Fixed Income Focus.

Developed strength and emerging weakness

Since 2009, robust emerging markets have managed to prop up global growth despite developed market recessions and crises. But that dynamic has now changed.

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Fixed Income Focus represents the viewpoint of the Active Fixed Income team at LGIM.

Brazil and Russia are currently experiencing economic contractions and Chinese growth is slowing. At the same time, the US has recovered from its traditional slow start to the year and the euro zone is gradually emerging from its drawn out recession. Developed strength, or emerging weakness – what will win out?

Developed markets on the up?

Taking developed markets first, confidence is improving, and both Europe and the US are currently growing above potential with tightening labour markets suggesting the tantalizing prospect of accelerating wages. The hope is that workers use their expanding salaries to consume more, prompting more production with the result that a positive feedback loop takes hold. The counter-argument is that high debt and sluggish growth means companies cannot afford higher wages, and will instead cut workers to try and maintain profitability. The evidence ebbs and flows, but there has been a boost for the optimistic case in recent months, particularly from a robust US housing market, recovering European retail sales and nascent UK wage growth. Indeed, if they were operating in isolation, the US Federal Reserve and even the Bank of England would probably be raising interest rates very soon. But they are not in isolation.

Emerging markets slowdown

Within emerging markets (EM), Brazil and Russia are experiencing deep recessions, and many other commodity exporters are also under severe pressure. The common link of course is China's economic slowdown. It's well known that China underwent a massive debt-fuelled investment surge following the collapse of Lehman Brothers, boosting demand for raw materials across the globe. But such a rapid burst of activity naturally led to some capital misallocation and declining investment returns. Indeed, overinvestment combined with extraordinary debt growth are often precursors to a recession, particularly if triggered by an asset bubble bursting, as has clearly happened this year in the Chinese stock market. The trouble is that it is very hard to judge Chinese economic activity. Developed market GDP figures are not particularly accurate when first released due to measurement problems, leading to large subsequent revisions. Despite the huge resources at their disposal, China must also suffer from such measurement difficulties, which makes the announcement of 7% for Q2 GDP growth a rough estimate at best. The collapse in commodity prices and declining world trade highlights the slowdown in Chinese heavy

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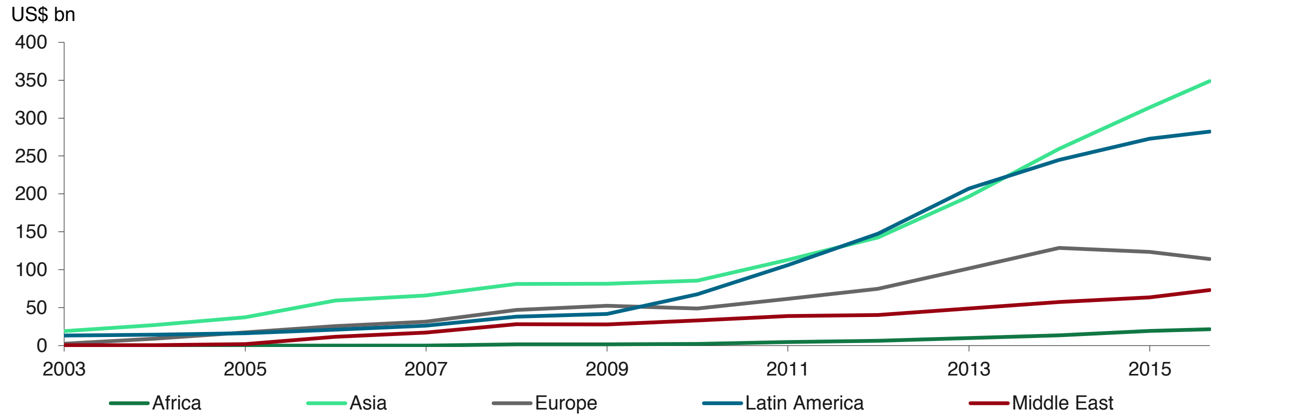
Figure 1: Emerging Market USD corporate debt has increased rapidly



Source: JP Morgan CEMBI Broad Index face value

industrial activity, and while the service sector is doing better, it may not be able to fully offset such weakness. To put this in perspective, Citi's global economist, Willem Buiter, suggests 4% or less for current Chinese growth. Whatever the case, Chinese growth has slowed from the boom experienced during the post-crisis fiscal expansion, and may already be heading below potential, which would translate into a traditional recession with associated climbing unemployment and rising defaults.

The market perspective

So then we come to how the combination of improving developed and weak emerging economic growth impacts fixed income markets. From a monetary policy perspective, lower commodity prices have fed into lower inflation, pushing back rate hike expectations in the US and the UK and prompting speculation about further loosening in Europe and Japan. If developed market growth is indeed improving, this would be a good combination for fixed income markets, with suppressed government bond yields and falling credit risk premium for domestic focused companies. But we also have to factor in weak EM growth. Unsurprisingly, given the debt-fuelled nature of recent growth, there has been a significant increase in the region's bond market. Having been badly burned during the Asia crisis in 1997, sovereigns have tried to limit their debt denominated in foreign currencies, instead building up large local currency liabilities. However, corporates have not been so careful, with Figure 1 showing the acceleration in dollar bond debt issued by the region. Add bank loans to this total and you get a rather worrying picture. EM bonds have been weak this year, but not dramatically so – certainly nothing like prior EM debt crises. So it's hard to argue that you are compensated for an outright EM recession.

Then there's the feedback loop into developed market corporate bonds. Directly, there are energy and mining companies that suffer from the collapse in commodity prices. There are also companies that are suffering from a lack of demand from EM consumers, such as auto and luxury goods manufacturers. Then there's the banking sector which has exposure to EM corporate borrowers. Indeed, if you try and invest in corporate bonds that are solely exposed to developed markets, you are facing a rather restricted selection.

Perhaps this is the answer to the question I posed at the beginning. Emerging economies have grown dramatically in importance in recent years and now directly impact a large proportion of global capital markets. If EM experiences a recession in the coming months, expect significant fixed income market volatility, and defensive strategies to do well.

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