## 2023-08-09 - EM and Multi Sector Positioning Podcast - V3.mp3

**Katie Klingensmith** [00:00:01] Welcome, everybody, to Brandywine Global's podcast series, Around the Curve. I'm Katie Klingensmith with Brandywine Global, and I'm delighted to be joined today by Mike Arno, who is a portfolio manager and part of the Global Fixed Income team and is specifically focused on emerging markets with a deep background, especially in Latin America. There's been a lot of conversations as of late about emerging markets, so it's great that Mike can join us. Just get us started, Mike. There's been a lot of volatility this year, a lot of movements in emerging markets. What have been the big drivers? What's going on?

**Michael Arno** [00:00:36] Hey, Katie, thanks for having me. Listen, it's local emerging markets. We deal with volatility every year. Whether that's up or down. This year has been a good run so far for emerging markets, especially in local markets. Indices through the end of July are up anywhere around 10%. And when you really peel that back and start to look at some of the some of the countries had some really solid performance, got Colombia up 40%, Mexico, Brazil up 20%, Hungary up 20%. You know, even Peru, which threw out another president earlier this year, is up 15 or so percent. So, we've seen some really strong returns in the emerging market space, but some differentiation. This rally really started back in October. We saw the decline in Treasury volatility that really sparked a rally in risk assets, whether it's equities, high yield, and local markets. So, you know we've really been enjoying this rally since probably late October after a pretty sizable drawdown up until then from in 2022, across most markets. Last fall was a really good setup. You know, you had very attractive high nominal yields. We wrote about that briefly in the summer blog piece. Very elevated inflation rates, driven by a combination of COVID-era stimulus, fiscal stimulus, similar to what we saw in the US. You had global energy and food prices following the conflict in the Ukraine with Russia. And so, really a handful of drivers pushing inflation across markets to levels we haven't seen for a long time. What got us excited is that you had very aggressive central banks hiking rates, almost Volcker-esque in some of these EM countries. And we felt that with peaking inflation, tight monetary policy, that was a great setup to see some good returns over the next year or so.

**Katie Klingensmith** [00:02:43] There's a lot to unpack there, and I'm fascinated by the Peru reference and thinking about how much a lot of emerging markets have benefited in spite of, perhaps, what's going on domestically. It gets me to a backdrop question. I think a lot of us have been surprised by the growth momentum that has come out of the US in the past year. I mean, we really started this year with a lot of fear. How much of the emerging market success is really about that US growth story?

**Michael Arno** [00:03:13] That's a great question. You know, I think earlier this year we thought about the set up. You know, markets were really excited about the reopening in China, and that's actually been quite the disappointment so far. Even in the US, we've had to deal with a regional banking crisis and a shifting further higher US terminal rates from the Fed. And despite all this, local markets have actually continued to perform quite well. And I think that really goes back to the fact that we were experiencing very high nominal yields, and we saw a catalyst for inflation to start to decline. High policy rates would dampen credit, dampen consumption growth. That would have a positive knock-on effect with the balance of payments in some of these countries, and you know, via goods demand--very similar setup that we saw in the US. So, it hasn't necessarily been all driven by US growth. Obviously, countries with linkages to the US, like Mexico, that's a country where you certainly had one of the drivers being the growth story in the US. You know, remittances, for example, have continued to come in quite strong, partially driven by the fact that we've got a strong labor market in the US in both construction and services. So, that's something that we continue to keep an eye on as it relates to remittances going forward. But one interesting thing with remittances is you can assume pretty much that 100% of those are converted back to peso, which has probably been one of the drivers that we've seen in Mexico in the Mexican peso, in a surprise to markets, in addition to a very hawkish central bank.

**Katie Klingensmith** [00:04:59] We'll definitely get back to some of the country dynamics. But it does seem like just those nominal yields like have been really attractive for EM. And as risk appetite has generally picked up in 2023, how much do you think that the success of EM local currency markets is just thanks to an interest in carry?

**Michael Arno** [00:05:19] Yeah, this is an interesting topic and very topical right now, especially as we start to enter in rate-cutting cycles, especially amongst the higher-yielding markets. I'd say the performance so far this year really has been driven--I'd say more important from the fact that you did have these high nominal yields, you know, multi-decade in some cases inflation rates from the excess stimulus from COVID, and as I was saying earlier, energy and food prices. But the aggressive monetary tightening has finally crimped demand and goods imports. Transportation prices have come down actually. Actually, in some countries very meaningful for their balance of payments in the current account, the transportation costs. If we remember all the shipping challenges from a year or so ago, that translated into very elevated cargo rates. Those have come down. In fact, they've normalized essentially, which has been very helpful from a balance of payments standpoint. So, those are some of the factors that have been helpful in driving markets this year. And now going forward, one of the things that we're going to be keeping an eye on is the central banks cutting rates and what that does to carry. And will some of these countries be able to maintain their performance as they reduce the carry attractiveness of their currencies?

