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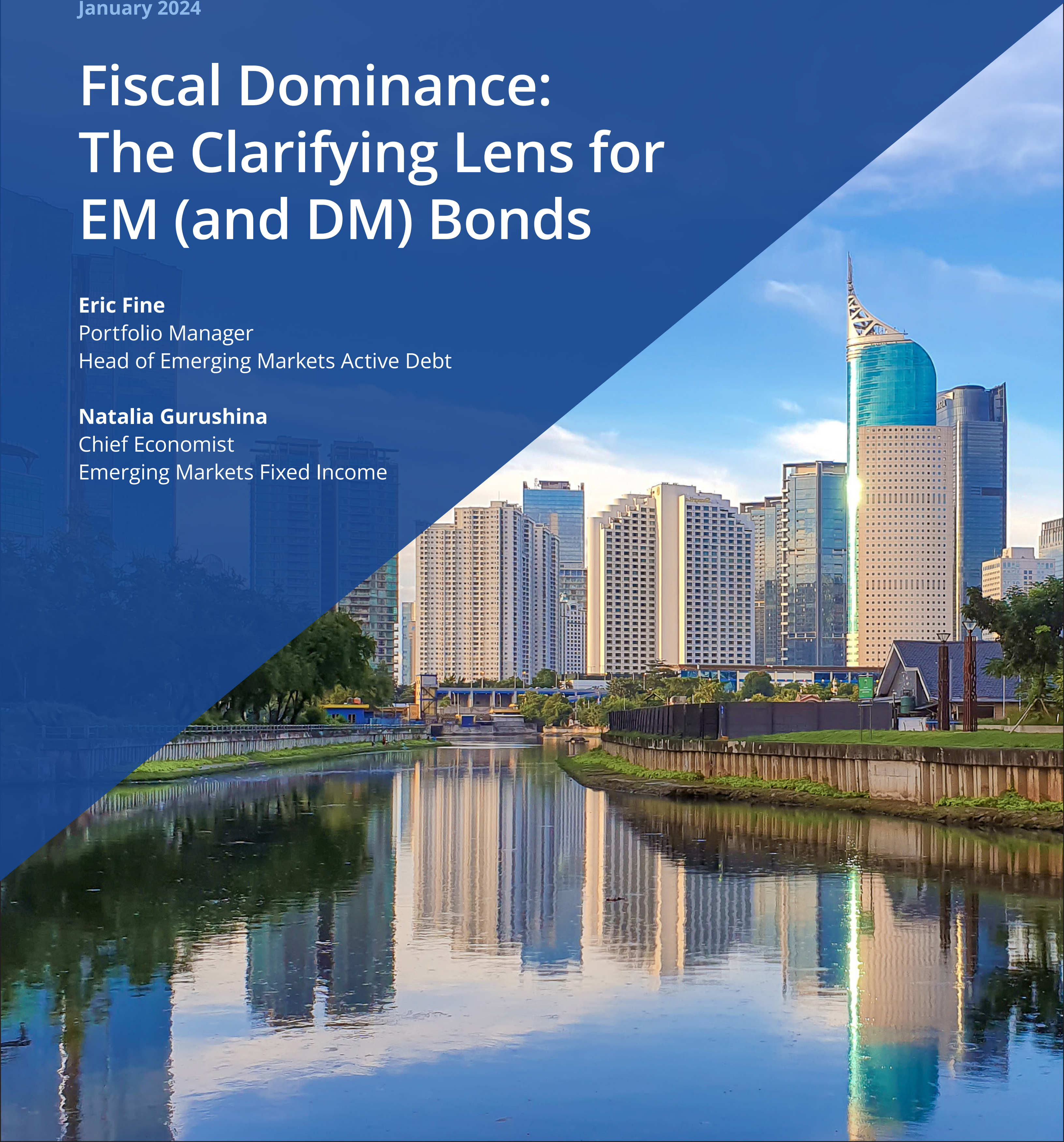
Fiscal Dominance: The Clarifying Lens for EM (and DM) Bonds

