inflation and currency depreciation feed each other in a negative spiral, which is the reason why Turkey needs to take its inflation problem seriously. As soon as the Lira weakens, it has a direct negative impact on inflation, through the price of imports, backward indexation and FX-pass through. Obviously, oil prices are rising at the worst possible moment, and Turkey is back to double-digit inflation.

Twin deficits

Erdogan's populist policies have been achieved through budget expansion and have thus resulted in a rising fiscal deficit. In the last six months alone, the government has already announced four stimulus packages targeting tax payers, unemployed people and corporates. As a result, the fiscal deficit is likely to end the year above 3%.

Meanwhile, the decline of the Lira has an immediate reverse effect on the current account deficit through energy imports and a lack of elasticity in export prices. Turkey has been running twin deficits for over a decade and always features very high up in the various vulnerability scores. Another worrying aspect is the decline in foreign direct investment (FDI), which is now only financing a small portion of the current account deficit. FDI ended 2016 at 1% of GDP whilst the deficit accounted for 5.6% of GDP. Having said that, we are likely to see a re-balancing of the current account deficit in the near term as FX weakness will hit imports.

Chart 3. Source: BoAML

There was a change of tone last Friday, with the Central Bank sending a positive signal by raising benchmark rates to 17.75%, more than the market expected. After the elections (coming on June 24), we expect more clarity on economic policy from the government, and some stability.

In this context, we are monitoring our Turkish exposure closely. We think that some names have been oversold. We are comfortable with the credits we are holding, but for new cash allocations we are starting to be selective and looking closely for attractive risk-reward. A lot has been said about the private sector's leverage in Turkey, and banks' unhedged positions. According to Moody's, Turkey's external debt/GDP is expected to end 2018 at 58%, split equally between private and public sector. But Turkish banks are well-capitalised and have extended foreign currency lending only to companies with FX revenues, or with products and service prices linked to the FX.

Argentina

In 2015, after running a campaign centred around reform, Mauricio Macri became the President of Argentina. Mr Macri, who had successfully been mayor of Buenos Aires for six years, quickly put together a team of accomplished technocrats and 'ex-bankers' with a view of normalizing the Argentinean economy and returning the country to international capital markets.

His plan was simple and focused on reducing the large subsidies provided to many segments of the Argentinean population (social security represented 38% of the 2016 budget). This would have the dual benefit of reducing the country's fiscal deficit whilst also reducing the country's chronically high inflation (22% in 2017). To minimise the impact on the electorate who would be forced to pay more for many essential services (energy, utilities, transportation) as part of this social security reduction, Mr Macri adopted a gradual path to normalisation. In order to execute this change in policy, the

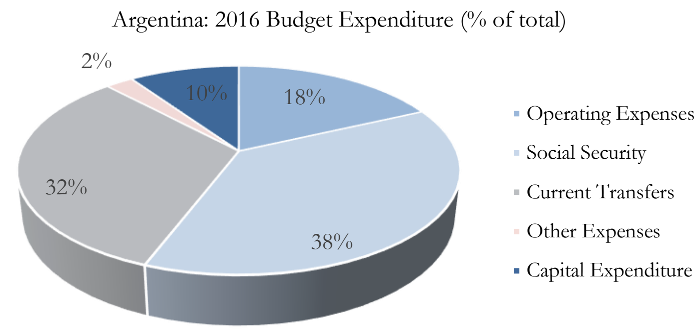

Chart 4. Source: Morgan Stanley

government needed funding as the mismatch between revenues and expenses remained high ($23bn in 2016 and $24bn in 2017).

To fill the gap Argentina issued $19bn in sovereign bonds in 2016 and $24bn in 2017, making the country the largest issuer in emerging markets over the last 2 years. So, what has gone wrong? The dramatic repricing in Argentinean assets since mid-April has been driven by both internal and external factors.

