Tactical overweight on Emerging market sovereign dollar bonds

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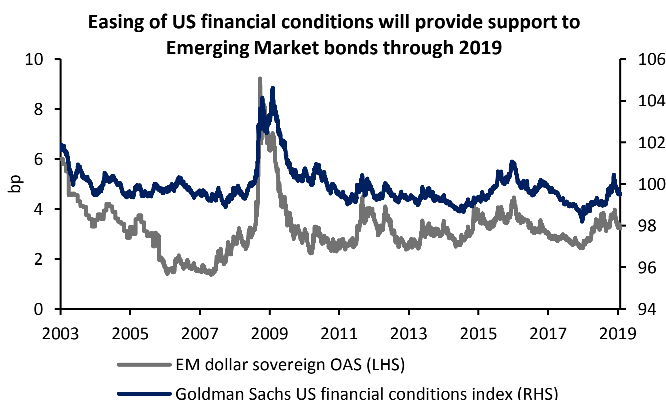
Dovish surprise by Fed, China stimulus and weaker dollar to boost demand for EM bonds

- **Fed has surprised more on the dovish side by removing the possibility of rate hikes for this year.**
- **US financial conditions should improve with the Fed pause and its balance sheet shrinkage coming to an end latter this year.**
- **Yield inversions may be flashing recession signals, but we recommend not reading too much into it given the dissimilarity between the Fed's hiking cycle with previous ones. For now the US expansion is still on.**
- **In addition to Fed's dovishness, China stimulus is also positive for emerging market bonds.**
- **The combination of more dovish signals from the US and China, make continuing US dollar strength less likely, providing relief for emerging market debt.**
- **With the US yields likely to be range-bound and European bond yields turning negative, emerging market bonds are attractive.**
- **We also insist on selectivity and recommend countries with the most solid fundamentals- Brazil, Russia, most of the GCC countries, Indonesia (due to reduced external risks) and – as far as local bonds are concerned – India.**
- **At the same time we stress that beyond 2019 continuing dovishness by the Fed, and continuing stimulus by China, are not a foregone conclusion. Hence the tactical nature of our call.**

Combination of Fed dovishness and prudent China is turning tables around, for now

Emerging markets bonds have been rallying since the beginning of the year since the Fed's policy "pivot" in January 2019. We had been maintaining a cautious stance on emerging market bonds, in spite of the recent rally and advocated a more selective approach, focussing on GCC, Brazilian and Russian bonds. One of the reasons behind our selective approach was that we were not yet fully convinced of the Fed freezing rates fully for the remainder of 2019, nor of the degree to which China would provide significant additional stimulus. It is the combination of more China stimulus and Fed dovishness that puts downward pressure on global yields and the US dollar, thereby ultimately supporting emerging market bonds.

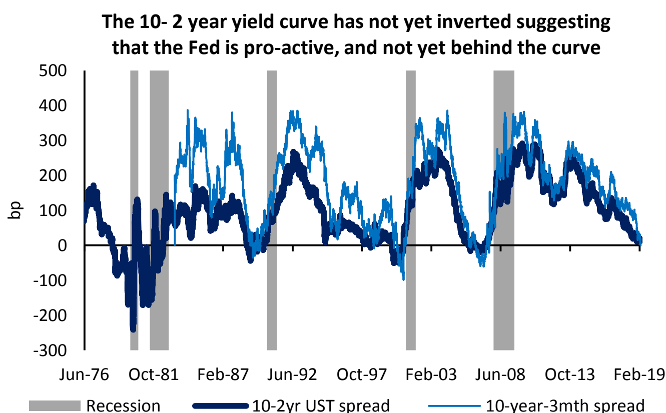
The Fed has now surprised by fully clarifying that it intends to depart from its usual practice of consistent rate hikes in the late phase of the business cycle. The dovishness of the Fed is also being amplified by its decision to stop its balance sheet reduction, clearly signalling its determination to ease financial conditions across the board. And whilst the extent of the China stimulus is not yet clear, it should be supportive enough to prevent a further weakening of the renminbi. We would like to stress though that there is a continuing likelihood of the Fed hiking rates in 2020. At the same time we don't believe China stimulus will be of the same scope and size as its 2015-16 stimulus. Hence the good chance that emerging markets will again come under pressure towards the end of 2019. This then explains the tactical nature of our call.



Source: Bloomberg

Reflections on the "yield curve inversion"

Recent market fears of the US yield inversions flashing recession should be put into context. Unlike all prior inversion on the 10 year – 3 month yield curve, this one has not been preceded by an inversion of the 10-year-2-year yield curve. The fact that the other has not yet inverted says a lot of the pro-activity of the Fed in countering the current economic slowdown, thus bringing down yields across the bulk of the curve. The fact that the specifically the 3-month rate has not come down yet, has a lot to do with the quantitative tightening that will continue until September. The ongoing reduction of the Fed's balance sheet naturally constitutes a drain on liquidity and thus inevitably pushes up the shortest maturities, such as the 3-month rate.