Eric Fine
Portfolio Manager
Head of Emerging Markets Active Debt

Natalia Gurushina
Chief Economist
Emerging Markets Fixed Income



Executive Summary

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so"

Mark Twain

- **The absence of "fiscal dominance" in emerging markets (EM) helps explain why EM hard-currency bonds outperformed their developed markets (DM) counterparts for the past 20 years.**
- **Emerging markets' superior fiscal and monetary policy stance is also beginning to generate better risk/return statistics in EM local-currency bonds.**
- **Low debt and deficits have allowed emerging markets monetary authorities to conduct inflation-focused monetary policy, while high debt and deficits in developed markets have diluted central bank independence and their focus on inflation.**
- **The result of developed markets' "fiscal dominance" has, in recent decades, meant that all financial crises since 1998 basically involve the large developed markets.**
- **The result is also declining inflation risks in emerging markets, but rising inflation risks in developed markets.**
- **The deficit-producing developed markets need financing from the surplus-producing emerging markets, but the emerging markets are increasingly geopolitical rivals with developed markets, increasing risks to developed markets.**
- **Within emerging markets, Asia is the first beneficiary, with the strongest policy track record and the strongest results in terms of historic bond performance and anchored inflation.**

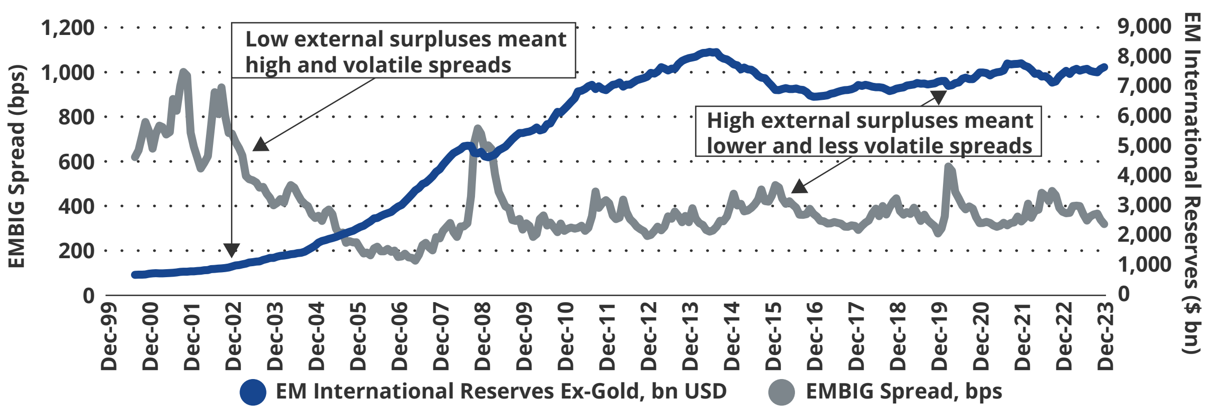
Why have emerging markets (EM) bonds outperformed their developed markets (DM) counterparts for the past 20 years?

Over the past 20 years, EM debt generated return/volatility ratios that warrant much higher investor allocations than exist. In fact, EM bonds were the only categories actually *on* the frontier itself, other than U.S. Treasuries and U.S. high yield. But to many, emerging markets are synonymous with perceived risk: the Latin debt crises of the 1980s, Mexico's Tequila crisis in 1994, Asia's 1997 crises, and Russia's 1998 crisis. These crises were resolved *decades* ago, yet linger as memories to market participants who are often "tourists" in emerging markets, despite its size, liquidity, and this historical performance (often leading to "chasing" performance at exactly the wrong moment). The reality is that much changed after 1998, as emerging markets started generating domestic savings and thus consistent and large (external) surpluses. This was the result of a "Washington consensus" on economic policy which we discussed here on RealClearPolitics *way* back in 2012.

We show this history graphically, below. The bottom line is that external surpluses (represented by central bank reserve accumulation) grew, and this led to a reduction in the level and volatility of credit spreads on EM sovereigns.

