Emerging Markets Fixed Income

IMF 2023 Fall Meetings: The World Begins to Worry about the U.S. Fiscal Deficit

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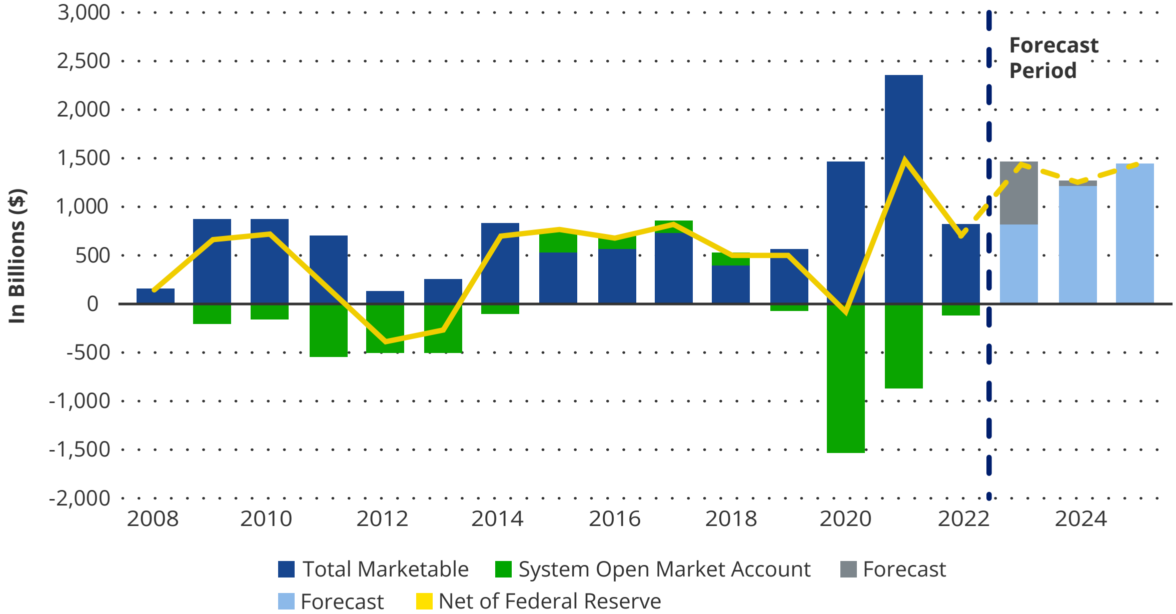
> Deputy Portfolio Manager David Austerweil and Chief Economist Natalia Gurushina spent a week in Marrakech, Morocco attending the International Monetary Funds (IMF) Fall meetings where they met with official sector creditors, policy makers, and other investors. The local authorities did an amazing job hosting the meetings without any issues, especially in light of Morocco's recent earthquake.

Global growth outlook is mediocre, with only the U.S. and China characterized by exceptionalism. When excluding U.S. growth, developed market growth is forecasted to be just 1% for 2023. The U.S. growth outlook was revised upwards by 0.3% to 2.1% from the Spring meetings, when most expected the U.S. to enter a recession this year. In contrast, the remainder of developed economies saw their growth forecasts revised downwards. Similarly, in emerging markets (ex-China) growth is forecasted at just 3% in 2023. China is still expected to achieve a 5% growth rate, which makes it the second fastest growing economy in the world after India.

Global inflation is falling, with U.S. inflation far from its target. U.S. inflation is not expected to return to the Fed's target rate of 2% until 2025. Forecasts for core inflation were revised upwards. Labor markets remain tight, not just in the United States but across Europe and many emerging markets. The lack of a more convincing global disinflation process makes it very difficult for credible central banks to ease policy and those that believe policy rates are sufficiently restrictive are likely to hold them there for longer than markets are pricing. Even in a country, like Brazil, where inflation has converged to its target, cutting interest rates too quickly would lead to currency depreciation and imported inflation. The "higher for longer" narrative was pervasive throughout all meetings. For as long as the Federal Reserve maintains that stance, the rest of the world will remain under its spell.

