An abrupt sell-off in emerging market (EM) assets has raised questions about the long-term outlook despite drivers of risk-off sentiment not being unique to EM. Does the recent volatility represent the early stages of a blow-up as the EM growth cycle turns negative? Or will volatility blow over, with the recent downturn providing an opportunity to find value given its indiscriminate impact on EM assets? In this Q&A, we discuss the factors behind recent weakness in EM fixed income and why we think the longer-term outlook for EM remains positive.

What’s driving the weakness in EM assets?

The weakness in EM assets has come in three waves. The first wave was driven by slower global growth in the first quarter. Slower growth led to concerns about EM countries that depend on foreign investment to finance current account deficits. With higher interest rates in the US and slower growth in EM and elsewhere, there were concerns that the flows these countries need wouldn’t be there. This group included countries like Turkey, Argentina, Indonesia and India. The second wave was driven more by political developments in countries like Brazil and Mexico. And the third wave came more recently with the increase in trade tensions between the US and China, which has led to underperformance in smaller Asian economies that are part of China’s supply chain.

This collection of headwinds has raised concerns about whether EM weakness signals a turn in the EM cycle. We do not think that is the case. The decline in EM currencies has been very consistent with the performance of the euro and other developed market (DM) currencies versus the US dollar (Exhibit 1). This suggests to us that EM weakness is in large part due to broad dollar strength rather than EM-specific factors. We think dollar strength reflects the divergence in the global growth backdrop, where the US economy now appears to be accelerating while growth is moderating in other countries, including China.

In the near term, we think patience may be required when assessing value and the potential for a rebound in EM assets. However, we believe the longer-term case for holding EM assets—strong growth, favorable demographics, low debt, overall balance sheet resilience and corporate earnings growth potential—remains intact. We think the EM universe continues to offer many attractive investment opportunities for active investors, particularly in an environment where growth in the US and global economy remains expansionary.

EXHIBIT 1: EM WEAKNESS MAY BE DUE TO BROAD DOLLAR STRENGTH RATHER THAN EM-SPECIFIC

Index (Jan’18=100)  
Currency Total Return Versus US Dollar

<table>
<thead>
<tr>
<th></th>
<th>DM ex-EUR</th>
<th>EUR</th>
<th>EM</th>
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<tbody>
<tr>
<td>Jan-18</td>
<td></td>
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<td>Feb-18</td>
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<td>Jun-18</td>
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Source: GS Global Investment Research (GIR). Note: EM and G10 ex-EUR baskets are equally weighted. As of June 18, 2018. GSAM leverages the resources of Goldman Sachs & Co. LLC subject to legal, internal and regulatory restrictions.

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Are EM countries vulnerable to reduced inflows of foreign capital?

In our view, EM countries are in a much better position to manage a sudden stop in foreign capital inflows compared to previous periods of stress. First, most EM countries have built up abundant foreign exchange reserves, which can be used to help offset capital outflows. Second, EM countries are in a better fundamental position compared to previous episodes of stress. Third, EM assets have already priced in a significant amount of risk, which in our view reduces the potential for further declines in asset valuations that could prompt additional outflows.

Exhibit 2 shows a measure of vulnerability to foreign flows for 30 EM countries (the measure is potential 12-month financing needs\(^1\) as a percent of foreign exchange reserves). As the chart shows, most countries have financing needs that are less than their FX reserves (any reading below 100%). In addition, most countries have improved their position relative to previous episodes of EM stress in 2008 and 2013—when Federal Reserve (Fed) Chair Ben Bernanke indicated that the Fed would taper its pace of asset purchases, raising concerns about EM vulnerability to reduced foreign flows if US interest rates increased. The few EM countries that do appear vulnerable on this measure exhibit favorable features on other fronts. Argentina, for example, has recently secured a three-year Stand-By Arrangement with the International Monetary Fund - a step in the right direction from a macroeconomic and financial stability standpoint. Turkey is not without political and current account challenges but has a strong fiscal position; its debt stock as a percentage of GDP has declined from over 40% in 2009 to below 29% today.

EXHIBIT 2: EM COUNTRIES ARE BETTER POSITIONED TO MANAGE EXTERNAL RISKS

Source: Citigroup, GSAM. As of December 2017. Note: For illustration purposes, 2008 data has been rounded to zero for China (-6%) and Malaysia (-7%).

\(^1\) Foreign financing needs are calculated in line with the expanded Greenspan-Guidotti rule, consisting of short-term debt minus current account balance, see International Monetary Fund “Assessing Reserve Adequacy – Specific Proposals” (April 2015) for details.

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What is the outlook for capital flows into EM economies?

Looking ahead, we will be watching three cycles for potential changes in the macro backdrop for EM economies: liquidity in developed countries (including interest rates and central bank balance sheets), the US dollar, and the trajectory of global growth including the differential between EM and developed market (DM) economic growth rates. In our view, EM economies—and flows into EM—are likely to withstand these cycles if they are a reflection of strong US and global growth, as was the case in 2017.

**Liquidity in developed economies** is declining as the Fed normalizes policy and the European Central Bank moves to halt asset purchases at the end of 2018. The withdrawal of liquidity by DM central banks is occurring at a gradual pace relative to the strength of the global economy. We expect the combined balance sheets of the Fed, ECB and Bank of Japan (BoJ) to continue growing through year-end and then begin shrinking modestly in early 2019 as the BoJ’s asset purchases offset most of the Fed’s balance sheet reduction. Declining liquidity—as global quantitative easing turns to quantitative tightening—alongside higher DM rates may have contributed to reduced capital flows into EM countries, however, we think this is likely evidence of a broader global portfolio re-balancing effect and is not specific to EM-economies. To the extent declining liquidity has contributed to EM volatility, it has also likely been a factor in other 2018 bouts of volatility, including the volatility in US equities earlier this year, the sharp rise in Italian bond yields following Italy’s election and the recent drop in Chinese equities and corporate bonds.