Exhibit 1 – When EMs Generated External Surpluses, Crises Abated

Emerging Markets Reserves and Spreads



Source: Bloomberg LP, as of December 23, 2023

EMs' orthodox policy stance was behind these superior risk/return statistics in EM hard currency bonds, and the stance is beginning to generate superior risk/return statistics in EM *local* currency bonds as well. We argue herein that EMs' economic policy orthodoxy over the past 20+ years, that was obvious in the performance of its hard-currency bonds, is now supporting returns of *local* currency bonds (which performed poorly in the previous 20 years from an efficient-frontier perspective). Obviously, when markets realize the broadening implications of these strong economic foundations for all EM bonds, the investment thesis will be concluded; this is a hypothesis. EM local currency bonds have not performed well in the past 20 years (again from the perspective of the efficient frontier), and we see this as having changed in recent years.

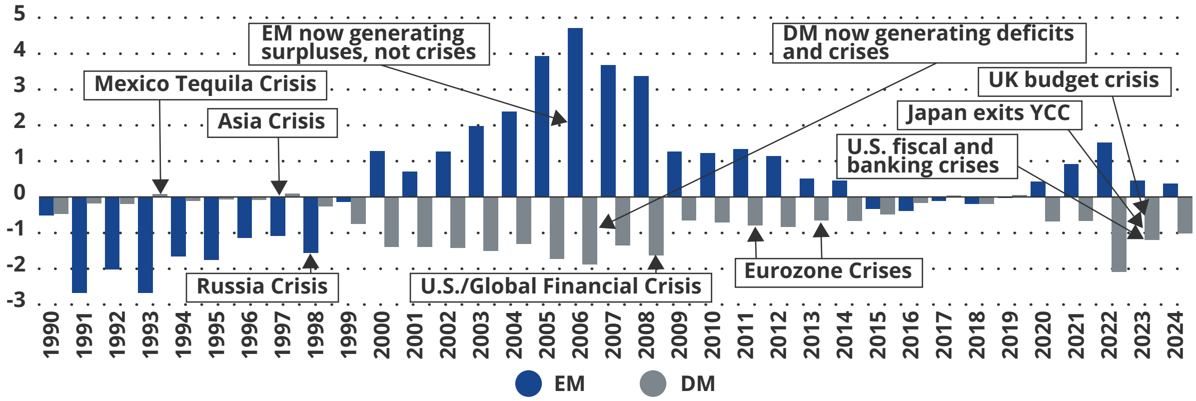
A critical "other side of the coin" is that DM bond markets have generated *disappointing* performance in the past 20 years, and DMs are the economies that fit the "fiscal dominance" criteria of high debt and debt servicing costs impinging on monetary policy. This is the "it's what you know for sure that just ain't so" part of our argument. EM bonds outperformed the Global Bond Aggregate for the past 20 years, as just a headline example (again, see our white paper for the full analysis). The chart below tracks external surpluses of the DM (and EM), showing DM external deficits dominating recently. Could DM bond markets that are stalwarts of investor portfolios be less attractive than investors expect? We think so.

During Asia's crisis (and during all other emerging market crises that I've been involved in) U.S. authorities gave the precise opposite advice (to Asian governments) that those same U.S. authorities are now giving themselves. That advice (to Asian governments) involved fiscal austerity, structural reforms, and tight monetary policy to anchor inflation expectations. And, if banking systems were over-levered, only protect depositors and congratulate bank debtors as equity holders in newly well-capitalized banks. This advice worked, which is why Asia is home to so many of our creditors, not to mention higher growth rates.

