CAN EMERGING MARKETS WITHSTAND GLOBAL MONETARY TIGHTENING?

Global central banks—the U.S. Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of Japan (BoJ)—have stopped easing. There is little doubt that monetary policy tightening will follow. Only the pace is uncertain. The question now is, can emerging markets (EM) thrive when global monetary conditions tighten? We believe the answer is yes.

Have global monetary conditions really been that easy?
Since the Great Financial Crisis (GFC), a large number of economic commentators have confused central bank action with global monetary conditions. While there is no doubt that central banks have eased money aggressively post 2008, it is less clear that global monetary conditions have actually been easy. In fact, if one judged global monetary conditions by the global supply of money aggregate (M2), one could argue that global monetary conditions have been tighter following the GFC than they were before. Global M2 growth has fallen from 9.5% per annum from 2005–2008 to 6.3% from 2009–2018. Using this method, it is not surprising that global inflation has been so well behaved (FIGURE 1).

Taken at face value, figure 1 also suggests that global central banks should be in no rush to tighten—something that cannot be denied given the lengthy time that both the Fed and the ECB have underachieved their inflation targets.

But even if global monetary conditions have not been as easy as commonly believed, and assuming that central banks will tighten monetary conditions at a somewhat faster pace, does that mean now is not a good time to invest in EM—especially considering that EM currencies are the most sensitive asset class to global monetary conditions? On the contrary, we believe EM remain quite attractive.

FIGURE 1: GLOBAL M2 GROWTH AND GLOBAL INFLATION (ANNUAL PERCENTAGE CHANGE)

SOURCE: BLOOMBERG PROFESSIONAL, HAVER AND BARINGS LLC. AS OF FEBRUARY 2018.
GLOBAL M2 IS THE GLOBAL SUPPLY OF MONEY AGGREGATE.

Highlights
- In assessing the investment case for EM assets, focusing only on central banks’ expected actions could be very misleading.
- It is unclear how much EM assets benefited from quantitative easing, making it difficult to argue that they will suffer without it.
- A global environment where central banks tighten but commercial banks regain strength could be very supportive of EM assets.
Upending conventional wisdom about EMs

It was in anticipation of ECB easing and in its early stages (post 2013) when EM currencies fell the most. It is therefore difficult to argue that in the absence of quantitative easing, EM currencies and other EM assets will suffer, given that it is unclear how much they actually benefited from it.

This observation is confirmed by looking at EM financial inflows net of foreign direct investment (FDI). Quantitative easing did not result in an acceleration of flows into EM. The big jump in financing inflows into EM occurred in the first two years following the GFC, when EM received $750 billion in financial inflows net of foreign direct investments. During the most aggressive Fed, ECB and BoJ balance sheet expansions, EM inflows slowed down to slightly over $100 billion a year (FIGURE 2).

Where has all the money created by global central banks been going? As important as central banks are in determining global monetary conditions, they only control reserve money, with commercial banks completing their work through the money multiplier. Following the GFC, global banks contracted M2 twice as much as during the Great Depression (FIGURE 3). Had it not been for central banks’ aggressive monetary action, the world would likely have experienced another great depression.

Bank of International Settlements data make the same point. The ratio of global banks’ foreign claims (ultimate counterparty) to global GDP (IMF/WEO data), net of ECB and Fed assets (our measure of global bank leverage), shows how much less levered the global banking system is than before the GFC (FIGURE 4).

Focusing only on central banks’ expected actions in deciding whether or not to invest in EM assets could be very misleading. Since the GFC, commercial banks have been undoing what central banks have been creating; alternatively, central banks have been filling the gap created by commercial banks. At present, there are tentative signs of global bank re-leveraging (FIGURE 5). Should our assessment be correct about global monetary conditions not having been particularly easy, future central bank tightening will only need to be fast enough to partially compensate for commercial bank re-leveraging, while keeping the pace of global M2 growth on an even keel.
An ideal environment for EMs?

