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The Glass Is All Full:
Key Takeaways from 2021 Spring IMF Meetings

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The glass is all full—we come away more constructive on EM debt (especially local), following a conference that was lagging (not lacking) positive growth news and overreacting to the interest rate selloff.

Growth forecasts are being upgraded, interest rates are rising gently, financial conditions are accommodative and monetary and fiscal policy remain supportive. But somehow, the glass is all empty and this setup is very bad for EM. That was the gist of the meetings. Participants were bearish on all things EM—equities and debt. Participants were bullish on all things U.S., especially equities. And what is the big concern driving their worries? Rising yields. That's it … the big risk is something that is already well in-train, and may even be pausing. This strikes us as a very bullish setup for EM debt. Below are the details.

Global growth galore—forecasts were upgraded, more are likely and it could be durable.

- **The IMF (Fund) upgraded its 2021 global growth forecast to 6%, up from 5.2%.** The Fund also revised its 2020 GDP upward to -3.3% (1.1% higher than its previous forecast only six months ago!). The Fund is calling this "asynchronous", but to us it looks staggered. China recovered in 2020, the U.S. is recovering in 2021 and Europe and the rest of the world (ROW) should recover in subsequent years as vaccine roll outs proceed. U.S. growth looks set to be durable, giving plenty of time for laggards. China returned to pre-Covid production levels last year, the U.S. will break above pre-Covid GDP this year, with the rest of the world following, though at a slower pace and with "vaccine versus virus" as a big driver.
- **We see the global growth baton being passed from China to the U.S. that could last well beyond 2021.** We think it is important to view global growth as staggered, because there was much lamentation at our meetings over "asynchronous" growth. Instead of viewing U.S. and global growth upgrades as generally positive, and following up with a country-by-country approach to see who is growing most (in additional to other variables), there was focus (excessive, in our view) on the potential for higher relative U.S. growth. It was somehow bad that U.S. growth was surging more than most other countries'. Our view is that U.S. growth is broadly supportive of fundamentals and, if there are divergences, sort them out on a country-by-country basis, and do not resort to "U.S. good/ROW bad" frameworks. Anyway, we see a world where the growth baton is being handed to the U.S. in 2021 and which will be handed to current Covid recovery laggards in 2022. That's a good story, not a bad one, in our view.

The U.S. economy has the growth baton, is running ahead of most forecasts, and may persist.

- **The U.S. combination of excess savings, pent up demand and a vaccine amount to a potential economic boom.** The big difference between now and the global financial crisis (GFC) is that consumer and corporate balance sheets are in, what we see as, great shape currently. The virus itself and the policy reaction (i.e., lockdowns or not) remain the main risks to growth. But they are fading with vaccine rollouts, as well as less willingness to employ lockdowns. And, growth was ultimately viewed as the only solution to rising debt, while any inflation was viewed as being ignorable by the Fed for the time being.

- **We think market participants underappreciate the magnitude and durability of the coming U.S. economic boom, particularly the singular focus of the Biden administration on growth at any cost.** Everyone sang the same song of U.S. growth leadership in 2021, but it was not as fortissimo as deserved. Deficits, or the virus, or higher interest rates, or the Fed, or the absence of an infrastructure bill were all presented as risks to continued growth momentum. We note in another section the Biden administration's singular focus on growth, which we also think is not fully appreciated by markets. The Fed hiking interest rates early was a commonly-presented risk, but we see no evidence for that. Inflation was the more serious risk mentioned, and that topic is important enough to merit its own section.

Inflation and the Fed are the topic du jour—everyone expects inflation, the Fed's reaction to it was the main question.