Eric Fine, *RealClearPolitics*, 2012

Exhibit 2 – DM Now Has Persistent External Deficits and Crises

EM and DM Current Account Balances, % GDP

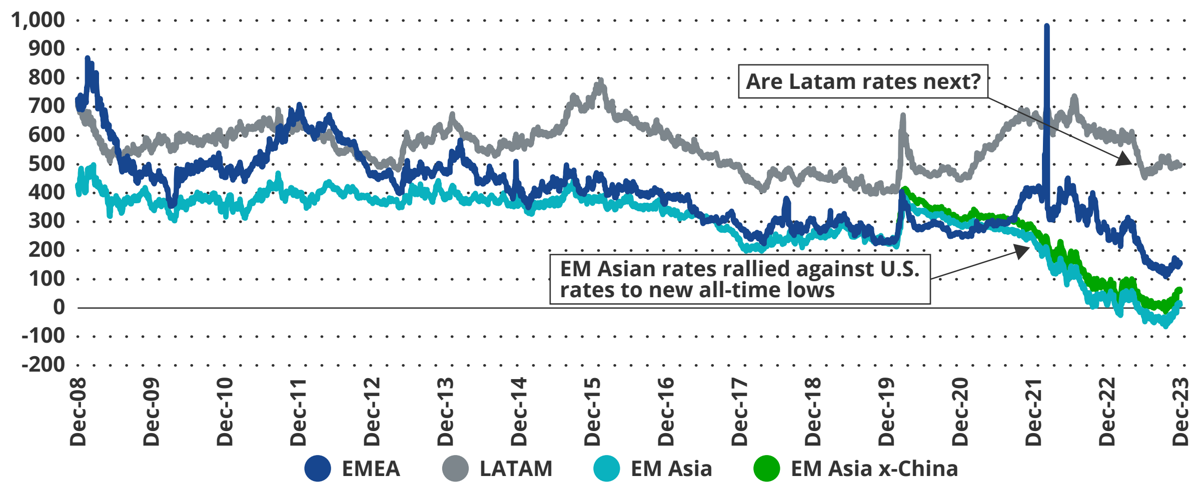


Source: Bloomberg LP, As of December 2023

What has been the outcome of DMs' "fiscal dominance" of recent decades? *All* financial crises since 1998 basically involve the large DMs. The 2008 Global Financial Crisis originated in the United States and euro zone, and was derivative-centered. The two proceeding euro zone crises (2011 and 2013) both highlighted over-indebted European governments that paid virtually no interest rate on their bonds. Looking back at those 20 years, the result has been that EM debt performance was superior to DM's. And it doesn't look set to change, if anything EM's outperformance is showing deeper strengths. Just look at 2023, a year during which the U.S. faced two fiscal crises, a banking crisis, the U.K. faced a fiscal crisis, and Japan is engaging on a challenging exit from experimental monetary policy. All of these are highly indebted economies. As we wrote in many of our monthly publications especially during the beginning of the year, much of EM (particularly EM Asian local markets) behaved as a flight-to-safety asset. And EM bonds again outperformed the Global Bond Aggregate in 2023. **We see "fiscal dominance" as the clarifying lens of this past 1-, 3- and 20-years of fixed income performance.**

Exhibit 3 – EM Asia Rates Rallied During Tumultuous 2020s

EM Regions – GBI-EM/5Y UST Yield Differentials, bps



Source: VanEck Research; Bloomberg LP, as of December 31, 2023.

Fiscal Dominance

Fiscal dominance is an economic condition that arises when debts and deficits are so high that monetary policy loses traction. This is because as debt service costs rise beyond a certain level, fiscal deficits obviously rise, but their main policy implication is that they create the need for more monetary financing. The main driver of money creation becomes fiscal policy ("fiscal dominance"), and traditional tools like higher policy rates only *feed* inflation and inflation expectations (by increasing debt servicing costs), rather than starve them. Of course, there should be a scale applied to the degree of fiscal dominance characterizing an economy, and the description above is the extreme end-result of the fiscal dominance condition, and there are intermediary stages. Also, these crises play out differently in each situation, with the financial system a key mediator. Another key fact to keep in mind is that experience with governments with unsustainable debt is almost exclusively in the hands of EM debt practitioners – DM policymakers and investors don't have experience in this area.

Fiscal dominance appears to characterize DM, not EM. The topic of fiscal dominance is relevant for many reasons, and is discussed from various angles in popular media (all those articles headlining debt service or interest costs in the U.S. and U.K., or the Bank of Japan's exit from yield curve control are all ultimately about fiscal dominance).

