VanEck Research

Emerging Markets Awake at the Wheel

Eric Fine

Portfolio Manager, and the Active Emerging Market Debt Team

IMF Spring 2022 Meetings Takeaways

> **Coming out of the Spring 2022 IMF meetings, we are looking to increase low-beta spread duration and decrease some EMFX exposure.**

Summary

The bad news of higher rates has been digested, but the bad news of weaker growth has not. Recession risks are rising, with a European recession, oil embargo risks, and China's 0-Covid uncertainties adding to Fed rate hikes as headwinds. And, the Fed is unlikely to change its policy path soon. The fast increase in policy rates is with us all year (the pricing of the policy rate and the rhetoric behind the policy), we think. But, who doesn't know that the Fed is activated? That's why we think we are getting closer to stability in long-end U.S. treasuries. Policy rates should remain priced for a hawkish Fed, and any death-rattles for the long bond should be bought (we'd say 3%-3.5%). However, what the market hasn't fully digested, we think, are the risks to growth. Recession risks are mounting and un-anticipated by the market, we think. This means a complicated market. To simplify them, we come away from meetings looking to increase low-beta spread duration and decrease some EMFX.

- **Risks to growth gather, including a European recession, oil embargos, and China's many layers of risks.**
- **US policy rates may be as hawkish as they'll be this year, investors are too bearish on long-duration bonds.**
- **Emerging markets are not being adversely affected by the same factors that are hitting global markets. Many emerging markets already have high real and nominal interest rates, and many emerging markets benefit from high commodity prices.**

Europe risks entering recession. At the start of meetings, the IMF downgraded its 2022 German GDP forecast by 1%, more than the 0.8% downgrade for global growth (IMF World Economic Outlook, April 2022). Risks to European growth were a key discussion point at meetings. The IMF sees Germany as facing a huge terms-of-trade shock with additional inflationary risks/systemic constraints, we'd note, presented by the Green agenda. These are weighing on confidence. Inflation pressures are serious and potentially persistent, with commodity prices the key driver. It was unsaid, but to us this presents a scenario in which the ECB is unable to tighten policy (sufficiently) due to growth concerns, leaving inflation not fully addressed. An important macro positive is a more flexible fiscal stance, which could improve growth prospects at some point, though not inflation. Still, an even weaker Euro would be our specific asset-price conclusion. Entrenched inflation expectations will be something to watch in the years ahead. And we haven't yet mentioned embargo risk.

Embargo risk is real and markets are unprepared. How long will European energy consumers fund Russia's war on Ukraine? All western discussion on the Russia/Ukraine situation is framed in humanitarian terms. And yet here we are, with Russian exports actually up sharply this year versus last and the ruble fully recovered from its sanctions-triggered collapse. We come away from IMF meetings thinking that risks from the overall Russia/Ukraine situation are still very much escalating (NATO weapons supplies, more sanctions, for example), even if the conflict inside Ukraine could be frozen with Russia simply consolidating territorial gains. And, market participants almost unanimously thought (or wished) no embargo is coming and

seem unprepared. We think an embargo is only a matter of time, and could come from the Russian side as well (technically by requiring ruble payment for gas and oil). Two specific interesting pieces of information are an idea to embargo oil via sanctions on tanker insurance. This would affect around 80% of Russian oil exports, wouldn't require importing nations to agree, and most insurance is provided by UK companies (with a UK government that we reckon is on board with the idea). The other interesting data point is the change in polling in Germany, with now roughly 80% of the population supporting an oil embargo according to one presenter. All of German economic and military policy of the past several decades is now being called into question. The newly-elected government has been quickly executing a 180-degree turn towards rebuilding its military and ending Russian energy imports but its implications are un-appreciated by markets.