First Inversion date of 10-2yr UST curve	Recession start	No of months
17-Aug-78	1-Jan-80	17
11-Sep-80	1-Jul-81	10
14-Dec-88	2-Jul-90	19
2-Feb-00	1-Mar-01	13
8-Jun-06	3-Dec-07	18

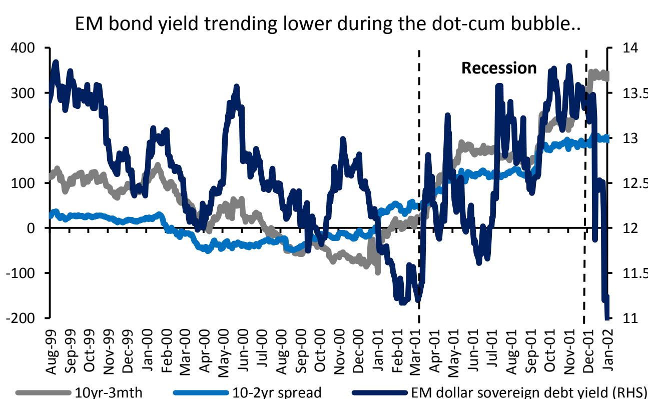
Source: Bloomberg, ADCB

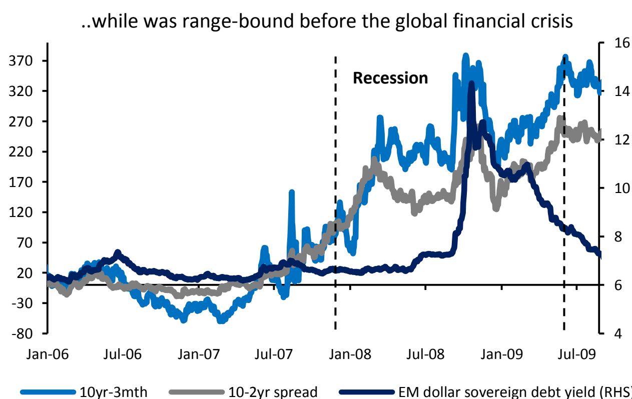
Critically, whilst the yield curve inversion has always been a correct indicator of recession, it has not always been a timely indicator. As can be seen from the above table, it can take a lot of time after the inversion of the 10 year – 2 year yield curve, before the expansion of the US economy comes to an end. The possible timing horizons implicit in that table are still rather consistent with our recent assessment that a US recession would materialize some time in 2021, following a renewal of Fed rate hikes in 2020.

Positive implications for emerging markets bonds

The search for higher yield naturally boost demand for emerging market bonds. With the US treasury yields remaining range-bound for the year and European bond yields moving in the negative territory, emerging market bonds offer attractive yields. On the "supply" side, one should also point out the beneficial implications of the Fed pause for monetary policy in the emerging markets, allowing local central banks to pursue a looser rather than a tighter policy, as is already done by major players such as China, India, Argentina and Turkey. Subdued inflation and stable oil prices make such policies reasonable. The end of a strengthening US dollar make them feasible.

Finally, once more there is an important timing dimension here. Over the last two US "pre-recession yield curve inversion" periods, emerging market bonds have either trended downwards or moved sideward. Only once the recession really kicked in, the emerging market bond yields shoot up. Thus, even if we are wrong in our assessment that the current yield curve inversion is not yet indicative of an imminent US recession, there should still be some tactical upside to the owning of EM bonds.





Source: Bloomberg, ADCB

A sustainable rebound in EM bonds looks unlikely, and we continue to insist on selectivity

While the case for emerging market debt rebound may be looking favourable, downside risks cannot be ruled out completely. There are emerging economies that have been facing increased fiscal uncertainty as well as the most recent risk dominant has been the deterioration in the credit outlook of some of the economies. These credit concerns are coming from the elevated debt levels in state-owned enterprises, whose debt is mostly sovereign in nature and hence pose risks for the fiscal accounts of the country. As we have already seen in Mexico, the negative credit outlook of its state-owned enterprises is having implications on the country's overall sovereign rating. Credit rating agencies have warned about the rising debt levels in emerging markets. The S&P rating agency, in particular, has cautioned that a third of big bond issuers in emerging markets have serious debt sustainability issues. We refer here to our own latest Emerging Bond Credit Ranking Strategy Note, where we take a deeper dive in the need for selectivity. For now we stress that the countries with the most solid fiscal fundamentals are Brazil, Russia, most of the GCC countries, Indonesia (reduced external risks) and – as fare as local bonds are concerned – India.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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