A global environment where central banks tighten but commercial banks regain strength will be close to an ideal environment for EM assets, in our view. As shown in figure 6, we forecast EM net financing needs to be $100 billion in 2018 (current account balance). We anticipate foreign direct investment inflows (FDI) into EM of around $200 billion; FDI flows have historically been stable and unaffected by global monetary policy conditions. We expect global financing flows net of FDI to slow down from $80 billion in 2017 to about $60 billion in 2018. As a result, even in a world where global central banks tighten, EM should receive $160 billion in excess of their 2018 financing needs. EM asset prices could be very well supported in such a global environment.

RICARDO ADROGUÉ
HEAD OF EMERGING MARKETS DEBT GROUP

Dr. Ricardo Adrogué is Head of Barings’ Emerging Markets Debt Group. Ricardo is the lead portfolio manager for the Emerging Markets Local Debt strategy, and co-portfolio manager for the Emerging Markets Sovereign Hard Currency Debt and Blended Total Return Debt strategies. Ricardo has worked in the industry since 1992 and his experience has encompassed portfolio management, economic strategy and academia. Prior to joining the firm in 2013, he was at Cabezon Investment Group, LLC as well as at Wellington Management Company where he built a successful track record for the Emerging Markets Local Debt program and managed over $11 billion. Before Wellington, Ricardo worked at the International Monetary Fund conducting inflation modeling work for central banks and was country desk for Brazil, Costa Rica, and Trinidad and Tobago. He also worked with Salomon Smith Barney/Citigroup as a vice president of markets and economic analysis, a senior economist and a strategist for Panama and Peru, and New York University as an adjunct professor of Latin American Economics. Ricardo holds a B.A. in Economics from the Universidad Católica Argentina, an M.A. in Economics and a Ph.D. from the University of California, Los Angeles.
As of December 31, 2017

Barings is the brand name for the worldwide asset management or associated businesses of The Barings Group.

*Past performance is no indication of current or future performance. Past performance is not necessarily indicative of future results. Barings LLC, which is a registered investment adviser with the Securities and Exchange Commission (SEC) under the Investment Advisers Act of 1940, as amended (Barings LLC also relies on section 8.26 of NI 31-103 (International adviser exemption) and has filed the Form 31-103F2 in Ontario, Quebec, British Columbia, Alberta, Nova Scotia, Manitoba, New Brunswick, Newfoundland and Labrador, Prince Edward Island and Saskatchewan).

Barings Securities LLC, which is a registered limited purpose broker-dealer with the Financial Industry Regulatory Authority (Barings Securities LLC also relies on section 8.18 of NI 31-103 (International dealer exemption) and has filed the Form 31-103F2 in Ontario, Quebec, British Columbia, Alberta, Nova Scotia, Manitoba, New Brunswick, Newfoundland and Labrador, Prince Edward Island and Saskatchewan).

Barings (U.K.) Limited, which is authorized and regulated by the Financial Conduct Authority in the United Kingdom (Ref No. 709904); and

Barings Fund Managers Limited, which is authorized as a manager of collective investment schemes with the Financial Conduct Authority in the United Kingdom and is authorized as an Alternative Investment Fund Manager in several European Union jurisdictions under the Alternative Investment Fund Managers Directive (AIFMD) passport regime.

Barings International Fund Managers (Ireland) Limited, which is authorized as an Alternative Investment Fund Manager in several European Union jurisdictions under the Alternative Investment Fund Managers Directive (AIFMD) passport regime and, since April 28, 2006, as a UCITS management company with the Central Bank of Ireland.

Barings Asset Management Switzerland Sàrl, which is authorized by the Swiss Financial Market Supervisory Authority to offer and/or distribute collective capital investments.

Barings Australia Pty Ltd (ACN 140 045 656), which is authorized to offer financial services in Australia under its Australian Financial Services License (No. 342787) issued by the Australian Securities and Investments Commission.