China's risks are multi-layered and hard for markets to discount. To start, Chinese officials maintain a very low profile at meetings, so all information is indirect. Economically, concerns surround its 0-Covid policy and its potential spread to Beijing and wherever omicron takes them. This is creating downside risks to growth. The IMF only downgraded its 2022 growth forecast for China by 0.4%, less than the global growth downgrade. But, we'd note that Asian oil importers Japan and India saw their growth forecasts downgraded by 0.9% and 0.8% respectively. Our concern is that CNY (Chinese Renminbi spot rate) could come under pressure for growth reasons, given the jobs-intensity of the export sector in a political year. Inflation is low, so pass-through of currency weakness into inflation shouldn't be a constraint. And, real interest rates are not that high by global standards, so even lower interest rates aren't an obvious policy move to us, making currency weakness all the more attractive as policy tool. Also discussed were political risks to Xi from 0-Covid. And, the risk of capital flight is always under-rated, in our view. The proximate way this is getting thought about is either direct **sanctions on China** (for human rights or other pretexts) or "secondary" sanctions for helping Russia evade sanctions. Our view is that tensions are still rising sharply with China and that sanctions talk always end with sanctions, and sanctions never end. It is just a matter of time, in our opinion, and maddening for markets to absorb. Anyway, this came up in discussions. One specific data point is that a significant majority of financial institutions are re-thinking their China businesses as a result of China's divorce from the U.S., which is being accelerated following sanctions on Russia. This is hard-to-price stuff. And the market is doing what you'd expect – not pricing it at all (equities aside), in our opinion. Much better to do nothing and fail conventionally than succeed unconventionally seems to be the modus operandi for most.

US rate expectations might be pausing; the market for policy rates may be priced as hawkish as it will be this year. Who doesn't know the Fed is hiking? Fed fund futures price 250bp in hikes for the rest of 2022. A U.S. 10-year around 3% or higher was a popular view. We're almost there already! The only interesting or under-appreciated elements of the discussion surrounded Quantitative Tightening (QT). We saw market participants still grappling with the (in our view very bearish/hawkish) implications of the Fed's now-faster QT program. This directly affects mortgage rates (they would be selling Mortgage-Backed Securities) and the long-end of the rates curve. In our view, this is how the market will cap rates and where the first signs of stability will appear. Maybe there's upside to rates out to 5 years, but beyond that we see a curve that is trying to stabilize. Put in terms of a narrative, can we really face much higher rates given these new risks to growth? Especially when the USD has done so much work in tightening financial conditions already, and the U.S. fiscal impulse is getting more negative? The Fed will hike (until it can't), but that hiking is largely "priced" into long ends. Food for thought. That's very consistent with our view that the USD should be strong against the majors like EUR and JPY (the U.S. has higher nominal and real growth rates and interest rates, need one say more?). It's also consistent with our view that the USD should be weak against selected EM currencies that have hiked interest rates too much already and/or benefit from high commodity prices.

Emerging market central bankers were wide awake at the wheel! Although it was not an explicit takeaway, how could it not be? The broad theme of the meetings is that participants were already bearish on inflation and higher rates, and haven't yet digested weaker growth. Well, EMs have many central banks that hiked policy rates significantly and well before the price shock coming from the Ukraine invasion. And, many EMs will be positively affected by the multiple underpinnings for commodity prices. In fact, some were predicting a new commodities super cycle. We were glad to see participants note that there's been no increase in energy sector capex commensurate with prices, something we've been harping on. Oh, and it's not going to change. And it's good because of the "Green agenda" . That's almost the way the discussions go. But, now that it's biting and guiding asset prices, there's a bit more hard-headedness. An example would be that participants were attracted to Brazil, which is arguably almost done with its hiking cycle and has enjoyed a significant currency rally this year despite the hit to global asset prices. In fact, one of the key "uncertainties" in Brazil is how much this currency strength has already done the job of rate hikes. Anyway, Brazil is a good example of the EMs with high real rates, benefit from high commodity prices, and have strong external accounts. South Africa would be another.

There's a global food and energy crisis with no collective response ready; this has big implications for social unrest, especially in EM, so be selective. The typical consumption basket in major EMs is about 35% food and energy, or closer to 50% for lower-income countries. Countries with independent central banks and strong external accounts (that can stabilize inflation expectations), and thankfully this describes most EM countries, are likely to keep it under control. But, even Peru, Chile, and to some extent Colombia have experienced social unrest related to inflation, although corruption and loss of trust in the system seem to be the deeper drivers there. Anyway, in a range of countries, economic, political, and social systems will be tested. To us, this means selectivity and nimbleness in investing. These risks will play out country-by-country, and you just have to look at each one on its own, and be prepared to do something about your conclusions with less reference to tracking error than usual.