- **The true path of inflation will be impossible to establish contemporaneously, so it is going come down to the anecdotes we tell ourselves versus what is already priced in.** Measured U.S. inflation is rising and this rise will be especially sharp in the coming months due to base effects. Other than that, we do not know much. It is hard to measure the output gap or productivity even historically, let alone in real time. So, whatever the true story will be on inflation, media anecdotes will be a big part of that story. It will be one of labor market tightness, supply constraints, combined with a surge in demand. The key balancing factors are that a lot of this is already priced into markets and the Fed has repeatedly communicated that it will see through any near-term inflation.
- **On the "inflation is transitory" side of the docket are the following: Technology.** It is obvious and well-reported, but the Covid crisis could be seen as having accelerated long-term trends and pushed up productivity in the service sector significantly. It will be virtually impossible to measure contemporaneously, but a lot of it must seem self-evident to many readers. Similarly, the inflation story so far is one of surging demand and lagging supply in the context of high savings, stimulus and reopening/vaccines. That hardly sounds like a repeated phenomenon, which is what the Fed will focus on. Also, one could make a case that output gaps in ROW are high and not closing as fast as the U.S.', so some countries may be exporting disinflation, but that is not clear.
- **On the "inflation is finally here" side of the docket are the unprecedented policy support for growth, combined with the "growth at any cost" agenda of the new Biden administration.** The fiscal stimulus in the U.S. is estimated to be worth around 30% of GDP over two years, which is unprecedented. High savings rates and the reality, or expectation, of further income support may slow the reentry of workers into the workforce. This may be the case especially for older workers, who had kept a ceiling on labor costs prior to the Covid crisis. Scarring is another factor, though we are skeptical of its meaning in service jobs with limited skill requirements. Commodity prices get thrown into the argument, but for central bankers that is almost always going to be viewed as transitory.
- **What does this mean for the Fed? Not much and the market is right to not see hikes anytime soon.** We think the Fed has been clear and consistent in saying it will see through any near-term inflation, targeting an average inflation rate. This requires it to stay on hold for a prolonged period of time to close the inflation gap. The market has not been pressuring the Fed to do anything, as rates inside two and even five years have been subdued compared to longer-term rates.
- **The real problem will come if the U.S. output gap has closed, delivered and anecdotal inflation rise and we begin to see internal disagreement at the Fed; don't hold your breath.** Rising inflation expectations could be a driver here, too. But, overall, we find it very hard to think that the Fed is going to tighten prematurely. All its communication has been to the opposite effect. The coordination between a U.S. Treasury run by the former boss (Janet Yellen) of the current crew at the U.S. central bank (led by Jay Powell) also cannot be under-stated. We also see no evidence of deficit hawks anywhere—in politics, academics and markets. Perhaps the best question to consider about inflation is—Is the inflation we're going to see sustainable? That's a trickier question to answer, but it's the one the Fed will try to focus on, and pushes it in the "lower for longer" direction, in our view, regardless of inflation outcomes. Growth is the answer for the foreseeable future.

China the grown-up, with U.S. strategic rivalry on the back-burner.

- **China loomed over meetings as a benevolent force.** Most importantly, economic policy was viewed as modulated—tight to address imbalances whenever possible, supportive (targeted or blanket) when necessary. That was the key background context to narrower discussions of this year's economics. Anyway, China is tightening monetary policy in 2021 and there's a lower fiscal impulse as well, the last perhaps for several years. Because of this, China will be less of a global contributor to GDP. This is in contrast to a U.S. where monetary authorities are promising a long period of forbearance and where there seem to be no limits to fiscal policy. (How this ends up after another 10 years is more for historians, but it is consistent with the Chinese yuan's rise as a global reserve currency).
- **China/U.S. strategic competition is on the back-burner.** Just six months ago, U.S./China tensions were the market's top concern. Now, though, the Biden administration's China approach seems to be characterized by less noise and drama, which the market has welcomed. The market has also been calmed by a sense that U.S. policy will be coordinated within the administration, better communicated and more multi-lateral. Markets like predictability. The Biden administration is also more focused on domestic issues. China, too, is more focused on domestic issues and not seeking confrontation, in our sense. We have a 100-year Chinese Communist Party anniversary and an Olympics coming up, which are obviously focusing moments for Chinese policymakers.
- **Strategic competition is here to stay, though and only the tone has changed—more and more policy on both sides is being driven by strategic competition.** There are, after all, 481 anti-China bills in the U.S. Congress and new policy spheres are being reframed as meeting China's challenge. It's not just traditional defense spending and the issues around technology transfer and ownership. For example, the upcoming digital yuan is generating new openness to innovation in Washington over crypto, due to it being viewed as a challenge from China. Likewise in China, the economic imperative of increased domestic consumption and lower investment has become more acute. It was always there, but it is now seen as central to economic independence.

