Audio Transcript: Emerging Markets Test Inflation Credentials
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Katie Klingensmith [00:00:03] Welcome everybody to today's recording of the Around the Curve podcast here at Brandywine Global. I'm Katie Klingensmith, and it's my pleasure to be joined by Alberto Boquin, who is a senior research analyst on the fixed income team at Brandywine, and spends his time and has spent his career focused on emerging markets. And that's what we're going to do today, is focus on emerging markets. It's been a rough road recently for investors in emerging market countries across asset classes. We're obviously going to talk about the fixed income side of the equation today. Alberto, welcome. And just get us started. Tell us what's going on overall with just global growth, with how synchronized, how regional, how differentiated is the global growth situation?

Alberto Boquin [00:00:50] Hey, Katie, happy to be here. I would say that the direction of growth, everyone agrees that we're slowing down, and the debate is about how much we're going to slow down. This is a function of central banks starting to talk about tightening in the developed world and the reopening sort of trade being behind us. And so really the question is, we know the U.S. Is going to slow down. How much is it going to slow down? Europe is the same. And how much are central banks actually going to blink into that slowdown? The one sort of quirky growth anomaly right now is China. Because of their zero-COVID policy, their growth has been on a different cycle. And now as they tentatively reopen, that's the only region of the world that's generally in an upswing. But it's generally a growth slowdown that people are trying to sort of figure out how bad it gets.

Katie Klingensmith [00:01:38] So certainly you've just enumerated some of the big global factors, but what are the other drivers? What else are you looking at for emerging market growth?

Alberto Boquin [00:01:46] So emerging markets started tightening a lot earlier than the developed market central banks, as early as last summer. And so you have a lot of tightening in the pipeline. Fiscal policy is also going to be very important--if you recall during COVID, everyone spent when everyone stayed at home--to offset that drop in spending. And now they're tightening the purse strings again. It depends on the country, but the direction of that monetary policy tightening and that fiscal tightening means that the growth slowdown in EMs is going to be very different, and that's in the context of the most challenging inflation backdrop, I think, in 20 years.

Katie Klingensmith [00:02:21] So a lot of focus on policy and sounds like that policy really reacting to inflation. We're all talking about inflation everywhere. Is inflation different in the emerging world or different in different parts of the emerging world?

Alberto Boquin [00:02:34] Yes and no. It used to be that in '21 we were evaluating responses to COVID and sort of ranking the better responses. But everyone seems to be dealing with double-digit inflation. I think what happened was that what was initially sort of a supply-led inflation, having to do with supply chains, commodity prices, got contaminated into inflation expectations. And so everyone in different sectors of the economy, whether it was restaurants that were opening up or schools that were revising tuition prices, everyone started raising prices. And so as much as you can squint and try to differentiate between EM, everyone's dealing with very generalized inflation pressures at the moment, unfortunately.

Katie Klingensmith [00:03:15] But wouldn't commodity prices have a differentiated impact on emerging markets? I mean, I suppose if they produce them, but also given that poorer countries tend to have a larger chunk of their consumer basket comprised of those commodities?

Alberto Boquin [00:03:29] So, there's definitely positives and negatives, and I'll just list them and then we can talk about what matters most. On the positive side, if you're a net commodity exporter, the thing you're selling is now higher in price, and so you're seeing current accounts improve in places like Brazil or South Africa. You're also collecting a lot more in terms of commodity revenues from mining companies, oil companies, that are making more profit. And so your fiscal balance is improving. But on the flipside of that, as you hinted at, food is a bigger issue in emerging markets because it's a larger weighting in consumer price indices. There also tend to be less competitive market structures. And so the supermarkets and the farmers of the world tend to pass on those price increases a lot faster. And so you weigh the pros and cons. I would say that the cons win overall, and that the inflation issue is so bad that no one's really noticing that your fiscal balance or your current account balance is improving on the margin.

Katie Klingensmith [00:04:26] Well, you did mention that policy's a big focus, and figuring out the trajectory for emerging markets or maybe finding the winners. A lot of work has been done. Emerging markets were hiking rates before most developed markets. Do they have to do a lot more work, and can they? Can they meaningfully hike rates more?