Rapidly rising long-term U.S. real yields are sucking up global capital and raising global borrowing costs. There was tremendous focus and criticism of U.S. fiscal policy and the resulting borrowing needs. The 2023 U.S. budget deficit of $1.7tn is inconsistent with the current economic expansion in the U.S. and is mostly the result of structural factors stemming from large tax cut packages, increased entitlement spending and growing interest expenditures. Additionally, the Fed's quantitative tightening (QT) of $900bn means $2.7tn of annual borrowing needs. These large borrowing requirements are putting upward pressure on U.S. long-term real yields. When the U.S. finally enters a recession, these borrowing needs will only increase. The Fed will cut interest rates to help the economy and this will relieve some pressure on government interest expenditure, but the Fed will still not stop QT as it seeks to bring its balance sheet back to a size that no longer stimulates the economy.

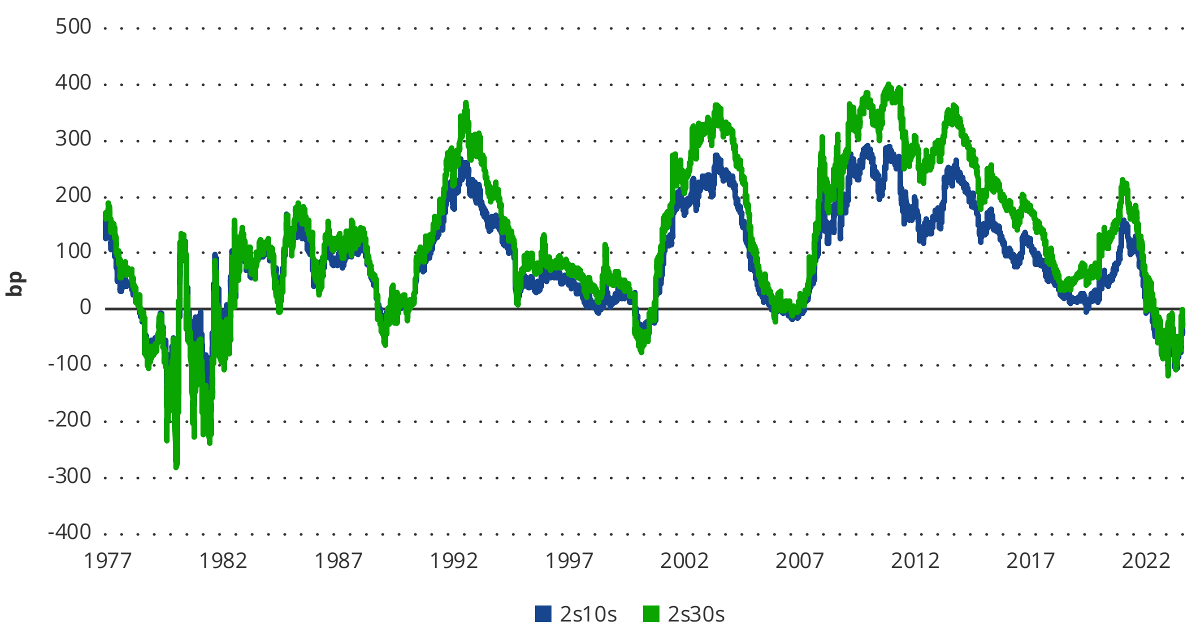
Net U.S. Treasury Duration Supply
(10-year equivalent in U.S. Billion Dollars)



Source: International Monetary Fund; October 2023. Not intended as a prediction of future results. For illustrative purposes only.

Global savings are needed to finance increased U.S. borrowing, but price sensitive private sector savings are not being properly compensated to increase their holdings. Countries with large current account surpluses, like China, Russia, and Saudi Arabia are no longer interested in financing U.S. borrowing. By sanctioning Russian holdings of U.S. reserve assets, the U.S. sent the message that U.S. Treasuries were no longer a safe investment for central banks that were not in the "U.S. friend zone". China realized the mistake it made in hoarding U.S. dollar reserves to protect against a financial crisis and instead is switching to holding strategic resources such as commodities as reserves instead for national security interests. Without price insensitive central bank buyers, more of the burden falls on private sector lenders, both domestic and foreign, who are highly price sensitive buyers.