Europe still a morass, with Italy a potential hope.

- **"Europe" came off as the next zombie, potentially anchoring U.S. yields.** We say this in almost every IMF meeting summary and, to be fair to us, the consistent low productivity, sluggish growth and a lagging Covid response, despite significant monetary and fiscal support bolster our case. In the conferences, there was actually little attention paid to Europe, other than concerns over scarring due to their relatively weaker vaccination levels and lower stimulus (relative to the U.S.). Europe also has greater willingness to displace markets in response to challenges. As a result, Europe is a top choice of market participants as the next "zombie" economy.
- **Italy under the leadership of Prime Minister Mario Draghi is a potential bright spot, which could be euro positive.** Draghi is implementing structural reforms and has implicit cooperation from the European Commission. Moreover, as vaccinations pick up, it could be that the worst is behind us on that front.
- **Implicitly, there were only two serious global growth drivers being considered—the U.S. and China.** We note this because the euro is often posited as an "anti-USD", as a good way to express a negative view on the USD because Europe has none of the U.S.' problems. It sounds silly and incorrect when we put it that way, but we think that's the essence of the trade idea. This is very bullish for bonds and anchors U.S. yields, arguably.

Market participants are too bearish, seeing mostly negatives from the recent rate rise, even while acknowledging that EM is becoming the #1 answer to the question "Where do I go for yield in this low-yield environment?"

- **Market participants were bearish after being burned lightly in the first quarter of 2021 (which we think improves the setup for EM debt, especially local).** Despite market participants seeing EM as a growing answer to the global portfolio calculus, our strongest

observation is that we saw participants creating a bearish narrative to fit year-to-date (YTD) price action. In particular, the fact that EM debt is down YTD (local and hard currency indices are down around 4.5%) is being narrated into an "EM is vulnerable" story. This may be reasonable for particular countries—we see serious risks ahead for some big EM constituents, including Brazil, Russia and Turkey. But, a country-by-country stance makes more sense than what we saw as an "EM loses to developed markets (DM)" narrative.

- **Global growth was great news in many of the country-specific meetings, but bad news in many of the asset class meetings.** In virtually every country-specific meeting, the surging U.S. and global growth context was viewed as a positive for credit quality. But in the top-down "strategic" discussions about EM debt, somehow all this good growth couldn't be turned into a positive verdict on the EM debt asset class. The market is beginning to change its view, we think. The most remarkable feature of the U.S. Treasury selloff so far, in our opinion, is that credit spreads are virtually unchanged … and yet the narrative remains one of EM vulnerability.
- **Participants still saw a greater role for EM debt in mainstream portfolios in the longer run.** Insurance companies, in particular, are seen as likely to adjust their bond holdings in favor of emerging markets, particularly hard currency EM debt. This is due to the strong performance of EM debt over the past three decades, combined with the absence of yield in Treasuries and U.S. investment-grade debt. EM debt is quietly becoming the main answer to "Where do I go for yield in this new low-yield environment?" Much was made of comments to the effect that there are only two "normal" bond markets (i.e., not simply low-yielding Treasury proxies) in the world—U.S. corporates and EM.
- **There was some concern over market bubbles that policy may be creating, but not in EM and not in the major markets.** The search for asset bubbles was seen more as appropriate in "green", "tech" and "crypto" than in bond and equity market valuations. In fact, there has been limited late-cycle behavior, such as large increases in risk or leverage that typically characterize over-done markets. There was some concern over the ability of markets to absorb upcoming Treasury supply, which in 2021 grows to a net $3tn from a recent annual issuance program of about $0.5tn.

A number of risks to EM were highlighted, mostly related to debt and susceptibility to higher financing costs—fear of higher rates is pronounced.

