# The Emerging-Market Rally Is Far from Over

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## by Shamaila Khan, Christian DiClementi
## of AllianceBernstein


Afraid you've missed the rally in emerging-market (EM) assets? Don't be. Responsible policies and pragmatic politics have taken hold in many developing countries. That bodes well for growth and suggests the rally has room to run.

EM bonds—both US-dollar and local-currency denominated—have produced strong returns over the last year. But some investors worry that rising interest rates in the US could lure money out of EM assets and put pressure on EM government and corporate balance sheets.

There was a time when that might have been so. But as we've pointed out in previous posts, EM countries as a group today are far less vulnerable to a capital outflow than they were a few years ago. A big reason for that is that many have reduced their external financing gaps. That has shored up local currencies, many of which stand to appreciate if the US dollar's recent weakness persists.

At the same time, inflation is under control, thanks in part to firmer commodity prices, making inflation-adjusted real yields on EM bonds among the highest available.

Finally, governments across the developing world are embracing fiscally responsible policies and pragmatic politics. For example, lawmakers in Brazil have passed a cap on public spending and are on track to reform a bloated pension system. That has started to pay off in improved economic growth—a trend we expect to continue.

**GLOBAL INVESTORS ARE STILL OVERLOOKING EM DEBT**

Despite all this, investors remain underinvested in EM bonds—especially local-currency debt. Many cut their exposure between 2013 and 2016 when macroeconomic conditions and country fundamentals were less favorable. This means valuations are attractive compared to those in other sectors of the global credit market, many of which look stretched today.

Even so, investors should be selective when it comes to their EM exposure. A one-size-fits-all approach is rarely a good one in any sector. But it's never advisable when it comes to emerging markets. Country and sector selection matter.

Consider Latin America. Brazil and Venezuela share a border—but the outlooks for their economies couldn't be farther apart. One is committed to reform, while the other is undergoing a deep political crisis that is ravaging its economy. But Venezuela remains a part of the main EM bond indices. That's why it's essential for EM investors to go beyond the benchmark and embrace an active approach.

**A SLOW AND STEADY FED**

Of course, some risks are beyond the control of EM policymakers, such as sudden declines in commodity prices or global risk tolerance.

And today, there's another one that worries investors. Not only is the Fed raising interest rates, but it will also soon start shrinking its massive balance sheet by letting some of the bonds it bought after the financial crisis mature.

It's true that nobody knows for sure how this withdrawal of monetary stimulus will play out. But the Fed has stressed that it is likely to wind down its balance sheet gradually. What's more, we expect it to telegraph its intentions clearly to the market, much as it's done with its interest-rate hikes.

If there are no surprises, we won't expect monetary tightening to be too disruptive for EM assets. Again, this is largely because EM countries are in a stronger position today than they were in 2013, the last time developed-market monetary tightening roiled EM assets.

To sum up, there are a lot of reasons to like EM debt today: improved economic fundamentals, a focus on economic and political reform, and attractive valuations. To us, that’s a clear signal that the rally in EM assets is far from over.

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