Emerging markets awake at the wheel

IMF Spring 2022 meetings takeaways

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Coming out of the Spring 2022 IMF meetings, we are looking to increase low-volatility spread duration and decrease some EMFX exposure.

Summary

The bad news of higher rates has been priced in by markets, but the bad news of weaker growth has not. The risk of a US recession is rising, because of a European recession, oil embargo risks and China's zero-COVID uncertainties. The Fed's rate hikes are also a headwind. And, the Fed is unlikely to change its policy path soon. The fast increase in policy rates is with us all year, we think. The market has priced this in.

However, what the market hasn't fully priced in, we think, are the risks to growth. Recession risks are mounting and the IMF seemingly remain unpriced by the market.

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Europe risks entering recession. At the start of meetings, the IMF downgraded its 2022 German GDP forecast by 1% (IMF World Economic Outlook, April 2022). Risks to European growth were a key discussion point at the meetings. The IMF sees Germany as facing a huge terms-of-trade shock with additional inflationary risks/systemic constraints. These are weighing on confidence. Inflation pressures are serious and have the potential to be persistent, with commodity prices the key driver. It was unsaid, but to us this presents a scenario in which the European Central Bank (ECB) is unable to tighten policy due to growth concerns, leaving inflation not fully addressed. An important macro positive is a more flexible fiscal stance, which could improve growth prospects at some point, though not inflation. Still, a weaker euro is our asset-price conclusion. Entrenched inflation expectations will be something to watch in the years ahead. Another 'headwind' is embargo risk.

Embargo risk is real and markets are unprepared. How long will European energy consumers fund Russia's war on Ukraine? All Western discussion on the Russia/Ukraine situation is framed in humanitarian terms. And yet Russian exports are up this year versus last and the ruble has fully recovered from its sanctions-triggered collapse. We came away from the IMF meetings thinking that risks from the overall Russia/Ukraine situation are still escalating. Even if the conflict inside Ukraine could be frozen, with Russia consolidating territorial gains. Market participants almost unanimously think no embargo is coming and seem unprepared. We think an embargo is only a matter of time, and could come from the Russian side as well, by requiring ruble payment for gas and oil. Two interesting observations or ideas regarding the embargo of oil; firstly via sanctions on tanker insurance. This would affect around 80% of Russian oil exports and wouldn't require importing nations to agree. Most insurance is provided by UK companies, with a UK government that we think is on board with the idea. Second, there has been a change in polling in Germany, now roughly 80% of the population support an oil embargo according to one presenter at the IMF meetings. German economic and military policy of the past several decades is now being called into question and the newly-elected government has been executing a 180-degree turn toward rebuilding its military and ending Russian energy imports. The implications of this are underappreciated by markets.

China's risks are multi-layered and hard for markets to discount. Chinese officials maintained a low profile at IMF meetings, so information is indirect. Economically, concerns surround its zero-COVID policy and its potential spread to Beijing weigh on China. This is creating downside risks to growth. The IMF however only downgraded its 2022 growth forecast for China by 0.4%. Our concern is that the Chinese renminbi spot rate could come under pressure for growth reasons. Inflation is low, so pass-through of currency weakness into inflation shouldn't be a constraint. Real interest rates are not that high by global standards, so even lower interest rates are not an obvious policy move to us. This makes currency weakness all the more attractive as a policy tool.

Also discussed were political risks to Xi, from zero-COVID to China's geopolitical positions. Our view is that tensions are still rising with China and that sanctions talk always end with sanctions, and sanctions never end. This came up in discussions. One specific data point is that many financial institutions are rethinking their China businesses as a result of China's divorce from the US which is being accelerated following sanctions on Russia. This is hard-to-price. And the market is doing what you'd expect, by not pricing it at all, equities aside.

The Fed's hikes were considered in discussions. Who doesn't know the Fed is hiking? Fed fund futures price 250 basis points in hikes for the rest of 2022. A US 10-year around 3% or higher was a popular view. An under-appreciated element of the discussion surrounded quantitative tightening (QT). Market participants are still grappling with the implications of the Fed's faster QT program. This affects mortgage rates, they would be selling mortgage-backed securities and the long-end of the rates curve. In our view, this is how the market will cap rates and where the first signs of stability will appear. Maybe there's upside to rates out to five years, but beyond that we see a curve that is trying to stabilise. Can we really face much higher rates given these new risks to growth? Especially when the US dollar has done so much work in tightening financial conditions already, and the US fiscal impulse is heading further negative? The Fed will hike, until it can't. That hiking is largely "priced" into long ends. That's consistent with our view that the US dollar should be strong against the majors like the euro and the yen. The US has higher nominal and real growth rates and interest rates than both of them. It's also consistent with our view that the US dollar should be weak against selected emerging markets currencies that have hiked interest rates already and/or benefit from high commodity prices.

Emerging market central bankers were wide awake at the wheel. The broad theme of the meetings is that participants were already worried about inflation and higher rates, but haven't yet digested weaker growth. Emerging markets have many central banks that hiked policy rates, and well before the price shock of the Ukraine invasion. Many are positively affected by the multiple underpinnings for commodity prices. In fact, some were predicting a new commodities super cycle. We were glad to see participants note that there's been no increase in energy sector capex commensurate with prices. An example would be Brazil, which is arguably almost done with its hiking cycle and has enjoyed a significant currency rally this year despite the hit to global asset prices. One of the key "uncertainties" in Brazil is how much this currency strength has already done the job of rate hikes. Anyway, Brazil is a good example of the emerging markets with high real rates, benefit from high commodity prices and have strong external accounts. South Africa would be another.

There's a global food and energy crisis with no collective response ready; this has big implications for social unrest, especially in emerging markets, so be selective. The typical consumption basket in major emerging markets is about 35% food and energy, or closer to 50% for lower-income emerging market countries. Countries with independent central banks and strong external accounts, that can stabilise inflation expectations, are likely to keep it under control. Thankfully this describes most emerging markets countries. But, even Peru, Chile, and to some extent Colombia have experienced social unrest related to inflation, although corruption and loss of trust in the system seem to be the deeper drivers there. In a range of countries, economic, political, and social systems will be tested. To us, this means selectivity and nimbleness in investing.

Commodity prices are rising, supply will only get more constrained and duplicative, and we don't believe anything will be done. US Treasury showed no indication of taking a supportive stance toward conventional US energy production. What struck us was how much of the reduction in capex is organic, reflecting the ESG movement and shareholders that are more sensitive to energy production, at least at the micro-level. What this means, to us, is that commodity prices should go higher. The supply needle will not move positively in most scenarios that we can see. It will take more before there is significant investment in production from the majors. This is a potential boon for a number of emerging market economies. The other points raised at the meetings were the issues we all know by now, namely that everything is increasingly viewed through a national security lens. This means embargos. This means new supply chains. This means duplicated supply lines. This means duplicated storage. All supportive of commodity prices, in our view.

There was strong support for Ukraine. We see close cooperation between Ukraine and the US, with close monitoring of Ukraine's budget and external financing needs. What this means to us, is that Ukraine will only default when it wants to default. If it wants to keeping repaying investors, the money and support are there. More practically, we don't see Ukraine choosing to miss its 2022 external bond payments, making those bonds attractive. Longer-term, though, the rebuilding costs following the invasion will be high and we don't see how there cannot be an eventual bond restructuring. Not this year though, we think.

Emerging markets are so diverse that they stand out as an opportunity in a world focused on how horrible higher interest rates and higher commodity prices are. Emerging market bonds, whose central banks have already hiked interest rates and which benefit from higher commodity prices stand out as an opportunity. The implications of the meetings for specific emerging markets are as varied as the drivers. To review, we see US long-end rates at risk of stabilising. This means higher duration for low-beta emerging markets bonds makes sense. We see commodity prices and high real interest rates as supporting some emerging markets local-currency bonds. We come away less positive on currencies in Asia, due to pressure from a weak China. We come away less positive on currencies in Europe, due to recession and embargo risks in Europe. Within local currency, this leaves us with Latin America, and luckily we see high real interest rates and high commodity price support there. There are still cheap, re-pricing reformers among smaller countries.