**Katie Klingensmith** [00:06:53] So, I mean, just in summary, this is not just a yield story. This is also a macro story.

**Michael Arno** [00:06:58] Yeah, I think so. I think it's, you know, it's definitely a macro story in certain markets. You know, like Hungary, for example, last year, the gas prices, European natural gas prices spiked. That had a massive impact on current account. Huge drag, which led to a significant weakening of their currency, which resulted in the central bank hiking rates very, very aggressively into the high teens to provide that stability for the currency. In some other countries, you know, we saw some political noise and volatility that also, you know, while they were dealing with high inflation, you also tacked on some political risk premia on there as well. So, it really is idiosyncratic across different countries amongst the high builders. And then you have what we like to think of as the lower-yielding countries, whereas their policy choice tended to be FX intervention through the use of reserves. So, these guys didn't hike rates as aggressively as some of the other high-yielding markets.

**Katie Klingensmith** [00:08:09] And I think that reserve intervention was more common among the Asian countries. I wanted to get back to your reference around China, their reopening really being lackluster. Tell me about the dynamics in Asia and how much of it really is a China story or is it about the other dynamics within countries or across countries?

**Michael Arno** [00:08:29] Asia, as a region in emerging markets this year, in local markets is up around 2%. So, really lagging the index, which is up roughly around 10% year to date through the end of July. I think there's three main points on Asia and why they've lagged. One, we didn't have the drawdown in Asia that we did last year in some of these other markets. So, it's partially a result of that. Some of these markets last year had pretty significant drawdowns through October, and Asia didn't experience those same level of drawdowns. So, lower volatility was one of them. Negative carry. You know, these central banks avoided the big rate increases and relied more on the FX intervention. You'd be shocked at the relative policy rates across some of these markets. You know, in Malaysia, where Malaysian policy rates are 250 basis points below the Fed. Thailand, 325 basis points below the Fed. Even Indonesia, 25 basis points above. South Korea, 200 basis points below. So, carry amongst these markets is very low and deeply negative in some cases. So, lastly, and I think this also ties back a little bit to the negative carry is the fact that we've had a weakening RMB and an underwhelming China reopening. Had that not been the case, had RMB been strengthening, we had a pretty sizable reopening, then the negative carry influence on these currencies probably would have been less of a drag. But that has not been the case. So, I think that's really what some of the drivers are of the weakness in Asia markets relative to some of the other places this year.

**Katie Klingensmith** [00:10:12] Fair. And Mike, you certainly explained that yield is not everything that's going on. But it does seem like it's one element of the Latin American story that has made it attractive. Generally speaking, how would you summarize the big trends in the continent.

**Michael Arno** [00:10:29] On the inflation side, you had a huge spike in inflation in the region. Some countries, it was driven by, like Chile, for example, massive COVID-era stimulus. In their case, they tapped their pension funds four times. There's big stimulus efforts across other countries in the region as well. So, you had a surge in consumption relative to trend. Very similar to the US. You had a surge in goods imports. And then obviously, all these countries had to deal with food and energy price shocks from last year from the Ukraine invasion. So, very elevated inflation. However, we had a, as I was saying earlier, Volcker-esque response from the central banks. In Chile, Brazil. And unlike Asia, where I was talking about relative policy rates, if you look at Latin America, the relative policy rates are actually, again, multi-decade highs spread to the Fed funds rate. And with inflation and inflation expectations, you know, these countries rely, or central banks do surveys on a monthly basis on expectations of inflation over the next one, two years and sometimes five-year periods. They were able to re-anchor the medium-term inflation expectations, which generated actually very high real policy rates, ex-ante, of course. But in peeling back and looking at the underlying inflation dynamics, we viewed that there was definitely support for inflation to roll. Whether it was contractionary monetary policy would lead to lower demand for goods and services in some cases, and also food and energy prices have come down significantly. So, that would be a catalyst to see inflation decline closer towards their target. And we've seen a lot of progress actually in some of these countries. And that's why we're entering in the cutting cycle across a number of these markets. Chile kicked off 100 basis point cut in July. We just had Brazil cut a few days ago. So, there's expectations for Colombia to start in the fall. Mexico somewhere in the fall or in the early part of '24. So, these countries have done a fantastic job from the monetary policy standpoint. And, you know, in fighting inflation. And we expect them to be able to start cutting rates now.