Barings Asset Management (Asia) Limited, which is licensed by the Securities and Futures Commission of Hong Kong to carry on regulated activities Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 9 (asset management) in Hong Kong in accordance with the requirements set out in the Securities and Futures Ordinance (Cap 571).


Barings SICE (Taiwan) Limited, an independently operated business (Business license number 2008 FSC - SICE - Xin - 030; Address: 21F, No. 333, Sec. 1 Keelung Road, Taipei 11012, Taiwan. Contact telephone number: 0980 062 688); or

Barings Asset Management Korea Limited, which is authorized by the Korean Financial Services Commission to engage in a business of investment management and is registered with the Korean Financial Services Commission to engage in privately placed collective investment business for professional investors, discretionary investment business and advisory business.

Copyright
Copyright in this document is owned by Barings. Information in this document may be used for your own personal use, but may not be altered, reproduced or distributed without Barings’ consent.

IMPORTANT INFORMATION
For Professional Investors / Institutional Investors only. This document should not be distributed to or relied on by Retail / Individual Investors.

Barings LLC, Barings Securities LLC, Barings (U.K.) Limited, Barings Global Advisers Limited, Barings Australia Pty Ltd, Barings Real Estate Advisers Europe Finance LLP, BREAIF LLC, Barings Asset Management Limited, Barings International Investment Limited, Barings Fund Managers Limited, Barings International Fund Managers (Ireland) Limited, Barings Asset Management (Asia) Limited, Barings SICE (Taiwan) Limited, Barings Asset Management Switzerland Sàrl, and Barings Asset Management Korea Limited each are affiliated financial service companies owned by Barings LLC (each, individually, an “Affiliate”), together known as “Barings.” The information, opinions, data, views, and forecasts set forth herein are solely by the recipient in considering the products or services described herein and may not be used for any other reason, personal or otherwise.

No OFFER
The document is for informational purposes only and is not an offer or solicitation for the purchase or sale of any financial instrument or service in any jurisdiction. The material herein was prepared without any consideration of the investment objectives, financial situation or particular needs of anyone who may receive it. This document is not, and must not be treated as, investment advice, an investment recommendation, investment research, or a recommendation about the suitability or appropriateness of any security. SmartTrade® or other fiduciary unrelated to Barings about whether any given course of action may be considered, and must not be construed as a predictions or projections.

In making an investment decision, prospective investors must rely on their own examination of the merits and risks involved and before making any investment decision; it is recommended that prospective investors seek independent investment, legal, tax, accounting or other professional advice as appropriate.

Unless otherwise mentioned, the views contained in this document are those of Barings. These views are made in good faith in relation to the facts known at the time of preparation and are subject to change without notice. Individual portfolio management teams may hold different views than the views expressed herein and may make different investment decisions for different clients. None of this document, nor any sources we believe to be reliable. Although every effort is taken to ensure that the information contained in this document is accurate. Barings makes no representation or warranty, express or implied, regarding the accuracy, completeness or adequacy of the information.

These materials are being provided on the express basis that they and any related communications (whether written or oral) will not cause Barings to become an investment advice fiduciary under ERISA or the Internal Revenue Code with respect to any retirement plan, IRA investor, individual retirement account or individual retirement annuity as the recipients are fully aware that Barings (i) is not undertaking to provide impartial investment advice, (ii) may act to provide impartial investment advice, make a recommendation regarding the acquisition, holding or disposal of an investment, act as an impartial adviser, or give advice in a fiduciary capacity, and (iii) has a financial interest in the offering and sale of one or more products and services, which may depend on a number of factors relating to Barings’ business objectives, and which has been disclosed to the recipient.

No security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

Any security, investment or product outlined in this document may not be suitable for a prospective investor or available in their jurisdiction.

The information with respect to UCITS Funds is not intended for U.S. Persons, as defined in Regulation S under the U.S. Securities Act of 1933, or persons in any other jurisdictions where such use or distribution would be contrary to law or local regulation.

INFORMATION
Barings is the brand name for the worldwide asset management or associated businesses of Barings. This document is issued by one or more of the following entities: