EM in a ZIRP world

Zero interest rate policies (ZIRP) in much of the developed world have led to negative yields on nearly $17trn of bonds including an estimated $1trn of corporate debt. The this has led to enormous pressure on banks as their spreads have collapsed which has distorted behaviour from companies that are leveraging themselves to increase share buy-backs rather than investment. A result of ZIRP is slower economic growth.

Low returns have removed any incentive to save and investors, pension funds in particular, are left with an awkward dilemma of where to invest given the obvious problems with the bond market. This is effectively a magnified version of what was happening in the run-up to the financial crisis when disastrous capital allocations were made in a desperate attempt to find some yield.

Against this backdrop, emerging market (EM) hard currency debt has found some favour while local currency debt and equities have been shunned as the currency risk is viewed as being too severe. This view has been reinforced by the recent collapse in the Argentinian peso which illustrated the increasing concern that politics has become more of a threat than economics. The economics of EMs is, unusually, not a cause of great concern. Undoubtedly growth is a problem, as it is globally, and economies are performing well below potential, notably those of India, Brazil, Russia and South Africa to name a few. However, the issues that are normally a source of great concern – current account deficits, budget deficits, real effective exchange rates and inflation – are all benign suggesting risks are lower than normal. This is reflected in both bond and CDS spreads which are historically low.

Although there are, of course, exceptions banks within emerging markets are able to earn a good net interest margin without unduly punishing savers. They tend to enjoy low cost-to-income ratios and have books that are well provisioned. As a result, returns on assets tend to be much higher than in developed countries and thus returns on equity substantially above the cost of equity can be earned without excessive leverage. A strong banking system, healthy domestic finances and a low dependence on external capital leave emerging markets in a much better position to navigate a global economic downturn than has been the case historically.

EMs also offer yield. Spreads on hard currency debt have shrunk but domestic debt offers substantial real yields, albeit with a currency risk that we argue is diminished relative to the recent downturn. Dividend yields in EMs are at historically high levels relative to developed markets and yet payout ratios are substantially lower. EMs are continuing to invest to grow in countries where there is growth and not indulging in buy-backs for the benefit of option holders. Despite this, sentiment towards the asset class is at rock bottom levels, with net redemptions from equities for the past 19 weeks.

FDDSGDP Index (US Treasury Federal Budget Deficit or Surplus as a % of Nominal G

Source: Polar Capital & Bloomberg, 13 September 2019.

The soaring dollar is pressuring EMs as it always does, yet the fundamentals of the dollar are poor given its overvaluation on a real, effective basis allied to the deteriorating current account and budget deficits. When the dollar and the economic cycle turn, the returns in EMs can be extraordinary, as was seen in 2009. Valuations, especially in cyclicals, are getting close to the levels seen in 2008 suggesting the downside is limited – best to position ahead of the turnaround.

William Calvert, Fund Manager

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