**Katie Klingensmith** [00:13:04] So it sounds like perhaps we're at a bit of a fork in the road about opportunities in Latin America or the macro momentum in Latin America. Is that fair?

**Michael Arno** [00:13:13] Some of these markets are up 20 to 40%. In Colombia's case, 40. There's a lot of other stuff going on there. But we've had pretty strong returns. Yields are fairly attractive. They're not extreme like they were last fall. But relative to their own history, relative to some peers, looking at real rates, looking at ex-ante real rates, we think there's still a good opportunity in this market. But, you know, I don't expect to see another 20% in the next 6 to 12 months. But I do think they can generate some attractive returns over that period.

**Katie Klingensmith** [00:13:48] For the very success of bringing inflation down means central banks can be cutting rates, which arguably makes it a little less attractive from an investment perspective.

**Michael Arno** [00:13:56] Yeah, I think what's going to matter now is as far as the disinflationary process continues, will, what does the growth profile look like for the world? Will we see some sort of recovery or a rebound in China? And I think that would support, probably continue to support these currencies and these markets.

**Katie Klingensmith** [00:14:20] So, given the team's focus on Latin America, I'd love to go a little deeper in a couple of the countries. I know that you really liked Colombia early on. Tell us about the dynamics over the last six, nine, 12 months and what you see going forward.

**Michael Arno** [00:14:36] I think Colombia has been a classic Brandywine opportunity. We like to look at everything in terms of price risk and information risk. So, in Colombia's case, the information risk, markets were petrified that we had a leftist president for the first time, I think, in Colombia's history. Gustavo Petro, who's a known entity, he's been in politics for a really long time. But he took office in August of '22, won through the second round in in the spring. Very confusing when he first took office. A lot of mixed messages from members of his government, especially regarding the energy sector. You'd have one person saying one thing and then the next day someone saying the complete opposite as it relates to future energy development, things like that. There's also a, and this is probably also weighed on markets, a huge concern with his heavier left-leaning reform agenda. So,, pension reform, health care reform, labor reform, and really trying to think of, people were concerned about the, you know, for example, the pension reform, what that would do to demand for the local bond market if you're changing up the pension system. And then also, obviously, the fiscal cost of that. So ultimately, we got really excited because the information risk was, it was pretty dire. Couldn't really find too many people that were positive on the setup there. Our view was that given the makeup of Congress, he would ultimately face pretty significant constraints and would not be able to push these reforms through. And then once markets realized that, you'd see a big reduction in the risk premia. On the valuation side, what we like to talk about is price risk. You had nominal yields of 14, 14 and a half percent. The spread to Treasuries is extremely elevated. The Colombian/Mexican local rates tend to trade close to each other. In this case, when we looked at this, the local Colombian bonds were trading at a spread to local Mexican bonds that were ranked at the 98th percentile. So, spreads were very wide relative. And when we looked at it versus Brazil, Colombia usually has a yield that's well below the Brazilian yields. And in this case, they were trading on top of each other. So, a very attractive setup was what got us really excited about Colombia. And we've seen some of the constraints over the last few months, and as we suspected, or as our investment thesis, part of our investment thesis was that he would not be able to push any of this stuff through. And then that's been the case so far.

**Katie Klingensmith** [00:17:21] So, obviously a very specific thesis around an individual country, and it sounds like there's a lot of heterogeneity within Latin America. You mentioned Brazil was also at the beginning of a cutting cycle. What are the dynamics in Brazil?

**Michael Arno** [00:17:35] Yeah, Brazil. It's been a, I'd say, you know, with Lula winning a very close election, you have Lula coming back, what could be for one term, again, a shift to the left. There was a lot of, you know, a lot of shift to the left in Latin America during this last election cycle. And that could have been related to COVID. You know, one of the outcomes of COVID was you saw poverty and extreme poverty rates throughout Latin America rise pretty significantly again. So, that was probably part of that shift back to the left. But in Brazil's case, you know, you had the central bank taking the daily beating from Lula in the press. He has been complaining about high interest rates since he joined in December. So, we've got the central bank who's been very patient. They produce a focus survey every week. One part of that survey is expectations around inflation. And we've seen that decline and approach, get closer to central bank's central target. And that's allowed, not only expectations of inflation, but also inflation itself has been coming down. So that's really opened up the central bank to start cutting rates. And ex-ante policy rates in Brazil are very elevated. So, very attractive from an FX standpoint, too. But it gives them a lot of scope to start the rate cutting cycle. And we think there, they'll probably be gradual at first just to make sure inflation is actually coming down. There's some expectation that you could see CPI rise through the latter part of this year a bit. But, you know, they're keeping an eye on that, and I think they'll be gradual in cutting. It's not just a few categories that are driving the disinflation process. There's lower prices across a number of categories. So that's been helpful. And this is in the context of growth that's actually come in better than expected.

**Katie Klingensmith** [00:19:40] So, it seems like every country has its own dynamics, of course. You already mentioned that Mexico has benefited from remittances from workers in the US buying Mexican peso. I know Mexico, just the many closer, much closer economic ties with the US. What else is driving Mexico?

**Michael Arno** [00:19:56] A similar case. I think you had, you know, they're benefiting obviously from US growth. The central bank has been very hawkish. They've been very careful as far as following Fed policy. So, there's another market where you've got very, very elevated high ex-ante real rates. And I think it's really those three things. And in addition to some of the benefits that Mexico will see from reshoring efforts. So, I think I've seen some interesting utilization data from warehouses. And actually, they're very--there's not a lot of space available, put it that way. So, that's an interesting dynamic that we'll watch through the FDI numbers.

**Katie Klingensmith** [00:20:44] Beyond those three biggies in Latin America, are there other countries that you are particularly watching, either from a risk perspective or an opportunities perspective?

**Michael Arno** [00:20:55] In Asia, given the underperformance, we're always evaluating things that have underperformed. I think one of the interesting things or one of the things we're following is just outbound tourism in China. That has a pretty significant impact on the balance of payments of countries like Thailand, Malaysia. So, watching that as potential opportunities and a potential shift to markets that have lagged or, you know, as the yield opportunities compress in the high yielders, then that may also make a rotation make sense in some of the other laggards. So, watching some markets in Asia as it relates to some of the China tourism and just general China recovery as well. Because these countries would obviously stand to benefit from that. As it relates to China, you know, we're really paying attention to what's going on in the property sector. That's an area where you need to keep an eye on that because of demand for commodities. It's also a fairly significant driver of Chinese growth. So, I think that's an important sector to keep an eye on. The bonds, corporate bonds in that space have traded down pretty significantly this year, trading at very distressed levels. So, keeping an eye on some of the stuff that's gone on there. The other thing that we've really been paying attention to or starting to, at least. As yields come down in some of these markets, you asked this question a bit earlier, was just about carry and these high-yielding FX markets and their ability to perform as central bank policy starts to get priced in. So, Chile was one of the most aggressive central banks in hiking rates. They're also going to be one of the most aggressive cutting. There's somewhere north of 700 basis points of cuts priced in through the end of next year, end of 2024. And what we've seen in the carry across the different tenors. So, when we look at FX carry, we look at one month, three months, six months, 12 months. The 12-month carry has fallen from a peak of 7% down to 1.6. So, keeping an eye on that. And, you know, if we don't have the China recovery, will that reduced carry cushion weigh on the currency? So that's one of the things that we're doing some work on and watching closely.

**Katie Klingensmith** [00:23:26] Yeah, no, there certainly are a lot of open questions right now around the direction of emerging markets. Well, you have mentioned throughout some different political factors in individual countries and to some extent regions. Just generally speaking, are there geopolitical risks that are really driving your investment theses right now?

**Michael Arno** [00:23:43] Obviously, as you said, the local domestic politics are very important, and we pay attention to the election cycles. From geopolitics, I think what you'll see in a number of these countries, and some of these countries have already been doing this in like Asia, for example. I think they'll play off this sort of US-China rivalry and sort of extract value from both sides is how I would see it, without them really taking sides. But I think that's an interesting way that they'll play it. You know, Mexico is clearly going to benefit from a, I'll say, US-government mandated reshoring theme for strategic sectors. In Asia, there's going to be some countries that are going to benefit from just diversifying supply chains, moving some of their production outside of China and into another country. So, I think that those are some of the major thematics that we're looking at from a geopolitical standpoint.

**Katie Klingensmith** [00:24:44] So just to wrap this up, Mike, I want to take advantage of the seat that you have on the Multi-sector team. How do you think emerging market opportunities stack up from a broad global fixed income perspective with other opportunities?

**Michael Arno** [00:24:57] The local markets have had a good run. In the fall of last year when we really ramped up our allocation to local emerging markets in our multi-sector portfolios. High yield credit was also pretty attractive back then as well. But the relative valuation opportunity really stood out to us in local emerging markets. So, as that yield compresses, and that relative attractiveness dissipates, I would expect you'd probably see some of that allocation being redeployed back to some of the other spread sectors, whether it's in high yield corporates, or investment grade corporates, or even structured credit around the world.

**Katie Klingensmith** [00:25:39] Well, thank you so much for all of those big and very specific insights, Mike Arno. And thank you to our listeners for once again listening in to an Around the Curve podcast from Brandywine Global.