History of U.S. Treasury curve shape for 10y - 2y (2s10s) and 30y - 2y (2s30s)



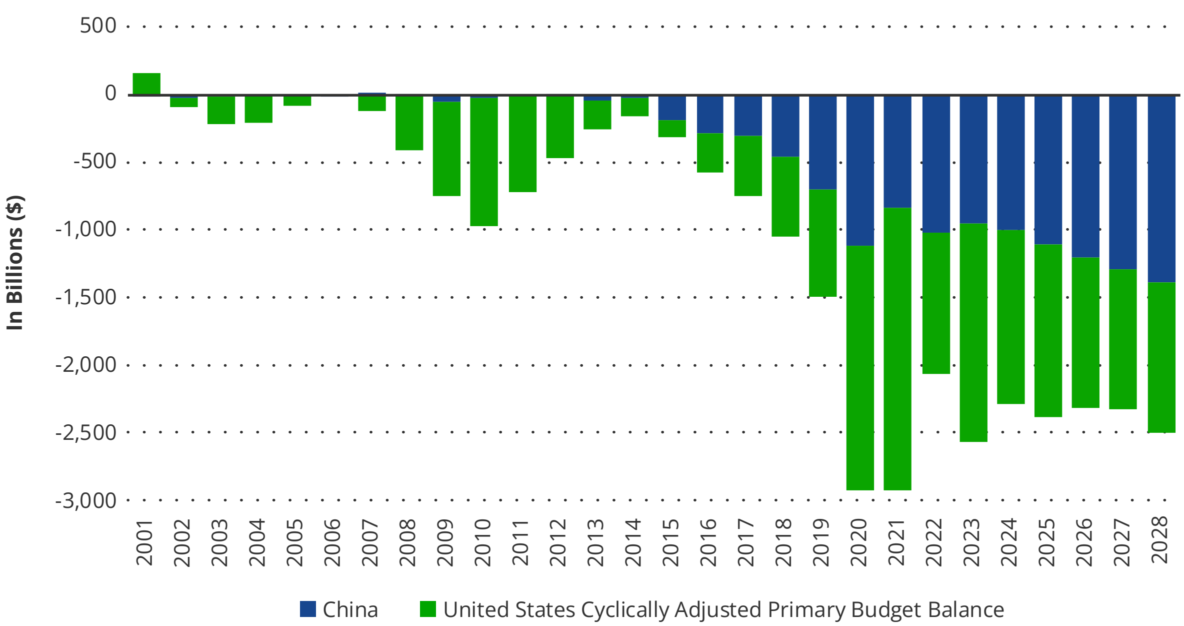
Source: VanEck Research, Bloomberg LP; October 2023. Past performance is no guarantee of future results.

U.S. government duration risk is still not adequately priced to compensate for the risk of ownership. The yield of both 10-year and 30-year U.S. treasuries are still below the yield on 2-year U.S. treasuries, meaning investors get paid less to take more risk! Historically, there was an average of 50 basis points (bps) of compensation paid for taking this additional duration risk. This repricing of duration risk, which is necessary to restore value, has been a violent and painful adjustment recently: most investors are already long duration, and expected yields to be lower due to a U.S. recession that never materialized. In addition, Treasury market liquidity is not functioning well as dealers cannot warehouse risk from large Treasury auctions, and the banking sector already owns too much interest rate risk. Additionally, there are discussions of a capital charge for U.S. banks for interest rate risk that would consequently lead to higher yields.

There was a lot of discussion about the U.S. neutral real interest rate now being higher than post global financial crisis (GFC) levels, with a return to either 2% (former NY Fed President, William Dudley's estimate) or 2.5% (Former U.S. Secretary of the Treasury, Larry Summer's estimate). Using a 2.5% real yield, adding in a 2.5% annual inflation rate and a 50 bps term premium, the fair value for real long-term U.S. interest rate comes to 5.5%. For the structural reasons just listed, it seems reasonable to think that a 5.5% nominal interest rate is closer to a market clearing level.