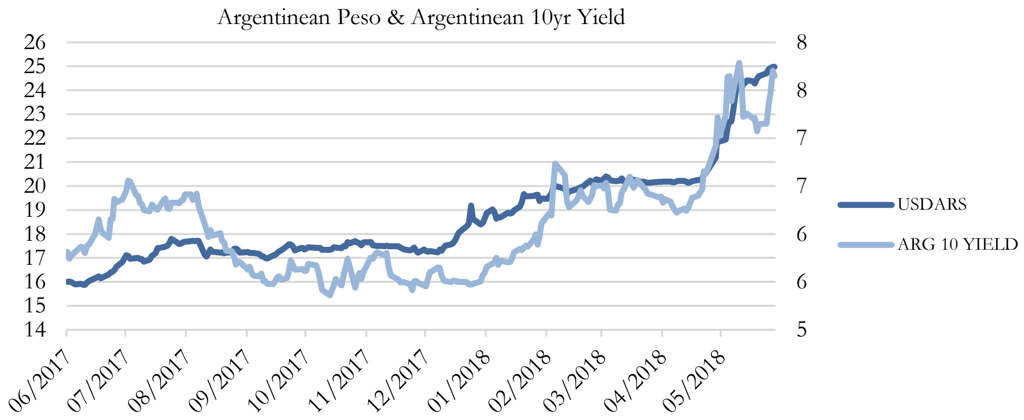

Chart 5. Source: Bloomberg

Firstly, the internal factors. In January the government changed its policy from one targeting 10% inflation to one comfortable with 15% inflation. This reduced the central bank's credibility and removed an anchor for the currency. The Peso was already overvalued but this monetary policy change provided a green light for further currency devaluation, which in itself pushes inflation further; this is a negative loop that is difficult to break.

Now the external factors. As we mentioned earlier, Mr Macri's gradual path of normalisation required financing. The IMF estimates these needs at $15-16bn per year (Table 1), consequently as yields in the US increased, the market became worried about Argentina's interest bill, particularly in respect of how much the country needed to borrow. These factors, when combined with a rapidly depreciating currency, policy errors and high financing needs have pressured the country's dollar bonds.

IMF Argentina Financing Needs (US$ bn)	2018	2019	2020	2021	2022
Primary Deficit	**20.8**	**15.8**	**15.6**	**16**	**16.2**
% GDP	*3.2%*	*2.2%*	*2.0%*	*1.9%*	*1.8%*
Interest Payments	**15**	**18**	**20**	**25**	**30**
% GDP	*2.3%*	*2.5%*	*2.5%*	*3.0%*	*3.5%*
NOMINAL DEFICIT AND FINANCING NEED	**35.6**	**33.8**	**35.2**	**40.5**	**46.2**
% GDP	*5.5%*	*4.7%*	*4.5%*	*4.9%*	*5.3%*
COMPOSITION OF FINANCING NEEDS	**35.6**	**33.8**	**35.2**	**40.5**	**46.2**
Domestic Institutions	*2.4*	*7.2*	*10.5*	*14.7*	*18.8*
External Loans	*1.0*	*4.0*	*5.0*	*6.1*	*7.3*
External Bonds	***15.3***	***15.9***	***14.5***	***16.1***	***17.7***
Other	*16.9*	*6.7*	*5.2*	*3.6*	*2.4*

Table 1. Source: IMF

In response Argentina increased local interest rates to 40% to protect the currency, and approached the IMF for a standby loan agreement of $50bn (3 years of financing see Table 1). These measures had the desired impact of stabilising both the currency and the country's dollar bonds.

So where do we go from here? And is this a buying opportunity?

We feel it is too early to get excited on Argentinian sovereign debt. Whilst the correction has been large we feel the path forward for Argentina has become less clear. The IMF has called for a more pronounced reduction in the fiscal deficit which will accelerate the reduction in subsidies, whilst positive from a fundamental perspective we fear these measures will prove unpopular and President Macri will struggle to retain power.

We may then be faced with the prospect of a populist government which reverses much of the good work completed by his government. Will that signal the beginning of the end? We feel another restructuring is unlikely as even Mr Macri's harshest critics represent a significant improvement on past regimes. But given Argentina remains a consensus overweight for many institutional bond funds, we feel the room for further selling remains high if the reform story around Argentina loses steam.

In corporates we are more optimistic and feel any further volatility may represent good entry points. We like names like YPF which have strong track records when it comes to honouring debt and generating dollar revenues, and which also have a strong strategic purpose for the country. In that respect, we remain vigilant observers looking for attractive entry points to anchor our long-term returns.

Conclusion

The correction seen in emerging market debt was not unexpected but we feel the trends of a stronger dollar, higher fuel prices and increased political uncertainty (namely the upcoming elections in Brazil & Mexico) will continue to weigh on sentiment over the next few months. The result of this volatility will no doubt bring dislocations in pricing, which we feel will provide attractive opportunities to buy bonds in companies with strong balance sheets and sound fundamentals at attractive yields.

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