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Thoughts from a Renaissance man
Economics

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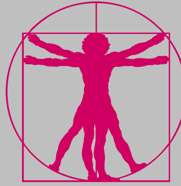

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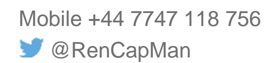
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Thoughts from a Renaissance man
When yields disappear: 0% EM interest

Well not quite zero, but most emerging markets (EMs) offer so little yield that hard currency bonds or equities might soon prove more attractive than unhedged local bonds.

The coronavirus crash has spread global disinflation into nearly all corners of EM

The interest rate pick-up from investing in many emerging market local currency bonds has nearly disappeared. We think the roots for this started in the fall of developed market (DM) yields since the peak in the early 1980s. It intensified after Japan's crash in 1990 and then spread to central Europe and Asia after the global financial crisis. The coronavirus crash has pushed the global disinflationary trend into 'proper' EMs ('proper' being countries where interest rates have been more interesting). Brazil cut its interest rate last night (17 June) to 2.25%, which we think is its lowest borrowing rate since independence in 1822. Rates are also extremely low in Russia, South Africa (SA) and Mexico too. The protection investors have had for decades (or centuries) of relatively high interest rates in unhedged bonds, often double digit, which offset periodic bouts of devaluation, has now gone.

For now, we think EM local currency funds can still justify exposure in unhedged EM local currency bonds as DM and EM rates have not fully converged, and more importantly due to FX levels. There is still hefty under-valuation of the real, Mexican peso and rand relative to our 1995-2020 REER model. But if that disappears due to general dollar weakness or current account (C/A) surpluses, we can count on just one hand the number of EM currencies that might be worth buying for the local interest rate: Egypt, Pakistan, Turkey and Argentina. We are not sure what happens to the many billions of dollars invested in local rates. At best (for EM issuers), they become very low-cost funds and remain invested ($43bn in Russia today) – and focus on one final hurrah for EM bond investing, which is taking a hedged position and hoping for 10-year yields to drop.

Record low borrowing costs in local currency should support EM equities

One beneficiary of this should be EM equities. From Russia to Brazil, borrowing costs are the lowest for decades (or ever). We expect this will lift consumption and help drive a GDP recovery.

Africa/Frontier local currency bonds are likely to continue offering high rates

We also assume African local fixed income, and Pakistan probably, will continue to see relatively high local interest rates due to the shortage of local savings. We think demographics are the key factor behind this and that may not change much in the 2020s.

A return of inflation is the biggest risk to this trend

Where might we be wrong? Most obviously if inflation rears its head in EM again, due to structural inefficiencies, political risks driving capital out of the country, quantitative easing (QE) leading to currency weakness, etc. That's not my base case though. EMs are getting older and, with a few exceptions (Turkey, Argentina), wiser on monetary policy direction; low inflation is here to stay. Given this, hard currency bonds, some cheap currencies, EM equities and Africa/Frontier bonds may hold more attraction for global investors. I'm keen to hear your views on this.

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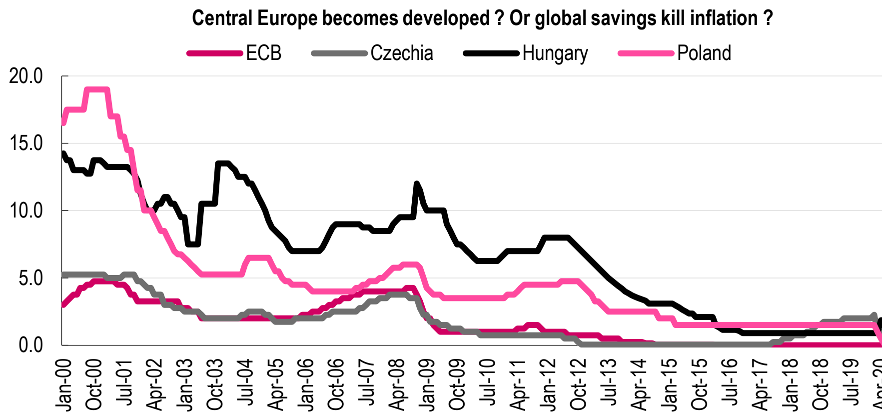
Overview