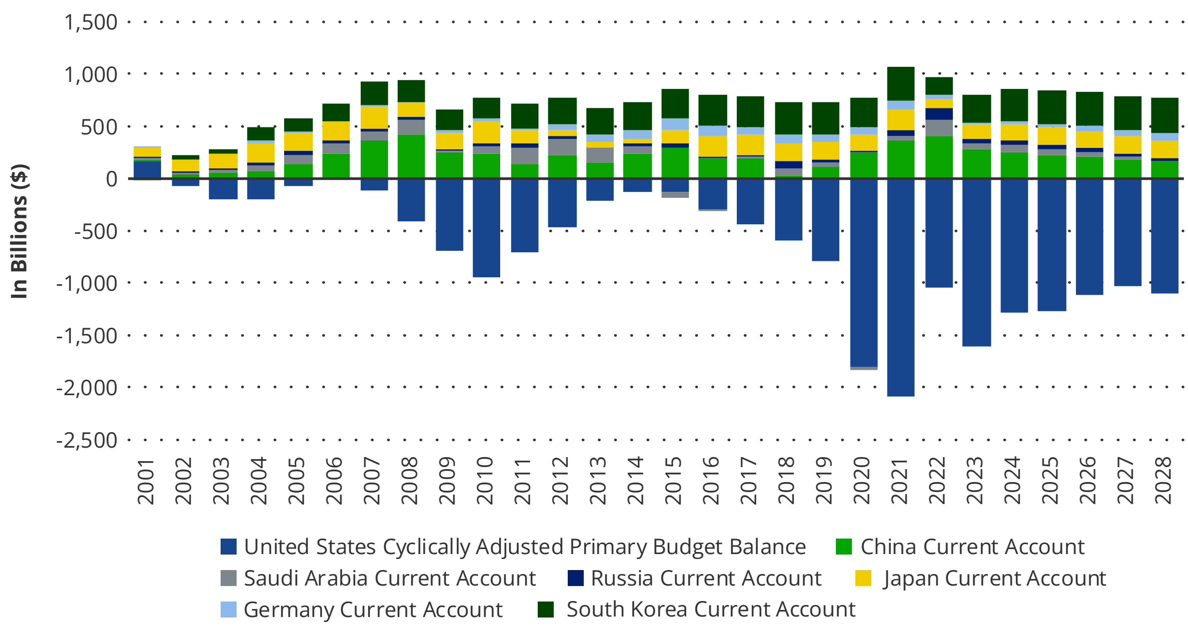
As real yields rise to attract new price sensitive buyers, it reduces the pool of savings available to other borrowers and increases the risk of financial accidents. The U.S. and the IMF want to incentivize the private sector to finance an ambitious global transition to green energy. The call to action has largely been ignored as the borrowing requirements of up to 50% of domestic GDP in financing costs over the life of investment is unrealistic when the concern is just financing the world's current borrowing needs. To put current borrowing needs in context, China and the US's deficits combine to 2.5% of world GDP! China is one of the few countries that can afford to finance its green transition with its own savings.

Cyclically-Adjusted Primary General Government Balances of China and U.S., % World GDP



Source: VanEck Research; International Monetary Fund; Bloomberg LP; October 2023

U.S. Cyclically-Adjusted Primary General Government Balance and Selected Current Account Surpluses, (bn USD)