- First, the greater and more persistent post-Covid fiscal stimulus from the U.S. and many DMs appears to be a more important inflation driver now, certainly more than is the case for EMs that had weaker and less persistent post-Covid fiscal stimulus.
- Second, EMs' fixed income asset price performance is superior to DMs', with EMs' low debts and deficits a key explanation.
- Third, DMs' fixed income asset price performance has been characterized by multiple recent "crises" (since the GFC in 2008), driven by high debts and deficits and the relaxation of monetary traction that resulted.
- Fourth, the world's biggest DM central banks embarked on monetary experimentation with the quantity of money, greatly facilitating fiscal deficits in their countries, watching the results of that experiment are important to predicting future asset-price outcomes.
- DMs engaging in monetary experimentation *because* normal monetary policy (i.e., setting the price of money, not its quantity) didn't have traction, a hallmark of "fiscal dominance" (that was tried and failed in EMs in previous decades).

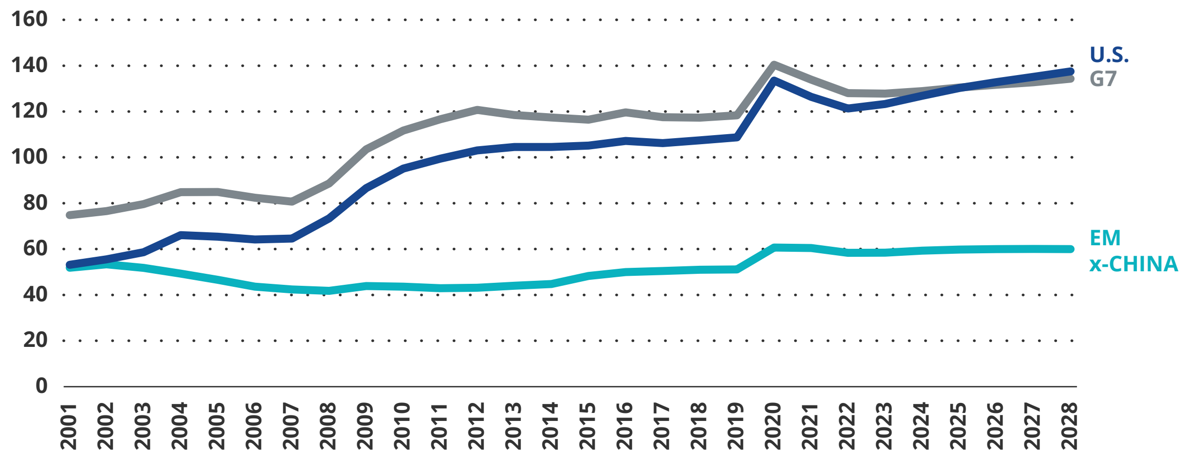
DM hard-currency government bond markets have not delivered attractive risk-adjusted returns compared to EM hard-currency government bond markets, and local-currency bonds look set to benefit next. As theory would predict, economic policy orthodoxy over decades should result in lower inflation and inflation expectations, and that's what we are seeing (details below). The neutral real rate (R*) appears to be declining in EM, supporting its local-currency fixed income markets, while rising in DM. Below, we argue that the lens of fiscal dominance explains these likely continued outcomes. If this is correct, it will mean yet another category of EM debt will be subject to supportive secular tailwinds.

