

Takeaways from IMF Fall 2022 Meetings



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Long and Wrong

The Active Emerging Markets Fixed Income team recently attended the Fall 2022 IMF meetings and share their key takeaways and observations.

Investors are nervous about higher rates, but index-hugging, and not reducing the duration or being selective. Investors are nervous about geopolitics but unsure of what to do (more index-hugging). There's no conviction. Everyone's waiting for peak yields, after which they will go max long EM local currencies that hiked early and large. But for now, they're awaiting orders from US treasuries. Too few think the answer to rising rates is to have low duration and look to slowly accumulate selective risk as yields find their peak. EM is yet again acknowledged as not the cause nor the primary victim, but few are willing to even scale into such a view. Too many are saying "Treasuries are the boss of me".

Summary:

- "I don't know" was the most popular opinion. Investors' reaction functions were more dominated by US rates and geopolitics than ever before. There was verbal bearishness, but the positioning reaction was low tracking error (i.e., failing conventionally). Investors struck us as "long and wrong".
- The most common question was when yields would peak, whether via an "accident" or a benign decline in inflation. Most saw a Fed that is not poised to pivot or pause (we agree, but have been comfortable with significantly lower duration than the indices', which remains an unusual reaction).
- Record duration was issued at record low interest rates, which are now rising. Holders of those assets (and their derivatives) will be prone to accidents just like the UK pension systems.
- No Plaza Accord is coming soon. The rising dollar is driven by interest rate differentials that have deep and divergent drivers. There're no obvious near-term obstacles to USD strength against the Euro and Yen, other than Japanese intervention to strengthen the Yen (which we expect) and an end to Japan's yield curve controls (YCC) which is further off. The G-7 and G-20 have a role, but a less clear one in a sharply divided world.
- In this latest "crisis", EM is yet again not the epicenter nor the key victim. Many EMs are vulnerable, but most of their debt is in their local currencies, their external positions remain strong (some surging due to commodity windfalls), and their central banks hiked way more and way earlier than DM central banks. EM debt will suffer along with other debt, due to the bond math of rising "risk-free" rates. But, market participants see EM debt, particularly EM currencies, as a key potential winner when interest rate volatility declines; they are just index-hugging, though, not choosing winners and losers, from our sense.

On Developed Markets/Global Macro:

“I don’t know” was the most popular view. Investors were more focused on US rates and geopolitics for guidance than ever before, and are somewhat bearish verbally, but are only reducing tracking error and hoping to fail conventionally. Failing conventionally has been a winning strategy for many, particularly if AUM is high. That seemed to be the case at this meeting, though there’s nervousness about a) outflows and b) the big dispersion in performance (they fear outflows into competitors and not just into cash, as many also see a big re-flow into bonds coming in the next quarter or so). Too many, in our view, were basing their entire strategy on waiting for a high in US yields, after which all of their investment conclusions would follow. (Our view this year has been that the implication of rising rates is having a low duration, and not extrapolating any further).

Geopolitics took a lot of oxygen out of the room, and the output was only mind-numbing carbon dioxide.

Geopolitical discussions were right off of the television set, meaning superficial to the point of misleading. China was more front-and-center, but too many business models depend on continuity with China/globalization, making it hard to come to conclusions such as “yeah, we’re done”. More specifically on markets, the discussion points were so manifold (is zero-Covid policy ending, will G-20 be a love-fest, what’s up with China Property, etc.), investors seemed unable to come to conclusions. (Our view has been that the “solve-for” is CNY; that helps one absorb all the issues and focus on investment implications, and that’s the only way we see contagion, for what it’s worth).

What was clearer is that security considerations are dominating policy in China, the US, Europe, and more. (More on China later). On Russia, there was great pessimism about the Ukraine war (i.e., longer, expanding, a “frozen conflict” at best, etc.). There was also ongoing digestion of the fact of the Nordstream pipeline destruction (actually, partial impairment), and the impossibility of any adjustments in German gas imports. There was virtually zero discussion of the new security and economic cooperation zones created by Russia, China, India, Iran, and some even including Turkey. Sanctions on Russia’s central bank were almost universally viewed as a failure, if not a boost to solidifying Eurasian groupings. US officials continued to state that sanctions are a great success. (Having dealt with sanctions as far back as North Korea’s, and of course Russia’s, our view remains that once the machine has started, failure is irrelevant, and we see the sanctions machine gearing up for China).