Source: VanEck Research; International Monetary Fund; Bloomberg LP; October 2023

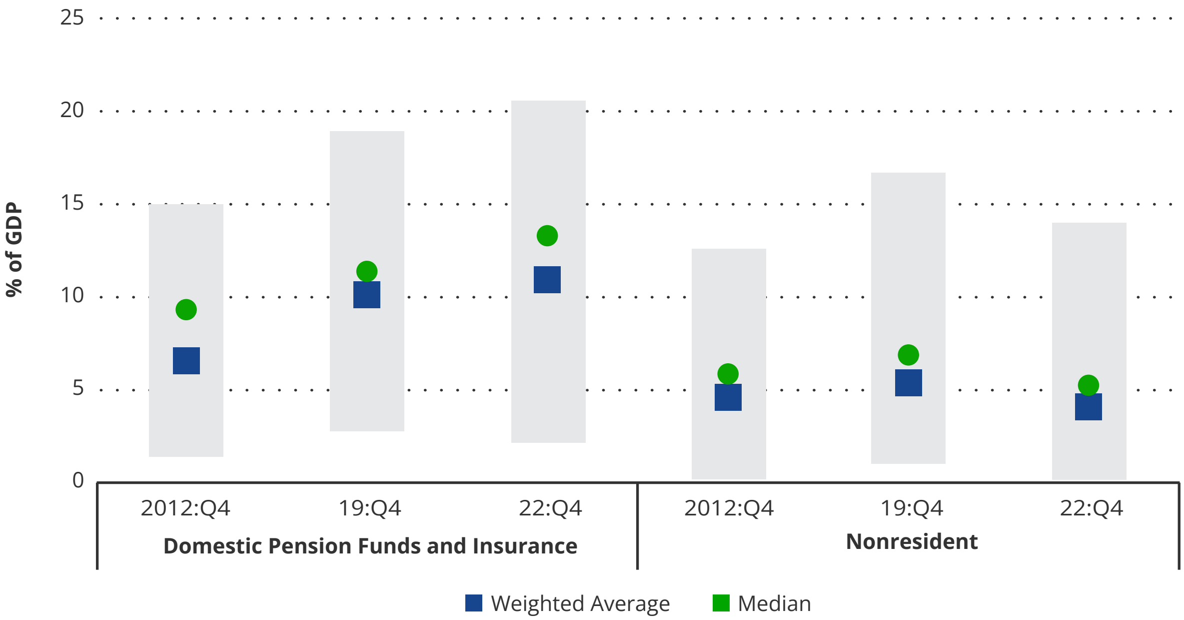
The U.S. deficit dwarfs the world's largest current account surpluses; global investment needs to fall and savings needs to grow to finance it. The structural need to attract more and more global savings is the main reason to expect interest rates to remain higher for longer, and the main reason the risk of a financial accident rises as there will be fewer savings available to lend to less creditworthy borrowers. The IMF ran global bank stress tests that incorporate a stagflationary scenario of higher for longer interest rates, a scenario U.S. stress tests overlooked, and the results were particularly troubling for the developed market banking sector plus China. Common Equity Tier 1 (CET1) ratios, which measures liquid bank holdings such as cash and stock, fall below 7% for 27% of developed market banks and 50% of Chinese banks. Emerging market banks, in contrast, fared well with just 10% falling below 7%.

Pessimism on the outlook for China's growth was pervasive but China has policy options. Only 4% of investors were willing to add risk to Chinese assets! It is hard to imagine a more pessimistic survey. The collapse in the property market and the subsequent risk of local government financing vehicle (LGFV) defaults that could cascade into banking sector insolvencies was a major concern. There is reason to be worried. Over 50% of LGFVs are unable to service debt when interest costs rise above 3%. But there is also domestic awareness of the issue and the Chinese government has the tools and fiscal space needed to avoid a debt crisis. The main issue is that so far there has not been a policy bazooka to resolutely solve the problem. The government is keen to avoid moral hazard issues but also given the centralization of decision making under President Xi, there may be some policy paralysis at lower levels of government. The other main investor concern is what China's growth model will be going forward as investors would like to see a rebalancing of the economy away from investment and toward consumption. One key event to watch for is setting a date for the Third Plenum where the economic policy strategy would normally be set. It typically takes place in November, but so far no date has been announced. If the government were to move more resolutely on tackling debt issues and addressing the country's future growth model, there could be a more sustained recovery in asset prices that are currently trading at very depressed valuations.

Against this concerning backdrop, the resilience of emerging markets economies shone though. There was an abundance of praise for emerging markets policy making across all geographies. Most emerging markets central banks hiked interest rates early to levels high enough to begin the disinflation process before inflation expectations could deteriorate. For the most part, they have been consolidated fiscal policy after the extraordinary spending during the COVID-19 era. Since emerging markets economies have not been able to rely consistently on portfolio flows post 2013's taper tantrum, domestic institutions have filled the space to channel domestic savings to fund government borrowings. By doing so, it has greatly reduced the volatility and sensitivity of government bond yields to U.S. bond yields.