Debt and Deficits

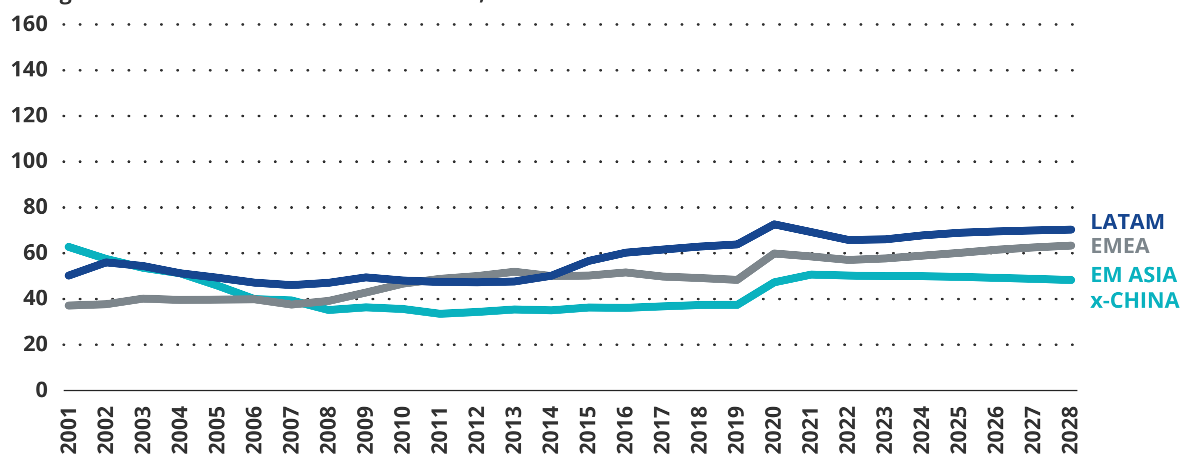
EM has much lower levels of government debt than DM. This is clear in Exhibit 4. What's also interesting to us is that *within* EM, Asia (ex-China) has been a leader in maintaining low debt levels, with South America lagging this improvement. This is a pattern you will see throughout – EM has better fiscal outcomes than DM, and within EM, Asia (ex-China) is the leader in fiscal rectitude. We mention these *two* outcomes because not only has EM outperformed DM, but Asian EM local-currency has performed exceptionally well within EM.

Exhibit 4 – EM Debt Lower than DM, Asia Lowest in EM

General Government Gross Debt, % GDP



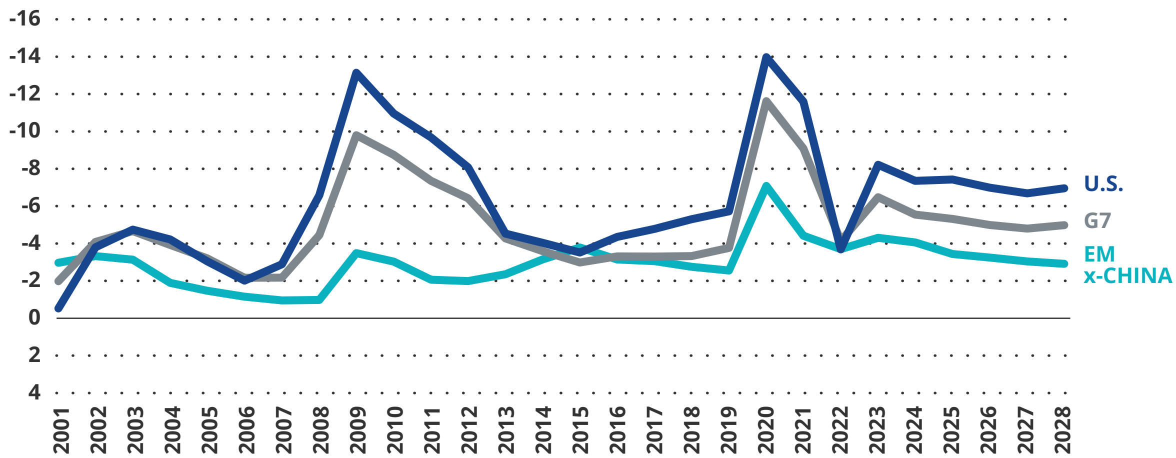
EM Regions - General Government Gross Debt, % GDP