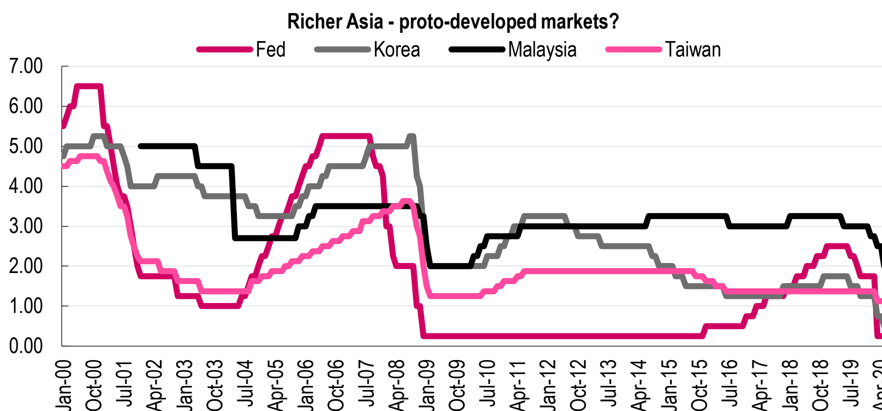
Two things shocked me about 2008/2009 and its aftermath: first, EM countries did not have to hike rates to defend their currencies. Second, after the crisis, interest rates in Asia and central Europe fell to DM levels (or close enough) but did not create an inflationary boom nor excessive C/A deficits.

Figure 1: Why could central Europe cut interest rates close to ECB levels in the 2010s?



Source: Bloomberg

Figure 2: Central bank policy rates in Asia and the US, 2000-2020



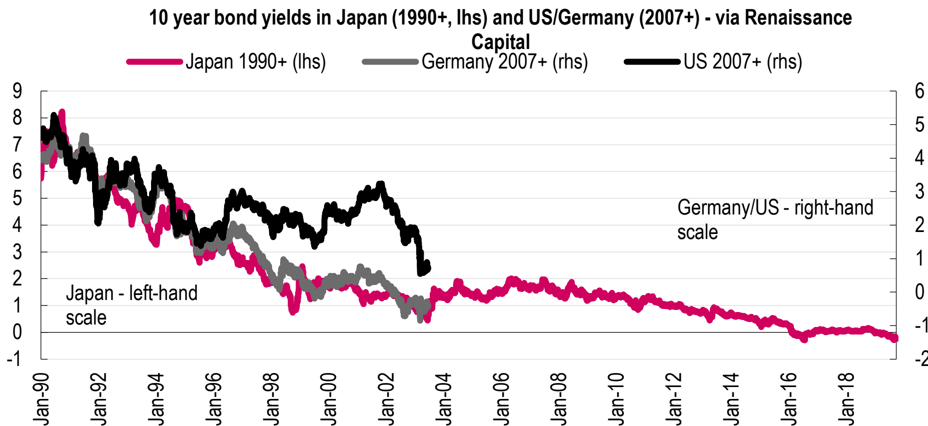
Source: Bloomberg

Both of these created some cognitive dissonance for a while. One option was to forget everything I'd learnt about EM in the 1990s and 2000s. The second was to re-label central Europe and east Asia as somewhat dull proto-developed markets and join RenCap. Doing the latter meant I could focus on 'proper' EMs where my 1990s experience was still useful.

A third option (which economist is ever really satisfied with just two hands?) did emerge through the 2010s. This was to recognise structural global changes that began with the rally of US treasuries in the 1980s and question whether global disinflationary forces were likely to engulf nearly all emerging markets. My answer was yes.

My base assumption was that Japan was leading Germany and these two would anchor US rates at low levels too. We think the high debt accrued in 2020-2021 reinforces this assumption – see *Thoughts from a Renaissance Man COVID-10s positive repercussions for EM*.

Figure 3: German bunds (rhs) track Japan (lhs) with a 17-year lag and some chart-crime with two different scales



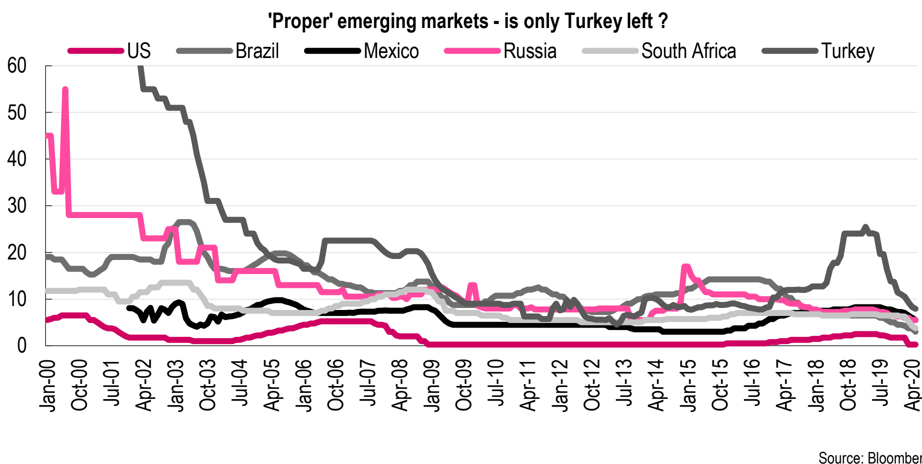
Source: Bloomberg

As EMs got older, savings increased and as global trade also increased (helping to equalise prices globally) and monetary policy proved more effective at keeping inflation down, 'proper' emerging markets might then follow central Europe and east Asia into the low inflation world. But I assumed it would need a global disinflationary shock to make it happen.