For large emerging markets, long-term domestic investment institutions have stepped in.

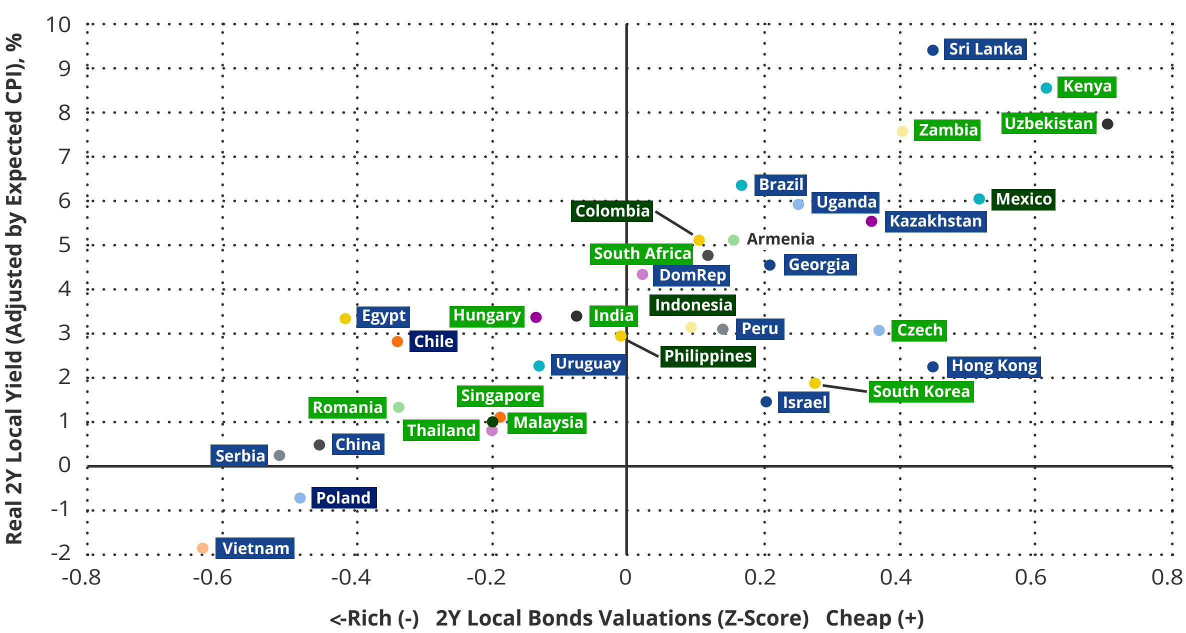
Local Currency Government Bond Ownership for the Eight Largest Emerging Market Economies, by Institutions
(Percent of GDP)



Source: International Monetary Fund; October 2023

The "higher for longer" message has been digested by most emerging markets central banks who have adjusted expectations around the terminal policy rate and future rate cutting cycles to include it. Colombia will cut less, Brazil will not increase the pace of rate cuts, and countries like the Philippines and Thailand are considering additional rate hikes. Indonesia just unexpectedly hiked interest rates to protect the exchange rate from higher U.S. interest rates. VanEck's Emerging Markets Debt team finds it useful to consider which emerging markets central bank policy paths are closely aligned to the U.S. policy path as a step 2 overlay in screening local currency markets. The chart below illustrates our valuation model for 2-year real yields on the x-axis plotted against real 2-year interest rates on the y-axis. The upper right corner of the graph shows the countries with the most attractive short-term interest rates. Each country has a color code indicating the policy stance of the central bank: the darker red the more aligned to U.S. policy and the lighter blue the more aligned to domestic policy needs.

2Y Real Local Yields vs. Valuation (Rich (-)/Cheap (+))



Source: VanEck Research; Moody's; World Bank; International Monetary Fund; Bloomberg LP; October 2023. Past performance is no guarantee of future results.