- **We'd say the key specific risks that surround higher debt levels globally are: rising corporate debt in China, EM banks' more limited capacity to absorb further government borrowing and vulnerability to higher global interest rates/financing pressures.** As we noted before, our sense is that this is being turned into too much of an "EM bad" story and not enough into a discussion of winners and losers (which we engage at the end when we discuss specific EM countries). Rising debt levels are an obvious risk in a rising interest rate environment and Covid-related debt issuance followed a previous large increase in debt around the GFC.
- **China's corporate debt, and the uncertain level of government support for the various issuers, remains a concern.** But, we were struck overall by the implicit credibility China now enjoys. China is often a major market concern, but those fears have subsided on what seems to be a secular basis. Normally, there would have been more panels focused on Chinese worries, but the authorities' quality economic management continues to see China "graduate" at every IMF meeting.

Policy worked—it is now permanent, expanding and globalizing, creating new sources of stability for EM.

- **Policymakers patted themselves on the back (deservedly, to us) for the rapid and immense monetary and fiscal policy reactions that resulted in a global recession far less scarring than the GFC's.** So far, the likely medium-term growth losses from the Covid crisis look far smaller—the IMF estimates the current crisis' loss is about one third that of the GFC. We know the laundry list of policy tools utilized, which included direct purchases of corporate bonds by the Fed, and foreign exchange (FX) swap lines between the Fed and other central banks. The former touched EM bonds indirectly, by anchoring U.S. corporate credit spreads and the latter also touched EM bonds indirectly, by providing dollar liquidity to EM central banks.

- **But, as we also know, these tools are now practically permanent and have spread to a wider range of countries.** Poland, Israel and even Indonesia have implemented versions of quantitative easing policies employed in the developed markets. There was acceptance that such policies in the DM were practically permanent and in the EM would be moderated by their weaker initial conditions. There was also appreciation that countries with fiscal space—many of which are in EM—were better positioned.
- **There was much discussion about how to expand these tools and "architectures" for future crises.** The most advanced concept is the "common framework". This is basically a process to incorporate China into debt workouts, when they happen. China is EM's largest bilateral creditor, so agreeing on parameters is important to preventing destabilizing or unsustainable workouts. Put simply, it's an attempt to keep China from ending up at the front of the queue in every debt rescheduling.

Regulatory policy.

- **All things digital, but especially cryptocurrencies, are now viewed as necessary innovations in the strategic competition with China, not threats to government power.** One interesting observation was that although non-bank finance accounts for half of the financial system, it is market-based. The risk is that the leverage might be clouded. Non-banks expanded dramatically, up 26%, during the Covid crisis, compared to the GFC. Fintech is also organizing and lobbying, increasing the odds of more favorable ears.

The Biden administration's growth focus.

- **It was pretty clear that the Biden administration has one policy, one political strategy and one goal—growth.** We continue to believe that this fact is very underappreciated by market participants. U.S. fiscal stimulus is not ending with the stimulus bill, as a $2tn infrastructure program now works its way through the U.S. Congress. Particularly to the Obama alumni, the inability of that administration to push through a major infrastructure bill lost the 2010 mid-terms and stymied the subsequent six years. This focus on supercharging the economy is existential to the Biden administration, to our sense.
- **The absence of deficit hawks is our most pronounced observation of the U.S. fiscal discussion.** It is unclear who in the Democratic party is truly insisting on financing the spending. Joe Manchin is the supposed deficit hawk and his contribution to the discussion has been to cap any corporate tax hike. The optics of taxes as retribution might be attractive to some Democrats and that's our point—not if it means the spending plans fail.
- **Anyway, for those focused on the soap opera, here's some of it, but we think passage of some bill is likely by year-end.** One debate will be over what qualifies as infrastructure. Many Progressives think in terms of "care infrastructure", as in child care and job training programs, for example. Politically, "infrastructure" is very popular, but much less so if broadened beyond bridges, roads, water, electrification, etc. So that will be one debate.
- **And then there will be the debate on financing, which will be hard to take seriously.** This will be much noisier and contentious, we reckon, but still not amount to much, in our view. Anyway, there's virtually no chance that the U.S. corporate tax rate will rise to 28% as currently proposed. Even Joe Manchin has capped it at 25%. Maybe it ends up between 22% and 24% (which, when including state rates, are in line with OECD averages). Our main point is that we view this debate over financing as more theater than substance in an era of co-opted central banks.