Starting a few years ago, my global presentations all ended with the same paragraph that when the next global recession came, it would destroy inflation in EM, cut interest rates dramatically and force a re-rating upwards of EM asset prices, from Russia to Brazil, and Mexico to SA. EM equities and bonds would perform as well as they did in the US from 1980-2008. That concluding page was just after the page on global risks, which always included the key risk of a global pandemic such as SARS (my black swan was a global lockdown, which I never imagined before March 2020).

Given this backdrop, EM and frontier market (FM) policy responses in the coronavirus crash (CC) have been only mildly surprising. DM has gone further than it did in 2008/2009 with bigger QE and even more stimulus. EM has acted like DM did in 2008/2009, with interest rate cuts, fiscal spending and some QE – and now Brazil, Mexico, Russia and SA look more like central Europe did a decade ago. FM has acted like EM did in 2008/2009 and did not hike rates. Well Kazakhstan did, but it swiftly reversed that, while Nigeria, Kenya and most recently Morocco even managed interest rate cuts.

Figure 4: Emerging market central bank policy rates, 2000-2020



Source: Bloomberg

Has this killed the carry trade?

I'm not talking about borrowing at the short end in local currency and investing at the long end, eg all in roubles here. I'm talking about the trade that even young members of the EM community will remember, when you could borrow at rates derived from the 0.5% of the Fed (until November 2016) and invest in Brazil at 14.25% (September 2016) or Russia at 10% (as recently as February 2017). Yes, you could lose money on the currency but a 1,375-bpts pick-up investing in Brazil meant that most years it was worth it. After Brazil cut the Selic rate to 2.25% - the lowest rate since independence in 1822 (I think) – we just don't get the same protection. The same is true for Russia, SA and Mexico.

There is still a case to buy EM currencies when they get oversold – as we flagged in *Thoughts from a Renaissance Man FX Updated for EM – cheapest in 15 years*, 8 April 2020 (about a month too early for some currencies).

However, it is a struggle to see the relative appeal of investing in the real at a few percent, when Brazil's eurobonds also offer a few percent yield, but in dollars. The same is true for Russia, Mexico and SA.

Does this mean that foreigners who hold RUB3,000bn ($43bn) in Russian local debt might leave? They still get a 4% pick-up over the eurobonds vs 1.5% in Brazil on one-year paper vs its eurobonds. And we are not suggesting EM funds will flee yet. The real is still 26% cheap to its long-term fair value and Mexico is 23% cheap. Russia looks 2% expensive, but we think it should be more expensive than this if oil returns to $50-60 next year, and given where the C/A is.

In the medium term, however, it is harder to see the appeal of local bonds, with rates this low, for investors taking an unhedged currency position

There will still be a few EMs, Egypt, Pakistan, Argentina and perhaps Turkey, which will show double-digit local currency yields at the longer end of the curve, for a while at least (forever if two centuries of Argentinean history is any guide).

It has been an incredible cycle to watch. 20 years ago, some central European countries had such immature bond markets that they did not yet have the 10-year issuance required to meet the Maastricht criteria and adopt the euro. Now the yields on these 10-year bonds are around 2%. This does still highlight that there is one last hurrah to be had for EM local currency bond funds that do hedge their investments. There is still the possibility that Brazil or Russia or SA see their 10-year bond yields come down towards the level of central Europe. Brazil's 10-year bond yield is still up at 7%. We are more confident about that for Russia than SA and Brazil (and certainly not confident about Turkey), but I'll leave that call for our Russia/CIS economist Sofya Donets to make.

