All the Credit®, Ep. 51

Transcript

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Female Voice: You're listening to *All the Credit*®, a monthly podcast series brought to you by PGIM Fixed Income, an active global fixed income investment manager.

Tom Porcelli, Chief U.S. Economist: Hi, this is Tom Porcelli, PGIM Fixed Income's Chief U.S. Economist, and I'm hosting another *All the Credit*® here and I have the great pleasure of having with me, Cathy Hepworth, who is head of PGIM Fixed Income's Emerging Market Debt group. And I also have Mehill Marku, who's our Lead Geopolitical Analyst. So, thank you both for being here. We're going to talk geopolitics and emerging markets. We could easily make this topic an hour plus, so we're really scratching the surface here on some of these topics. So why don't we just jump right into it. I think we should set the stage and we'll set the stage with Mehill. We have two active wars right now, is it fair to wonder why aren't they spilling over and maybe another way of asking the question is, what's different about some of the geopolitical risks now?

Mehill Marku, Lead Geopolitical Analyst: Escalation management has played I think an important role in preventing the two active conflicts from spilling over to other countries, reducing the potential market impact on assets. Cautioned by the U.S. and Germany as the leaders of the West in policy towards Russia has kept the conflict contained within Ukraine borders so far. On the other hand, China has not thrown its full support behind Russia in this war. In the case of the war in Middle East, all major players, including United States and China shared interest in avoiding a full-blown war in the region due to its potential impact on energy markets and prices. The war on Ukraine on the other hand, has signaled the prohibitive cost of war and has made particularly China think twice before taking military actions against Taiwan, providing some sense of strategic stability. On the other hand, the same war has increased the cost of global south countries due to disruption in trade and food. The very countries that China and Russia want to keep in their strategic orbit, then leading them to push back against what they see as mismanagement of the great power competition. And when the West could not bring these countries to support their stance on the war in Ukraine, it was at that time that the West decided to really change the approach to this group of countries that are uniformly referred to as the Global South countries. Jake Sullivan, the National Security Advisor has referred to this approach as new brand of diplomacy which consisted in mobilizing investment into emerging markets, expanding access to concessional and high-quality financing, closing infrastructure gap with China, committing to address the debt distress that many of these countries face, as well as supporting better representation of this group of countries into international forum.

Tom: You started off saying better escalation management, is that it? Is the bit about what Jake Sullivan highlighted, is that really sort of the crux of the escalation management part?

Mehill: Yes, it is undoubtedly one of the main things to bear in mind because it is growing realization among countries, and particularly the big powers, that even if I may use an analogy, a second league team actually can defend against a bigger league team and so that is the import of the war in Ukraine that it has signaled to countries that war can be costly and there can be no certainty who wins the war in the final account of things.

Tom: I guess if I was to ask a natural follow-up question on that, it would be why now? How did we get smarter to this approach?

Mehill: You just read the signs I think, and the rational analysts that look at what happened in Ukraine and what happened versus especially initial expectation, they would realize that there is no such thing as an easy way of winning a war. On top of that, you have the significant implications that such military confrontation have globally. You see for example, the complete breakdown of international norms, complete breakdown of international institutions, you have divisions among developed countries and emerging countries, and that leads into inability then of countries to address even issues that are of global importance, let's say climate and things like that. And that obviously even has other ramifications; fragmentation of close political divisions within the country and so on and so forth. So it is in a way learning by experience and things that should not have happened.

Tom: So one thing that we've talked about was this idea of strong China versus weak China. And with that as a framework, give us your China and your broad EM outlook. What benefits and/or risks does China represent for broader emerging markets?

Mehill: First let me, let me say an economically weak China obviously is not positive for emerging markets, especially in the short-term because it implies less financing and less demand for global commodities. And that obviously is a negative. But it can also be looked at from a different angle, it actually may be positive over the longer term mainly because an economically weak China would be a less adventurous China and so that implicitly would reduce the risk of China undertaking some adventurous, let's say military action in Asia. An economically strong China on the other hand, is a reverse of that, is positive for the emerging markets near-term but could really be negative over the long-term, that is because an economically strong China is also a militarily powerful China and it can be a China that is more confident and more risk accepting, and that implicitly raises the risk of China in the future becoming more aggressive and maybe even taking military action against Taiwan. Should this happen, then it is pretty disastrous for global markets, for the emerging markets, because of significant impact to global growth, regional growth, and other aspects, flows and everything else. So, in this sense it's always this question, which is an ideal China for emerging markets? And I would say, a China that is weak enough not to present a near-term risk, but not strong enough that would really present a risk over time of taking military adventures in the Asia Pacific. It's very difficult to quantify it, but probably five percent growth that is surprising, it's pretty good. It's not weak enough, it's decent, but it's not also strong enough to boost China's confidence in taking aggressive military action in the region.

Tom: How strong are they feeling now with regard to potentially taking some sort of aggressive tactic toward Taiwan?