Key EMs are exiting of the Covid era at varying speeds, but overall they are pursuing good policies, will grow with a lag to the global trend and are seeing virtually no strains on external accounts; Turkey and Brazil are important exceptions.

- **Chile is recovering.** Overall, Chile is embarking on a rebound from its Covid era. Two thirds of firms that closed in 2020 have reopened. The vaccine roll-out is speedy, with roughly 80% of the population expected to be vaccinated by mid-year. Add in a global recovery, easy domestic financial conditions and the outlook looks positive enough. Exports are growing at double digits and remember that Chile is also geared to Chinese demand, which was the story of 2020.

Pensions and transfers did ultimately drive growth, though, which underlines the need for continued monetary support. Which Chile has—it is saying it will remain accommodative until early 2022 at the earliest. Chile's use of China's less effective vaccine (compared to, for example, Israel's use of Pfizer's) is a downside growth risk.

- **Colombia has a good starting point.** Colombia's countercyclical policies helped to ease Covid's pain and low inflation can allow the central bank to keep its accommodative stance for longer. The central bank also managed to boost its international reserves, while Colombia's access to the IMF's Flexible Credit Line provided a much-needed safety net. However, the country's fiscal issues refuse to go away and political developments will keep the market at the edge of its seat for the next year. The outlook for the tax reform—a necessary precondition for medium-term fiscal adjustment—is uncertain at best. The current not-so-ambitious proposal is likely to be watered down due to the proximity of the presidential elections. Colombia's generational change can improve the chances of left-wing politicians and can mean a totally different game for the country and investors.
- **Ecuador gets a serious fresh start.** Guillermo Lasso's victory against Andrés Arauz for the presidency of Ecuador comes as a surprise to everyone and is an extremely positive development that could mark the end of Correismo (a market-unfriendly movement named after a former president currently in exile). The IMF stands ready to support the country with a new program and the U.S. Treasury will lend a strong hand of assistance as well. With oil prices above $60 per barrel (the price assumed in the budget is $48), along with a non-oil trade surplus, Ecuador has not had such a strong macro position in years. There is room for meaningful spread compression in the front end of the curve, in our opinion.
- **Peru's economy is strong, too bad about the politics.** Peru is running the largest trade surplus in its history: $14.5bn in 2021, with $15.7bn forecast for 2022. In addition to the positive terms of trade coming from commodities, the economy is getting a boost from extra loose monetary policy, with the policy rate just at the lower bound. This is in addition to a large fiscal stimulus in 2020. However, all this may not be enough to avoid an extreme outcome in the upcoming presidential election, with the far left candidate Pedro Castillo making it to the second round. If he were to win, he would inherit nearly $80bn of central bank reserves and the lowest debt levels in the region, giving him ample room to help the nation's poor, but potentially at the expense of foreign investors. Given Peru has recently discarded presidents like plastic bags, the market is not taking this potential outcome seriously, yet.
- **Argentina set to achieve its goal of muddling through.** Argentina's goal of muddling through without any major policy adjustment before the midterm elections this October appears feasible. The IMF's new SDR allocation of $4bn plus roughly covers the country's external financing needs. The lack of a clear long-term economic strategy from the Peronist governing coalition, combined with its plummeting popularity, could be enough to bring about political change in upcoming polls.
- **Brazilian policymakers are behind the ball.** There appears to be recognition at the central bank that taking the policy rate to just 2% went too far and that it didn't achieve the macro environment it targeted. While the economy keeps suffering from Covid, the central bank is tightening policy because it is looking through to future acceleration of the vaccination rate and economic reopening in the second half of 2021. For this reason, and because it views the recent pickup in inflation as temporary, it is guiding the market to a partial normalization of policy rates. However, given the horrendous fiscal dynamics and debt levels careening toward unsustainability, most investors view this policy stance quite skeptically. Brazil is, once again, on the edge of "fiscal dominance", in which monetary policy loses its efficacy. The country's strong external accounts are worth noting, however.
- **Indonesia skates smoothly, but close to thin ice.** Indonesia continues to enjoy very low inflation rates with 2020 inflation of just 1.4%, even as the government executes a massive fiscal stimulus that has been largely financed by the central bank. The central bank appears able to execute the same "costless"