Everyone was asking when yields were peaking, whether it would be via an “accident” or inflation progress, and most saw a Fed that is not poised to pivot or pause. Obviously. Interest rate volatility is the key worry and is legitimately disconcerting, we think. Some saw the UK as the “accident”, but many did not. We mentioned our suggestion – that “it” could come from a big private deal in the US, owned by a big private investor, with no transparency and thus magnified uncertainty – and this view was welcomed. Some saw the peak in yields as coming from improving (i.e., declining) inflation data (the Fed is looking at backward-looking data, by the way). And some saw the yield curve itself as marking the moment (i.e., long-end rates simply rally after front-end rates rise “too much”). We’re open to all of these scenarios. The problem is, with inflation at 8% and a Fed aiming at 2%, growth is very much in play. **We sense that we need to get to 5-handle rates at least on the 2-year.**

Growth is finally a key focus (In our Spring Takeaways we noted the absence of growth fears), with risks to the downside. The IMF itself, in its World Economic Outlook (WEO), only took its 2023 global growth forecast down by 0.2% of GDP (to 2.7%). That seems to be inconsistent with the world they describe in the 186-page document. To be fair, they are clear that the risks are almost all to the downside. They offer a construction we don’t usually notice in WEOs, which is that they see a 25% chance of 2.0% growth (which would be a bottom decile outcome for many decades) and a 5% odds of 0.5% growth. The culprits are obvious – Europe’s energy crisis, war, China, a Fed over- or under-hiking, etc. They also note that 2.7% would be the lowest growth (excluding crises) since 2001 (when it was 2.5%). Also interesting was that it was developed countries that were the problem areas – Europe, especially and obviously, but also the US, and China (where we disagree/ aren’t so sure) as leading downturn risks. This is interesting to us EM folks, as it will be yet again another global kerfuffle or crisis in the past 15 years in which EM is not the epicenter nor the most gruesome victim. Just saying.

Some saw developments in the UK as an example of bad fiscal policy being punished, and as implicitly supportive of EMs and other countries with lower debts, more independent central banks, and greater market-friendliness. We’ll talk about EM later. We’re not so sure DMs such as the UK are good guides, but it has been a theme of ours for over a decade that the DMs are becoming EMs and vice-versa. A key reason for our nervousness over what we see in many DMs is that we’ve seen these processes in EMs. What’s a sustainable level of debt? DM has no idea/EM is defined by knowledge of the level. Why have an independent central bank? DMs have pioneered “coordination” between fiscal and monetary authorities. EMs have central banks that are solely focused on inflation, leaving markets and government fiscal plans to the fiscal authority. This will be a learning moment, at least, in our view. With the DMs as the students.

USD strength was a big concern; watch JPY and KRW. Good. But it was the kind of dollar strength that we think is less useful as a guide to investing. The idea that the dollar has higher yields and growth, and will continue to, against a gasping Europe and a Japan for now locked into low yields via yield curve control (YCC) is reasonable. But that says more about Europe’s energy and structural problems, and Japan’s unique policy mix than it does about the dollar, in our view. Korea will be a great example for DM-focused folks, we think. When and if Japan ends YCC, we see the Yen exploding stronger and the Korean won doing the same. We mention this because the idea seemed to be novel to most participants who were very USD-bullish (a result of the vague top-down comparisons with Europe and Japan), making it a very interesting scenario to us.

Europe was a “downside risks to growth story”. Debt mutualization is seen as the easiest lever to pull if there's a “crisis”. The fact that Germany will have to shift to much more expensive and inefficient energy sources was seen as just “too bad”, and many came away reminded that Germany's political system isn't in control of decisions such as where it can purchase its gas, its military posture, etc. Few saw any reason to care if the Euro kept declining, a view with which we're sympathetic.

No Plaza Accord coming soon; G-7 and G-20 have a role but a weaker one. Some asked about another Plaza Accord, given USD strength. What we think gets forgotten is that the last Plaza was after the US dollar had already been declining, and was a way to get the US Congress off of its protectionist track. Those conditions don't hold now. Today, it is about interest rate differentials. It will take a far more serious crisis to get rate coordination meetings going; this seemed to be the policy line (and we agree). The Fed is fighting inflation and not worrying about the external sector. China doesn't want to tighten. Japan wants to keep its YCC and won't change at least until Kuroda departs, etc. And Europe is a mess of growth challenges.

It looks like the G-7 might get a mini-resurrection, given that G-20 now has countries the US considers unfriendly. There was discussion about the upcoming Bali G-20, whether Zelensky and Putin would be in the same room together, whether countries would walk out, etc., etc. Anyway, with India and then Brazil as presidents of the next G-20 rounds, the US seems to expect little progress toward re-globalization. The US construction is that globalization was great for all, and the only problem was that it generated unequal benefits. For what it's worth, the next G-20 could be the first Biden-Xi meeting (though that also seems subject to political posturing, as we read after our IMF meetings). China is presented, by the US, as not a standard-bearer for globalization. A tagline was that “instead of tariffs, China will make you buy from or sell to an SOE that can and will abandon you at a moment's notice”. This led to some concerns about CNY weakness. We share it, but also see it as orderly.