Commodity prices are rising, supply will only get more constrained and duplicative, and we don't believe anything will be done. U.S. Treasury showed no indication of taking a supportive stance toward conventional U.S. energy production. What struck us was how much of the reduction in capex is organic, reflecting the ESG movement and shareholders that are more sensitive to energy production, at least at the micro-level. What this means, to us, is that commodity prices should go much, much higher. The supply needle will not move positively (and in fact the point of an embargo would be to drown Russia in its oil) in most scenarios that we can see, as a result. It will take more before there is significant investment in production from the majors, we think. This is a potential boon for a number of emerging market economies, of course. The other points raised at the meetings were the issues we all know by now – namely that everything is increasingly viewed through a national security lens. This means embargos. This means new supply chains. This means duplicated supply lines. This means duplicated storage. All very bullish for commodity prices, in our view.

There was very strong support for Ukraine; it will not default this year, we think. We see very close cooperation between Ukraine and the U.S., with close monitoring of Ukraine's budget and external financing needs in particular. What this means to us, in our opinion, is that Ukraine will only default when it wants to default. If it wants to keeping paying, the money and support are there. More practically, we don't see Ukraine choosing to miss its 2022 (September specifically) external bond payments, making those bonds very attractive. Longer-term, though, the rebuilding costs following the invasion are high and we don't see how there can't be an eventual bond restructuring...just not this year, we think.

Emerging markets are so diverse that they stand out as an opportunity in a world focused solely on how horrible higher interest rates and higher commodity prices are. They are not horrible for emerging market bonds whose central banks have already hiked interest rates and which benefit from higher commodity prices. The implications of the meetings for specific emerging markets are as varied as the drivers. To review, we see U.S. long-end rates at risk of stabilizing. This means higher duration for low-beta EM bonds makes sense. We see commodity prices and high real interest rates as supporting some EM local-currency bonds. We come away less constructive on currencies in Asia, due to pressure from a weak China. We come away less constructive on currencies in Europe, due to recession and embargo risks in Europe. Within local currency, this leaves us largely with Latin America, and luckily we largely see high real interest rates and high commodity price support there. There are still a bunch of cheap, re-pricing reformers among smaller countries. Please see our monthlies and Current Views publications for a more detailed description of what we own and why.

Crypto normalized. IMF officials are much more precise in their analysis of digital currencies, in our view. In particular, there appears to be advancement in conceptualizing digital currencies in terms of M0 (think of it as cash) and M1 (think of it as a deposit). Maybe this means the eventual model is a banking one. We for sure don't know, and luckily VanEck has the crypto experience to navigate it. Our only point is that the IMF continues to view crypto through the lens of banking. As a result, there was great openness to stablecoins as permitting deposits. This would necessitate, so the logic continues, an M0 instrument like a central bank digital currency (CBDC). We'd also note that the longer authorities take to figure their attitude out, the more oxygen there is for the system to come alive. World events and the global collapse in trust in public systems is also supportive. The Fund seems also to see risks from a financial stability standpoint. Namely, the risk of deposit flight out of the financial system and into crypto. That doesn't seem unreasonable to us.

A final shameless plug – everyone thought sanctions that disappeared Russia's USD, EUR, and JPY reserves were important and nobody knew how to think about them...we might! We wrote about what we think it means in: How One Bond Manager Values Gold and Bitcoin. It's a big deal. Anyway, our point is that one should not be a deer in the headlights when history accelerates. Think it through and be as precise as possible. That was the spirit of the analysis – that the weakening of USD, EUR, and JPY's status as reserve currencies has specific and analyzable implications. The conclusions are supportive of gold as well as selected EMFX that is supported by commodities, in our view.

IMPORTANT DISCLOSURES

Source: IMF.

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Definitions:

Duration measures a bond's sensitivity to interest rate changes that reflects the change in a bond's price given a change in yield. This duration measure is appropriate for bonds with embedded options.

Quantitative Easing by a central bank increases the money supply engaging in open market operations in an effort to promote increased lending and liquidity.

Monetary Easing is an economic tool employed by a central bank to reduce interest rates and increase money supply in an effort to stimulate economic activity.

Correlation is a statistical measure of how two variables move in relation to one other.

Liquidity Illusion refers to the effect that an independent variable might have in the liquidity of a security as such variable fluctuates overtime.

A Holdouts Issue in the fixed income asset class occurs when a bond issuing country or entity is in default or at the brink of default, and launches an exchange offer in an attempt to restructure its debt held by existing bond holding investors.

Carry is the benefit or cost for owning an asset.

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Investments in commodities can be very volatile and direct investment in these markets can be very risky, especially for inexperienced investors.

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- An investment in cryptocurrency is not suitable or desirable for all investors.
- Cryptocurrency has limited operating history or performance.
- Fees and expenses associated with a cryptocurrency investment may be substantial.

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