quantitative easing (QE) as in developed markets, with 5.1% of GDP in government debt already on its balance sheet from purchases in the secondary market. This is in addition to the 3% of explicit financing support for the government via primary bond auctions that will continue through 2022. However, EM investors remain skeptical and purchases by offshore investors are running behind the central bank's forecast year to date. The big test will likely come if and when the U.S. dollar resumes an upward trend and all the rupiah printed of late decide to head for the exits—which, given the extraordinary fiscal spending in the U.S., does not seem like something to worry about any time soon.

- **Russia on the lookout for inflation.** The central bank sees meaningful non-food inflation pressures and a very tight labor market as key risks to meeting its inflation target. As a result, it is pursuing a moderately tight policy stance similar to the one taken in 2018. Regarding the impact of sanctions, the central bank made it clear that it would only address the shock via macro prudential measures unless the sanctions led to a change in Russia's r* (neutral rate of interest). The central bank also did not see any change in Russia's potential growth rate as a result of Covid.
- **Czech has rich country problems.** The Czech Republic is an "EM Graduate" and many of its problems and challenges are akin to those of developed markets. The economy is quite industrially oriented, which helped to mitigate Covid's impact on services and trade. The Czech Republic's strong economic links with Germany, and Germany's links to China, are another positive twist. The main issue right now is when the central bank will be in a position to start normalizing its policy rate. The discussions seem to suggest that the "true" policy rate path might be below the one implied by the central bank's model and that the Czech National Bank can start hiking in the second quarter of 2021 at the pace of 25 bps per quarter.
- **Turkey may grow, but at great risk.** Turkey might end up being among the fastest-growing economies in 2021, but the structure of growth—especially the return of cheap government-sponsored credit and its impact on external balances—is a big concern. The Turkey discussions took place after a major shake-up at the central bank and it looks like the new governor's ability to cut rates immediately might be limited—in part due to high and rising inflation. Turkey's "market vigilantes" are never too far away and they remain laser-focused on the state of the central bank's international reserves. The discussions confirmed that Turkey does have some buffers here, but not too much. Another major (albeit not surprising) takeaway is that the central bank's operational independence is over, which tells us that it will be a bumpy ride for local markets in the coming months.
- **Egypt's policymakers keep impressing, boosting revenues despite Covid-related pressure on tourism.** Egypt's exposure to tourism was the country's Achilles Heel during the pandemic, but the government was nevertheless able to boost revenue collection in the past months and re-allocate spending—a laudable achievement under the circumstances. What's at stake going forward is sticking to the primary balance target by using administrative resources, digitalization and bringing in the informal sector in order to rapidly reduce Egypt's debt/GDP ratio and create fiscal space for future development. The fact that most of Egypt's debt is very short term underscores the urgency of the problem.
- **Nigeria came off less badly than usual.** Nigeria's pandemic-related contraction was smaller than expected, the debt level still compares favorably to regional peers and the 2021 funding costs appear to be manageable. However, the medium-term growth path is well below the pre-pandemic level and there are sustainability risks due to fiscal vulnerabilities. Nigeria had managed to transition to a lower oil price regime, but non-oil revenues are low due to a lack of compliance and very low tax rates. Nigeria's piecemeal approach to the exchange rate liberalization is another major concern, as it reinforces the existing macroeconomic imbalances.
- **Angola continues to impress.** Angola is under the IMF program, it is getting an oil revenue windfall and its legislative agenda is impressive. However, the country's discussions were firmly focused on debt sustainability. The participation in the G20 debt agreement temporarily eased Angola's debt burden and improved its cash flow, but there are multiple uncertainties as to what happens when the debt moratorium expires at the end of 2021, especially if oil prices turn south.

Source: IMF.

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