There are hints of new facilities to help with hunger, and poverty, and accelerate the “energy transition”, but they are nascent and thin. The World Bank (the sister organization to the IMF that focuses on structural and project lending) is touting a new emissions-reduction project development program that could provide “up to \$1tn”. The IMF has its Resilience and Sustainability Trust (RST). Fast debt reschedulings where needed were also noted, of course. And, the “common framework” (getting China to the table with all other creditors in these situations) looks to have gotten nowhere, and there were more references to Chinese state banks “pretending” to be private creditors to avoid pain at the right moments. (Our point is not that that's true, our point is that that's a challenging way for the major IMF shareholders to present China's actions; there's a lot of pressure on China to join the framework as the world's largest bilateral creditor).

Commodities were presented positively. Risks to supply were emphasized (and we agree). The Black Sea grain flow was seen as having 0 certainties surrounding it. Natural gas prices were viewed as subject to upward pressure through 2024, but maybe face a glut in 2025 and 2026 when US gas starts to flood the market. Some presenters cited an “overdue backlash on ESG” due to hunger and energy issues for the poorest countries and individuals.

On the Emerging Markets:

USD strength was a big concern here, too. The IMF certainly pushed that risk, putting in the top 3 challenges to EM generally. We saw the same in our investor discussions – USD was loved. Brazil was a recent exception as it started its hiking cycle so early and so aggressively. We were struck by how dominant the “dollar view” was for EM folks who are normally, like ourselves, inclined to ask “what dollar cross are you talking about, exactly”. EM folks worried about rising US rates, and global growth, and tended to see EMFX as a kind-of monolith (our view is that EMFX is nicely set up given their earlier and larger rate hikes, as well as some of their superior debt statistics and that one has to have a currency-by-currency view; we are especially excited by some Asian EMFXs).

EM should benefit from “friendshoring” and be a more prominent geopolitical focus for the US...but isn't. We think this view is largely correct (other than the sillier headlines about US rapprochement with Venezuela to replace Russian oil). EM should be targeted by the west for closer relationships, and this doesn't seem to be happening. It's there to be done, in our opinion, and there are plenty of distractions in US politics to explain the lack of US strategy. At some point, once US national security officials are done (inadvertently) marrying Russia to China with Central Asia locked up, they will more formally look for friendship opportunities in Latin America and not just Asia. It'll be the only option left. Good luck with India and Brazil, is another of our views, but that's a story for another write-up – they'll be presented as friendly, at least initially.

EM inflation is more due to an exogenous shock that EM rate hikes can address. EM can more reasonably be divided between exporters and importers. Europe is facing a long-term energy crisis that is more structural. Energy price shocks are not moderating and have big passthroughs to inflation, and growth is already almost 0. The US is facing some rise in inflation expectations and the real estate component is not quickly addressed. Anyway, we've been noting in all of our writing how many EMs hiked earlier and were larger than their DM counterparts.

EM being in “good” shape was mentioned a lot, despite bearishness (that was mostly related to bearishness on DM growth and interest rates). It was broadly lauded that EM central banks hiked earlier and larger than DM central banks. And, it was broadly observed that many EMs have excellent external positions. It was also reiterated that EMs stopped emergency spending on Covid due to fiscal constraints way earlier than the profligate DMs, and EM's generally lower levels of

The China discussion, particularly on politics, became more sophisticated. President Xi was presented as taking advantage of real populist resentment against the rich, which was politically sustainable. Poverty alleviation is popular. Liberal intellectuals are not an important constituency right now. Military reform was also got discussed. China has fully left the Soviet-era model of a heavy ground force army, and towards the US model of a multi-force approach (i.e., land, sea, air, space). We were also reminded that Xi is seen by many as having saved the Communist Party when he went after Bo Xi Lai as an alternative force. The young are joining the party and dominating new membership. Security is the priority, and we could sense an almost disdainful attitude toward growth-focused policy. Security, health, and stability struck us as the key watchwords. Xi's political capital seems likely to be invested toward those goals.

