EM: 3 Performance Drivers

We believe conditions are improving for the asset class – while growth might be modest, there's potential for positive returns.

2019 proved to be a positive year for emerging market (EM) hard currency corporate and sovereign debt. Returns were positive despite poor global growth and a firm US dollar.

Coming into 2020, the global liquidity environment looks as though it will be supportive for the asset class. However, we believe EM growth is likely to remain modest, accompanied by a slow rise in default rates from the currently low level.

Here are my three predictions for what I feel will drive the performance of EM risk assets in 2020.

1. Shift from growth to stability = potential carry trade opportunities

Historically, investors were focused on growth as a key driver of EM performance. Yet some EM countries have moved away from a 'boom/bust' growth profile and towards macroeconomic stability, which we believe will provide positive risk-adjusted carry opportunities.

2. Maturing EM credit cycle = increased price dislocation in liquid stressed credits

As the credit cycle matures, we expect more stress in idiosyncratic credit stories given the tepid growth outlook combined with a gradual path towards global interest rate normalisation. While default rates are likely to increase towards the historical average (3.5% for corporate EM high-yield credits), we expect to see more price dislocation in liquid stressed credits.

3. Domestic stimulus = liquidity support to corporate credit

This theme has been playing out in Western Europe for several years. In 2020, we expect China to provide stimulus to the domestic economy both through infrastructure spending and loose monetary policy. Sectors like Chinese real estate, in our view, will be one of the key beneficiaries of that support.

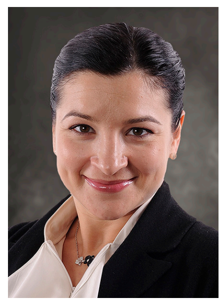
And as for the risks...

A more hawkish US Federal Reserve stance

A more hawkish attitude is likely to challenge our view on select defensive high-carry trades. If this scenario were to materialise, we would look to add protection through taking a short position in EM FX.

Challenging liquidity environment for EM credit given the global monetary and geopolitical backdrop.

A more difficult liquidity environment might reprice hard currency spreads to incorporate a higher liquidity premium, which could impact our trades in hard currency credits. If this scenario were to materialise, we could express a negative view through taking a short exposure in EM credit, as well as using CDS to reduce our exposure to market beta or express a negative beta view.



Polina Kurdyavko
Head of Emerging Markets,
Senior Portfolio Manager
BlueBay Asset Management