Figure 5: EM currencies in our Real Effective Exchange Rate (REER) 1995-2020 model

	Current FX rate vs $	FX rate implied by LT average REER	FX rate if REER falls to previous lows	Date of REER low	LT average divided by current rate	IMF 2019E C/A (% GDP)	IMF 2020E C/A (% GDP)	Standard deviations away from historic average	Yvonne's** avg. REER 9/19 estimate	RenCap 20YE forecast	1Y local currency yields
Philippines	50.2	61.0	85.8	Feb-04	1.22	-0.1	-2.3	1			2.3
China	7.09	8.55	11.8	Apr-95	1.21	1.0	0.5	1			2.2
Czech Republic	23.8	28.4	44.0	Jan-95	1.19	0.0	-2.1	1		17	0.1
Thailand	31.1	36.9	54.1	Jan-98	1.19	6.9	5.2	1			0.5
India	76.1	87.9	108	Nov-96	1.15	-1.1	-0.6	1			3.7
Indonesia	14,078	16,148	42,206	Jun-98	1.15	-2.7	-3.2	0			5.2
Egypt	16.2	18.5	28.4	Dec-03	1.14	-3.6	-4.3	0	16.73	17	12.4
Qatar	3.67	4.03	5.14	Dec-03	1.10	2.4	-1.9	0			1.4
Peru	3.50	3.80	4.32	Jul-07	1.09	-1.4	-0.9	1			1.0
Saudi Arabia	3.75	4.06	4.94	Mar-08	1.08	6.3	-3.1	0		3.75	1.0
UAE	3.67	3.86	4.43	Nov-07	1.05	7.4	1.5	0		3.67	1.0
Russia	69.7	71.3	140	Jan-99	1.02	3.8	0.7	0		73.6	4.2
Poland	3.98	4.03	4.86	Nov-97	1.01	0.5	0.2	0			0.1
Taiwan	29.6	29.7	34.8	Nov-09	1.00	10.5	8.2	0			0.8
Korea	1,208	1,211	1,877	Jan-98	1.00	3.7	4.9	0			0.6
Hungary	308	307	412	Apr-95	0.99	-0.8	-0.1	0			0.7
Greece	1.12	1.18	1.02	Sep-00	0.95	-2.1	-6.5	0			0.2
Chile	797	745	925	Jun-03	0.94	-3.9	-0.9	0			0.2
Pakistan	166	155	179	Sep-01	0.93	-5.0	-1.7	0			7.3
Malaysia	4.28	3.92	5.91	Dec-98	0.92	3.3	-0.1	0			2.0
Colombia	3,749	3,205	4,418	Mar-03	0.85	-4.3	-4.7	-1			3.1
South Africa	17.4	14.0	20.9	Dec-01	0.80	-3.0	0.2	-1	12.7	16.5	4.3
Mexico	22.5	17.4	28.0	Mar-95	0.77	-0.2	-0.3	-1			4.8
Brazil	5.33	3.97	7.64	Oct-02	0.74	-2.7	-1.8	-1			2.5
Turkey	6.86	5.09	7.54	Sep-18	0.74	1.1	0.4	-1		6.5	8.5
Argentina*	69.7	51.3	114	Jun-02	0.74	-0.8	na	0			57.4

Note: Govt bonds/bills except: Argentina (implied forward), Qatar, Taiwan, UAE (Interbank rates), Saudi Arabia (swap rate).
*Argentina's inflation data was unreliable for 2007-15 - we have constructed an REER series using 'shadow' inflation data
** Yvonne Mhango, our Sub-Saharan Africa economist

Source: Bruegel, IMF, Bloomberg, Renaissance Capital

Better for equities though

There is good news in this for equities though. We already have the lowest real interest rates for Brazilian consumers since 1994. In Russia, a government mission to support housing finance with 6.5% lending rates has already been uncut by its commercial banks, offering finance closer to 6.0%. Borrowing locally in low single digits, without the FX risk that central Europe took on with Swiss franc mortgages in the mid-2000s, seems a helpful low-risk way to support GDP growth.

Also, Africa local fixed income remains interesting

In addition, we suspect that African interest rates remain will remain high. This is not because investors misprice African risk. It is because local savings are extremely low due to the prevalence of large families – a link we got very interested in last year – see *Thoughts from a Renaissance Man: Let's talk about sex (and money)*, 14 November 2019. As a result, we expect to see foreign borrowing, C/A deficits, periodic currency sell-offs and inflation, which are likely to keep interest rates high. But these markets are not big enough to support the current size of the EM local fixed-income business.

Conclusion

The risk to this theory is of course that inflation surges, forcing interest rates back in EM and giving us back the carry. Structural inefficiencies in EM might yet provoke that.

Excessive QE or political risk might lead to a constant outflow of FX by locals that contributes to currency volatility and some inflation too. Perhaps that did not happen in central Europe because they are in the EU (Hungary is riskiest on this score and does have the highest interest rate in the region), and does not happen in South Korea and Taiwan because they are indeed DMs according to everyone but MSCI and equity investors. I'm keen to hear your views.

In the meantime, enjoy the relative risk-return of hard currency bonds and perhaps look to equities as the beneficiary of a new low interest rate world. Oh, and subscribe to RenCap research to understand Africa local fixed income slightly better than you do already.

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