Alberto Boquin [00:04:44] So we're in a moment of hope. If you listen to central bankers in emerging markets, a lot of them will repeat what you just said and they'll say, "Look, we started early. We've done a lot. It's now developed markets' turn to do it." But if you just look at the inflation prints we got in the month of June, which are the May inflation prints, there were still very significant upside inflation surprises. And so if you tell me they've already done a lot of the work, my report to you would be, well, then why isn't it showing up in results just yet? And so as much as all this year, we in the market have been hoping that it's the end of the tightening cycle in EM, we keep getting surprised every day.

Katie Klingensmith [00:05:32] That's a big surprise indeed. Well, I keep hearing about different emerging markets needing to tap into IMF programs. And you mentioned there's some balance of payment challenges from the commodities perspective. Maybe there are other drivers, too. What's going on? Are there sovereign default concerns right now?

Alberto Boquin [00:05:50] So if you take the hard currency index that has 80 some countries that have hard currency bonds outstanding, I'd say that about 10 to 15% of those bond markets trade in double digits now, which is usually a sign of distress. It's a concern depending on what you're investing in, right? Brandywine tends to invest in the larger, higher-quality emerging markets. I don't think anyone's concerned about the Mexicos, Indonesias of the world. The countries that are having to go to the IMF are the smaller frontier markets, the likes of Sri Lanka, Ghana, potentially El Salvador. Those issues are going to continue partly because when there was QE everywhere around the world, they could issue a bunch of bonds, and they're coming due, and you can't refinance at the same levels. And so I think it's a safe bet to expect a lot of countries to be asking the IMF for help. And the game is sort of different. Right? It becomes a distressed debt game as to what is the probability being priced in the market of default? What is the likelihood? Is there some money to be made there?

Katie Klingensmith [00:06:52] Is that mostly around hard currency debt?

Alberto Boquin [00:06:55] Yes. If you have local currency debt, we've found out that you can be very flexible in terms of the pockets that you tap. So you could convince local pension funds to buy more of your debt. In places like a Brazil, the local banks have been buying a lot of the debt that they've issued over time. What happens with hard currency debt is that your lenders are more profit-driven and less likely to negotiate, and so therefore it becomes more of an issue, essentially a hard currency balance of payments crisis.

Katie Klingensmith [00:07:25] Sure. And if your local currency depreciates, all the harder to make good on those hard currency payments. Talk to me about your perspective on China, but also what the Chinese growth story might mean for broader emerging market investing.

Alberto Boquin [00:07:37] There are signs that China is reopening, but the yardstick they're using to measure things is really tricky. If you think about the policy name: Zero-COVID policy. One case kind of screws up that reopening story, right? But let's assume for now that they're actually okay with vaccination rates being higher, and no longer have to be as strict on zero-COVID. The main channel of transmission that I think matters for emerging markets is commodity prices. And what's been funky about this cycle is that a lot of the commodity price increases weren't necessarily demand-led. They were supply-led. And so even when there was less demand from China, a lot of these commodity markets like oil, copper or even cotton, were on the rise. And so what's a little bit confusing, frankly, right now is that China is reopening, which is generally good for commodities, where you have a lot of these commodity markets trading down over the last few weeks. I always think of commodity markets and remind myself that it's a highly volatile asset class, even more volatile than EM. And so sometimes you look at a 10% drop and you try to derive a lot of information from it. But it has to do more with market positioning and flows rather than any fundamental information. But year on year, most commodity markets are still higher. So that means that's still good for commodity exporters, and it's still a contributor, unfortunately, for inflation.

Katie Klingensmith [00:08:55] So it sounds like the China story is wrapped up in a lot of those broader global stories. It's not just about China driving the story. All investing involves policy and politics. There have been some interesting election results, especially in Latin America, Chile, Colombia, with some leftist candidates winning where they hadn't before. Is that the beginning of a trend?

Alberto Boquin [00:09:18] It's definitely a trend, but I think it's less about left or right, and it's more about incumbent governments just not delivering on their promises. Staying in Latin America, Brazil's right-wing president is probably going to lose in the polls to a left-wing leader, for example. I think what happened was that back in the day, leaders were promising growth, price stability, and jobs and delivering on that. And now, given all of the headwinds that we're facing, no one really can deliver on that. And they're being voted out of office. So in Colombia and Chile happens to be left-wing, but elsewhere it's just whoever is not in office at the moment. It's definitely a trend that I think continues. One of the things we're watching is how pragmatic these governments are, and you're already starting to see coalitions being built with center-right and center parties, and maybe it's not as bad as one initially thinks. But there's definitely a lot of volatility in the political space, for sure.