Emerging markets countries that stand out are Mexico, Colombia, South Africa, Hungary, the Philippines, and Thailand. The Emerging Markets Debt team has allocations to these local markets, except for Mexico, where the team has concerns over the valuation of the exchange rate and fiscal policy around the election.

The government of Turkey deserves a special mention for the impressive showing given by both Economy Minister Simsek and Central Bank Governor Erkan. Minister Simsek is well known by foreign investors and he made a compelling case that Turkey has credibly changed policy course by reducing the fiscal deficit, reducing the quantity of subsidized credit and tightening standards, allowing an exchange-rate depreciation to restore competitiveness, begin rebuilding reserves and hike interest rates to levels restrictive enough to bring inflation lower. Governor Erkan, however, was not known to investors and she made a very good first impression. It was clear she had a mandate to hike interest rates to levels where monetary policy would be restrictive. The meeting with them was the most packed one of the conferences and some major investment banks are recommending an overweight in Turkish Lira for the first time in recent memory.

In addition to Turkey, there were many memorable country specific meetings:

Hungary's inflation is finally heading for single digits, which can become the most important growth driver in 2024, boosting both consumption and investments. Higher growth should be associated with better fiscal outcomes, reducing the country's borrowing needs. A major uncertainty is the disbursement of the EU funds – both the timing and the size. But in the meantime, the country is benefitting from sizable foreign direct investment (FDI) inflows, especially in EV battery manufacturing.

The **Czech Republic's** overall policy framework is probably the strongest in emerging markets, but it is often traded "in sympathy" with the rest of the region. The latest fiscal consolidation proposal was a gutsy move and will help offset somewhat lower real interest rates than regional peers Hungary and Romania.

Poland's general election results were well received by the market, but the government formation, the policy agenda, the fiscal outcomes (both parties promised a lot before the elections), and geopolitical considerations would be just as important going forward.

Brazil is one of emerging market's poster kids for successful policy tightening, which did not kill growth (past reforms might be to "blame") and opened room for gradual rate cuts. The focus now increasingly shifts to Brazil's ability to maintain fiscal discipline – a credible fiscal plan will keep inflation expectations and real interest rates under control and avoid "twin de-anchoring" (high inflation and uncertain fiscal results).

Chile's disinflation progress shows that the monetary policy transmission mechanism and the flexible exchange rate are working as intended. The central bank is now transitioning towards the policy rate's "normality" and continues to accumulate reserves, which can weigh on the Chilean peso, especially if there is more political noise associated with the new constitutional referendum.

Colombia is moving in the right direction... slowly. Inflation has finally peaked, but the tight labor market, rising wages, and the El Nino phenomenon pose additional upside risks, keeping the central bank on the defensive.

The market's key concern in the **Philippines** is the government's ability to reduce its fiscal gap. Plans look good, but the adjustment is expected to spread over many years. The central bank might need to tighten more to cool domestic demand, but the government is determined to maintain its pro-growth fiscal stance.

Indonesia remains a bright spot in EM Asia. Domestic activity, fiscal discipline, and the inflation outlook argue against additional policy tightening, while elevated trade surplus (buoyed by strong exports) provides fundamental support for the currency.

South Africa's inflation was more persistent than expected, with fiscal policy posing additional inflation risks. Multiple domestic and especially global risks make it difficult to simply look through them, keeping the central bank on the cautious side. South Africa's private energy generation is a potential positive for the country's assets, but it might take longer to play out.

Morocco remains a structural and economic success story in Northern Africa. The improving equilibrium current account balance is a major new positive that can help reducing Morocco's external financing needs from now on.

Angola continues to benefit from past reforms, and it continues to target greater diversification and the reduction of its debt burden. However, the economy remains too dependent on the price of oil – against the backdrop of stalling oil production and the end of the debt suspension agreement.

Kenya's growth story is still strong, and the IMF program remains a good policy anchor, but the market is frustrated about a lack of clarity about the maturing 2024 Eurobond, fearing that they will end up tapping into international reserves to make the payment.

IMPORTANT DISCLOSURES

Source: IMF.

International Monetary Fund (IMF) is an international U.S.-based organization of 190 countries focused on international trade, financial stability, and economic growth.

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