Mehill: I think right now China is in a pretty weak economic state, as you know, that private sector has gotten a hit. I don't think China right now would feel comfortable thinking about taking a military action against Taiwan. In my view, the clearest example how China's confidence has been eroded due to the economic problems, is this charm offensive that China has undertaken, trying to win back investor sentiment, sending huge delegation let's say to Davos, trying to throw in relations with the United States and trying also to win over U.S. businesses. I think as long as China continues to be under this economic pressure, I think we should be comfortable that they are not going to take any action against Taiwan.

Tom: If we were to think about that over a period of time, what are the odds of that happening say within three to five years?

Mehill: I don't think that the probabilities change much three years versus five years, because on top of the economic weakness, I think there are other factors that China will be looking to avoid a direct military confrontation with U.S. over Taiwan. The base scenario for me over the five year period is that we are going to see pretty much what we have seen since Pelosi's visit in 2022, whereby China continues to erode the status of the Taiwan Strait by violating the Median Line, the air space, putting pressure on the Taiwanese military, signaling let's say efforts to close the strait, put an embargo, and things like that. So they have a whole set of tools that they can use to erode the status quo before really thinking about military action. And I don't think they sound pessimistic about it, in the end the elections were not from Chinese point of view as bad as they probably expected initially. After all, even though the DPP party, which is the ruling Democratic People's Party in Taiwan, the DPP president won the election who is perceived to be pre-independence, more voters actually voted in favor of more like a status quo type of situation than independence. So, to me it's the same thing, erosion of the status quo and coercion.

Tom: I think you framed it perfectly. If I was to take your framing of this, particularly as it relates to the escalation management part of it. I'd love for you to apply that to what's happening in the Middle East right now.

Mehill: So far despite the escalation between Iran and Israel, still the conflict is well-contained within Gaza. So, it hasn't spilled over to other regional countries. Probably there are two main reasons for it. The first reason is obviously because all major players have interest in not seeing this war expanded. For example, take the Iran case, Iran is interested in sending oil to China, United States, and China also interested in stable prices for oil, United Arab Emirates and Saudi Arabia are interested, obviously, in stability of oil supplies to the rest of Asia and they are also interested really in having a stable Middle East environment so that they can carry out the 23rd division and developing plans and so on and so forth. So, that is one reason. Another reason is the importance that these countries, particularly Saudi Arabia, has in the Middle East. As you know, this is one of those countries that in the geopolitical narrative circle, the middle powers, even though they don't necessarily suggest what the weighting of the power is, but it does suggest that they lie somewhere between the United States and China in the spectrum of geopolitics. But this country is very important and it's actually symbolic of the importance of other middle powers. But Saudi Arabia obviously has significant interest in maintaining stable Middle East as well as China and the fact that in my view, the deal that China mediated between Iran and Saudi Arabia has held, is very, very important. I can't imagine that the same situation in the Middle East would have developed the same way if there was not an agreement mediated by China. It effectively committed both Iran and Saudi Arabia not to attack each other's interests in a potential conflict, and amazingly that has held so far. But I think more broadly speaking, these middle powers are very important geopolitical actors in the world, and I mean they have regional interests, they look at the current geopolitical environment as an opportunity to advance the national interests, and they have also the wherewithal, some of them, to expand the influence regionally. And this you can effectively see everywhere you see in Saudi Arabia expanding its role in Africa and Asia, you see Turkey expanding let's say its role and Central Asia, and you see countries obviously like India also expanding and showing deep interest in the region, in Asia, Middle East, as well all the way to Latin America. So, this is a favorable environment to the extent that we can speak of such a thing for emerging markets.

Tom: And Cathy, I don't know that there's a group here who is as impacted as your team. And I think a good starting point is probably the same question that I asked Mehill, which is what's different about some of the geopolitical risks now from your perspective?

Cathy Hepworth, CFA, Head of Emerging Markets Debt: What's different is the degree of resilience that we've seen from the different segments of the asset class. And in particular, after so many shocks, right? Not just the shocks that Mehill referenced, but the shock of COVID in 2020, and some of the shocks before that, some of the dislocations before that, so EM is not as down bad as it could have been and there are a number of reasons for this. The first one is developed markets, and in particular the U.S., have demonstrated a lot more strength. Some of that's just a function of policies. And that has been super supportive for the asset class, and just for risk sentiment in general. And importantly, it reduced financial stability risk, which is key for emerging markets. Second, EM just happened to be in a better position from a policy making perspective. They had more credible institutions, so when the shocks happened and they had to increase interest rates, the central banks were able to do so and not necessarily have the currencies respond the way they would have historically. There was better savings, commodity prices happened to be higher as a result of some of these shocks and for the most part, that helps a lot of the emerging market countries, in particular some of the weaker ones. I don't want to leave the impression that the asset class didn't price, because clearly there was an impact. But I think the nature of that impact was the dispersion in pricing that we saw, in particular by credit quality. And it was not only say within credit, but also was different within local bonds and within EM FX. Right now, you might say that higher quality spreads are actually at the tighter end of the range, and when you look at stressed and distressed credits, while they've clearly come up in price, had two quarters of tremendous performance from those segments, there's still some value, there's still a lot of downside priced in. And if you take this a step farther and say okay, what's the current narrative for fixed income? Obviously, we think we eat, sleep, and drink that, and the current narrative for fixed income is one of higher for longer and this actually helps identify value in emerging markets because the yields are high and importantly, we don't see a lot of defaults on the horizon. We've had a couple over the past few years, but it's not as though there's a domino effect. And we're going to see significant weakness among emerging markets at large. So, I think that the macro context in which these geopolitical risks are playing out and that escalation containment actually helps identify some value around those risks.