Katie Klingensmith [00:10:13] Not an easy or fun time to be a policy maker right now anywhere. So let's think a bit about how you're approaching investing in emerging markets. It seems like there's some pretty clear indicators that emerging market currencies, bonds, from spreads are looking pretty attractive. And valuations, I think, look good. Does that mean you're finding entry points right now, or how do you think about the valuation of emerging market assets?

Alberto Boquin [00:10:39] Sure. So if we split emerging markets into three broad asset classes: hard currency, local, and FX. Hard currency is tricky, because outside of COVID and the global financial crisis, hard currency, high yield spreads are at the wides of the last 20 years. But that means you're investing in some of the countries I mentioned earlier, like a Ghana or El Salvador that is facing restructuring, IMF sort of risk. And so I don't think you want to stand and try to catch that falling knife. Local currency, I think, is a lot more interesting because everyone has sort of reset their expectations for inflation. If you think about fair value for local currency bonds over time, you can think about inflation targets in most of these countries is about 3%. You probably need real rates of about 2% to 3%. So that puts you in a 5% to 6% range. There's a number of bonds trading closer to the 10% to 12% range. Now, the market isn't wrong in pricing bonds that way because there's a lot of inflation premium that has been justified because of all the upside inflation surprises. But if you think forward to a world where central banks are actually able to conquer inflation, and that inflation premia gets taken out, I think there's a lot of interest in bond markets where you can trade closer to that 6% or 7% fair value or even lower, depending on how low rates go. Currency, I think it's tricky. Currency has been trading on the next few months of Fed policy. And so in May you saw dollar weakness because people were thinking about September hikes no longer being on the table. And as soon as speakers came out talking about September definitely being a month to raise rates, the dollar strengthened again. The market is heavily positioned long dollars. So that's always a risk of a retracement. But you need to sort of pin down the Fed, which everyone's having a hard time with right now.

Katie Klingensmith [00:12:31] So you mentioned that we can hope for emerging market central banks conquering inflation at least in some places. There have been a lot of headwinds for emerging markets and big outflows from the geography, from the space. There's a scarcity of liquidity. As you noted, the Federal Reserve is hiking rates. So carry is a little easier to get in developed markets. You don't have to go as far. It just feels like there's a lot of headwinds. Make the case for emerging markets. Maybe it's not finding those entry levels right now, but what you'll be looking for to start once again going more aggressively into.

Alberto Boquin [00:13:10] So if you look at a number of short rates in EM, whether it's three-month or two-year rates, a lot of markets have those rates trading at the highest levels in 20 years. If you go back to 20 years ago, so 2002, emerging markets had not proved that they were inflation targeters. We weren't sure what their fiscal policies were, and there were a lot bigger issues to deal with. So either the market is right, and inflation is uncontrollable in EM, and we're going back to the hyperinflation days of 20 years ago, or the market is sort of skeptical that policymakers can deliver here. The moment you start seeing policymakers actually deliver on their inflation-fighting credentials, which involve a number of measures and not just policy rates, I think you can start to see emerging markets perform. And it is an asset class that because it's been challenged for the last few years, continues to be under-owned. And in emerging markets that aren't fiscally challenged, namely the bigger players out there like a Mexico or an Indonesia, credit risk is less of an issue, if you will. So you need things to line up. And I think inflation is the biggest factor right now.

Katie Klingensmith [00:14:16] Yeah, it's a factor everywhere. Well, given all that, what are the countries that you're watching in particular that may be opportunities, or the ones that you're thinking that you'd advise avoiding?

Alberto Boquin [00:14:27] So if textbook economics works, which I doubt it every day now, you would think that the countries that have been faster to tighten policy and more aggressive to tighten policy would start seeing the benefits from that sooner. And so that's a list that includes the likes of Chile and the Czech Republic. I think if those start rolling over, it would present opportunities not just in those countries, but it would be an indication that monetary policy still works and that inflation can actually decline from here.

Katie Klingensmith [00:15:00] Fair. Well, Alberto, thank you so much for your time and insights today on emerging market investing. And thank you, everybody, for participating in Brandywine Global's Around the Curve podcast.