Finally, on the relationship with Russia, the (interpreted) line from China seemed to be that “if you (the west) win in Ukraine and Russia, you have already told us we are next”. The point is they won't let that happen, though will do their best to not be obvious to avoid sanctions and destabilizing acrimony. Chinese are mostly asking when an attack on Taiwan will happen, not whether. The Chinese view the US as the generator of global geopolitical risk, and many other countries and investors appeared to agree with this framing. We sensed no light between Russia and China, other than Chinese lip-service aimed at avoiding sanctions (which we see as being on “autopilot” escalation anyway). Aerospace and aviation will also see their cohort better represented inside politics – they are being groomed for political power.

Central and Eastern Europe mixed. Hungary's central bank came off as very hawkish, and as catching up. Yields are high and they are concerned about currency weakness. (We are attracted to local-currency bonds in this setup). Poland came off as very dovish and as risking a currency-inflation spiral. Fiscal policy and monetary policy are too stimulative, it struck us. On Ukraine, the US struck us as very focused on ensuring financing and on supporting the country's domestic spending priorities. (We have a position in their bonds, but have had only tactical approaches in Ukraine this year). EMEA ratings, we should note, have been very volatile this year, which is uncommon for that region, but the obvious result of the war.

Asia came off well. Offshore investment in a lot of the EMs here declined significantly (Indonesia is noteworthy) which means that the central bank has a lot more flexibility on exchange rate management (i.e., they don't have to worry about outflows as much). Overall, fiscal policy is good, external accounts are strong, and they are simply following the DMs in their hiking cycles (not going big and early like the Latin American countries), and their currencies are still stable because their fundamentals are strong. They don't need to over-hike to generate credibility.

Latin America was loved, but we think it was not selective enough. Fairly enough, Brazil was lauded. They hiked way earlier and more than any other central bank, and are already seeing hints of progress on the inflation front. (We had exposure to Brazil locally and closed it simply because it hit our valuation targets and we are awaiting possible opportunities going into the second round of presidential elections). Mexico also got high marks, and we'd agree there. Mexico elected a leftist populist who remains very popular, kept to his fiscal targets, and made the central bank's objective function a stable currency. Colombia comes off to us as a possible accident waiting to happen; it was very loved, with no conviction (“long and wrong”, maybe?). We think there should be much greater worry over the new government's policy inclinations, and see Colombia as closer to a frontier African credit than a double-B Latin American Credit. Peru impressed, as we think it should. Its famed institutions worked and the country has reasonable fiscal and monetary policy despite an arguably market-unfriendly president (whose Finance Minister and Central Bank head are very orthodox). Chile seems to be working its way through its political growing pains, and many appreciated that extremely market-unfriendly results from its Constitutional re-think simply haven't materialized.

Turkey was interesting. But not because it was attractive. (We've criticized its heterodox policy mix for a long time, and only own one unique USD-denominated bond). Turkey was interesting due to the multiple alliances it is joining or courting. Russia and Saudi Arabia are widely viewed as behind the surprise surge in Turkish central bank reserves, which were a key weakness. This is a big, under-noticed development. We've referred to two countries as “hinges of history” in our writings over the past decade-plus – Ukraine (now in play), and Turkey (get out your popcorn). Pontification on the speed with which history is proceeding at the moment is spot-on in our opinion. The recent OPEC meeting is a good example of this. As are Russian-Turkish proposals to help gas flow to Europe via Turkstream.

Private creditors are a little noisier. Private creditors are becoming frustrated/panicked/hostile and don't yet realize the full extent to which they have zero power against the IMF and bilateral creditors. The IMF will lend into arrears on private sector debt for longer than the bondholders can keep their jobs. Private creditors were more vocal in getting the public sector (i.e., bilateral lenders in the so-called “Paris Club” and IFIs such as the IMF) to be more transparent. In particular, to share debt sustainability analyses (DSAs) for countries in debt negotiations, and to not present private creditors with fait accomplis. We don't see it. It will have to come from creditors and orthodox debtors that aren't comfortable trashing their perceived creditworthiness as readily as IFIs are.

Illiquidity and “frontier” EM were disliked...but it applies to DM bond markets, too. The terms illiquidity and frontier almost became synonymous. This struck us as an opportunity (our process is very bottom-up and if illiquidity is priced, we're biased to downplay it). Looking at October 13th intraday price move on S&P500 tells you that everything can be illiquid, so it turned out to be not a major concern for EMs.

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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Quantitative Easing by a central bank increases the money supply engaging in open market operations in an effort to promote increased lending and liquidity.

Monetary Easing is an economic tool employed by a central bank to reduce interest rates and increase money supply in an effort to stimulate economic activity.

Correlation is a statistical measure of how two variables move in relation to one other.

Liquidity Illusion refers to the effect that an independent variable might have in the liquidity of a security as such variable fluctuates overtime.

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