Tom: So we were just at the IMF meetings in D.C., and one of the things popping up with the Fed putting 500 plus basis points of tightening into the system, and most of the other developed markets, central banks doing something similar, if someone asked you five or ten years ago, hey, you're going to see 500 basis points of tightening in the developed markets, EM would not have responded nearly as well, and I think most people probably would have said this would be a disaster. Right? Or they use some big inflammatory words like that. But would you respond differently to that question?

Cathy: What I would have said first was; the 500 basis points of hikes that we saw in the U.S., it didn't break the U.S. That was critical and the financial stability risk, which maybe reared their heads last year with SVP, it kind of quickly went away. I think the underlying inherent strengths of the U.S. economy reflects the fact that there weren't major imbalances in spite of the fact that the global economy after COVID, after the inflation shocks, after all of the concerns that we had about supply chains, et cetera, it actually ended up being okay. Maybe there's going to be a legacy of that, when we look at fiscal policy and the consequences of the fiscal policies that made it be okay, this is a tune that's very familiar in the end because debt sustainability and how you finance yourself has been a theme that the asset class has to contend with forever. I think because of that, there wasn't significant debt in a lot of the major countries, yes, in a few where we had default. So there were already constraints which limited the extent to which a lot of the emerging market countries could have been in a vulnerable position already.

Tom: I think that's a great way of thinking of it actually. Again, the natural extension of everything you're saying begs the question; how do you price in geopolitical risks now?

Cathy: So now what we do is we sharpen the lens through which we evaluate emerging market countries, and we ask, what's the new alchemy, right? We always thought about geopolitical risks, but they're a little bit bigger, notwithstanding the fact that there is some containment. And at the end of the day, the sum of all of these direct and indirect impacts of geopolitics boils down to flows to emerging markets. So, the best way to understand the longer term impact that this is going to have is to understand what countries are getting money, which countries are going to have a problem because they're not getting money, which countries can't finance themselves. So what we need to understand when we talk about the nuances of these geopolitical contours, which are about conflicts, they're about competition, they're about alignments, how is it going to affect capital market flows, FDI flows, development and concessional flows, into the different emerging market countries? And it matters because the flows and the refinancing risks can impact growth and growth is key to emerging market countries and their development into the longer term investment thesis, it's that relative growth between EM and DM for all the reasons we know, demographics, et cetera, the fact that for energy transition a lot of emerging market countries have what's needed in order to accomplish that, but growth matters because ultimately debt sustainability matters and in particular in this higher interest rate environment, it's clearly a lot more relevant and there's competition for funds. You can get attractive rates on

U.S. Treasuries. So, it's imperative that we identify issuers that have the vulnerable imbalances. So that's the thing to look for when you're trying to figure out how to price this in.

Tom: It's pretty clear that you've been able to identify some sort of nice, I guess we'd call it alpha opportunities. What can you say about that specific to your mandate?

Cathy: The one point that often gets lost is, there's a big opportunity cost now to not investing. In part because rates are so high. And when you look at the dispersion of performance, and a lot of the distressed and lower rated segment of EM, particularly in credit, has made like a valiant roar in terms of their performance. Part of that was just a recovery for perhaps some of it being mispriced after the shocks. So I think being able to look for alpha opportunities where things are mispriced because perhaps the risks are misunderstood and everybody is throwing anybody that's rated single B or triple C into the default basket, when that's not necessarily the case, because of all the reasons that Mehill mentioned. Why? Because there is a geopolitical imperative. There's a reason why a lot of these countries want to court the emerging market countries. They want stability, not only do countries not want to have risks within their own domain, but they also don't want to have it in nearby territory. Mehill talked earlier about the Middle East and the role that the likes of Saudi Arabia play in outward investment. They clearly want stability, because a lot of these countries have their own plans. They are requiring inward investment along with that outward investment, so the best way to identify the opportunities is to understand what's happened in the first place. To identify that this is what's really happening underneath the hood and to be able to say okay, well I think that this risk is appropriately priced in or not priced in.

Tom: That's where this great collaboration between you two is perfect, and the conversation is always lively and I'm so happy to be a part of it. Honestly, I think this was a great *All the Credit*® and so happy to have Cathy and Mehill help out on this really important topic. To me this is like one of those topics that we can come back to, we'll probably want to be the case for us. So, thank you everyone, for joining in on another episode of *All the Credit*®. And we'll look forward to doing another one again soon.

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