The **US dollar** has gained significantly against EM and DM currencies in 2018. Dollar strength has been negative for EM growth in recent years and has probably been a bigger factor than US interest rates as a driver of weaker EM asset performance. Exhibit 3 shows the relationship between EM external debt (EMD) returns, US 10-year yields and the US dollar versus a broad range of other currencies since 2010.

The relationship between EMD and the US dollar (right chart) is reasonably strong, with periods of dollar strength versus EM currencies often occurring in conjunction with negative EMD returns. A stronger dollar tends be negative for EMD, either indicating a stop in EM capital flows or pressuring EM inflation higher, leading to tighter EM central bank policy.

The relationship between EMD returns and changes in US 10-year rates is relatively weak (left chart). Why? Higher US rates can be positive for EM if higher rates reflect stronger US growth, as is the case today. In contrast, higher US rates without strong growth may be negative for EM and other risk assets.

**EXHIBIT 3: THE US DOLLAR TENDS TO BE A BIGGER FACTOR THAN US RATES IN DRIVING EMD RETURNS**

![Exhibit 3: The US Dollar Tends to be a Bigger Factor Than US Rates in Driving EMD Returns](image)

Source: GSAM, Bloomberg. Based on monthly data from January 2010 through May 2018. EMD returns reflect EM external debt.

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We think recent dollar strength is a reflection of solid US growth relative to weaker non-US activity and Fed hiking, with shifts in investor positioning (which entered the year quite short the dollar) contributing to the magnitude of the move. Looking ahead, widening rate differentials do not imply further dollar appreciation if they occur in the context of constructive global growth, as was the case during the US tightening cycle in the early 2000s. Stabilization or resumption of positive momentum in global activity could check the dollar’s advance and alleviate pressure on EM.

The EM-DM growth differential remains significant and EM economies continue to grow at a faster pace than DM economies by a large margin. EM economies also braced the recent sell-off from a stronger level and above-trend pace of growth. China is a notable exception and growth is likely to slow as policymakers address excessive domestic credit growth, while the US appears to be accelerating. This could cause the EM-DM growth differential to contract somewhat. However, a deceleration in growth is not the same as a decline and we think the bigger picture remains intact as EM growth rates are likely to remain elevated compared to DM growth.

Is the recent price action in EM assets justified?

Recent EM underperformance has been abrupt and indiscriminate in its impact on EM assets. Idiosyncratic factors may have justified a price correction in select markets; however, we do not think broad-based and continued weakness is warranted given the fundamental backdrop. We retain our optimistic long-term stance on EM assets for the reasons outlined above; strong macro fundamentals and greater resilience today than in prior episodes of market stress.

A moderation in the pace of the global expansion and higher volatility – both of which we anticipated in our 2018 Outlook – has unnerved investors who became accustomed to low macro and market volatility after a benign 2017. However, it is important to recognize that volatility in EM assets is not uncommon and more importantly does not necessarily preclude positive performance. EMD has experienced a median annual drawdown of 129 bps² since 1998 while providing positive total returns in 17 years over this time period. In short, EM investing may involve higher volatility but can ultimately be accompanied by healthy returns over the medium- to long-term.

Despite entering the year on a constructive tone, EMD spreads have experienced material widening of around 110bps from a February tight-point to the recent peak. Spreads are now at levels that appear excessive based on what is implied by key fundamental factors that have typically been strong indicators of EMD risk premia (Exhibit 4).

EXHIBIT 4: EMD APPEARS UNDervalued Based on Fundamentals

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Additionally, risk-off sentiment has resulted in a negative narrative that has been specific to EM, even if drivers of reduced optimism are not unique to EM. This has resulted in outsized moves in EMD relative to the broader spectrum of risk assets; EMD spreads are nearing their widest level since the global financial crisis and EMD is the only asset class where spreads are substantially wider than post the Taper Tantrum in 2013 (Exhibit 5).

**EXHIBIT 5: EXAGERATED MOVES IN EMD RELATIVE TO OTHER RISK ASSETS**

![Graph showing exaggerated moves in EMD relative to other risk assets](image)


**What investment approach is appropriate for EM fixed income?**

The EM fixed income investment universe is vast, diverse and as outlined earlier, stands to benefit from promising macro and micro dynamics including strong growth, good demographics, overall balance sheet resilience and corporate earnings growth potential. These benefits will accrue over a medium-to-long-term investment horizon.

Diversity within the asset class creates diversity in performance. This is why active management is imperative. High yields and spread premiums can be a reflection of factors such as low liquidity, credit risk and political uncertainties, among others. However, astute security selection combined with top-down macro analysis can unveil idiosyncratic opportunities where yields and spread premium adequately compensates for associated risks.

And lastly, although EM economies are advancing and EM financial markets are deepening, performance in EM assets is still steered by both global and domestic forces. A dynamic and risk-aware investment process can help navigate investment performance in an ever-changing global macro, political and policy environment.

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EM external debt (EMD) refers to the J.P. Morgan Emerging Market Bond Index Global Diversified Index unless otherwise stated.

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