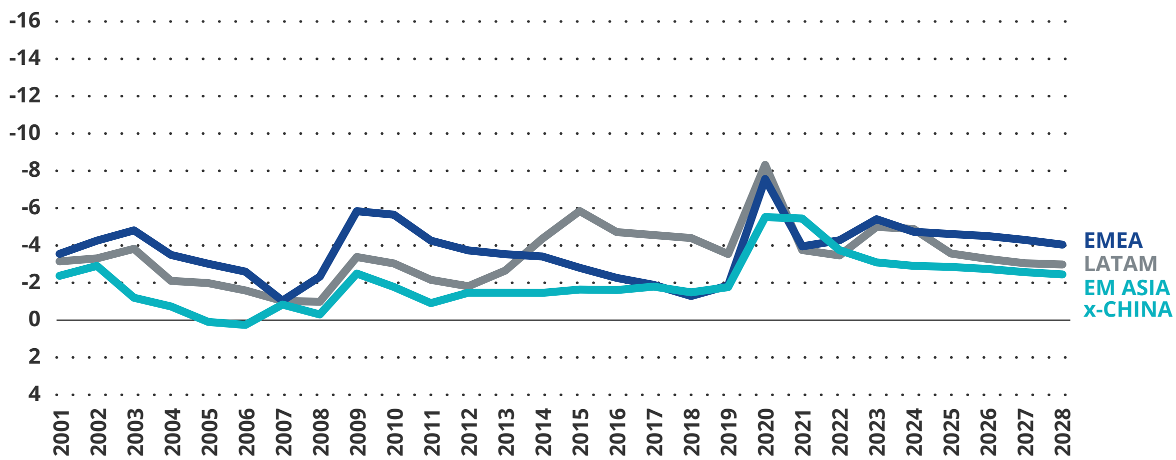
Source: IMF via Bloomberg LP; VanEck Research, as of December 2023

EM has much lower fiscal deficits than DM. This shows in Exhibit 5. EM deficits are consistently lower than DM's, and are forecast by the IMF to continue to be so. And again, within EM, Asia's deficits are consistently the lowest on a historical and forecast basis. We added Exhibit 6 to show net interest outlays in EM (ex-China) compared to the US, again using IMF forecasts. This shows the U.S.' growing fiscal dominance going forward, relative to the EMs (defined here as bond index components, not economies), as initial debt conditions translate into debt servicing cost. Low interest rates, whether sustainable or not, can't compensate for an excessive debt stock in DM. Conversely, a low debt stock can see debt sustainability preserved even through periods of high interest rates that EM sometimes experienced. And, inside the forecasts, Asia is also the leader.

Exhibit 5 – EM Deficits Low, Especially Asia, U.S. Deficits High
General Government Gross Debt, % GDP (inverted)

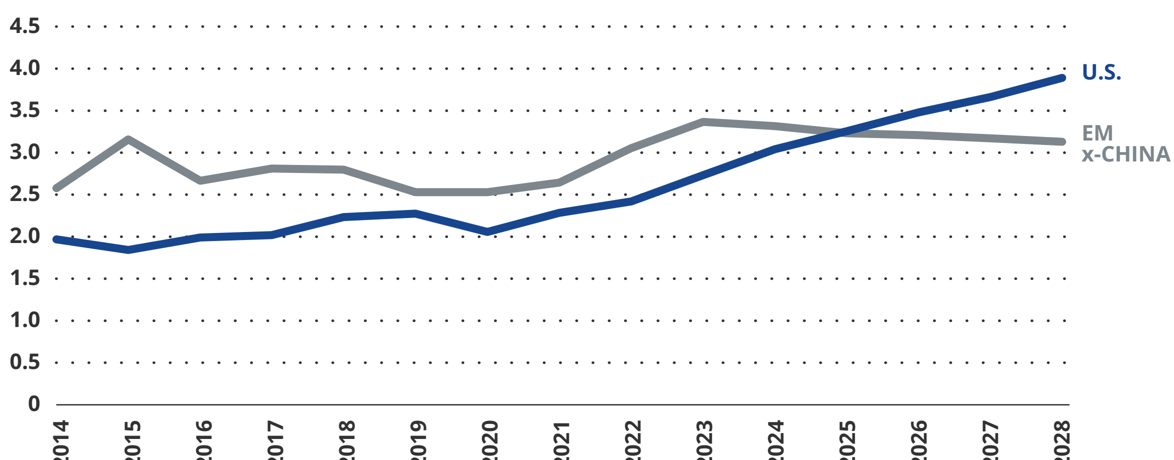


EM Regions - General Government Gross Debt, % GDP (inverted)



Source: IMF via Bloomberg LP; VanEck Research, As of December 2023

Exhibit 6 – U.S. Interest Outlays Keep Rising, EM Stable
Net Interest Outlays, % GDP



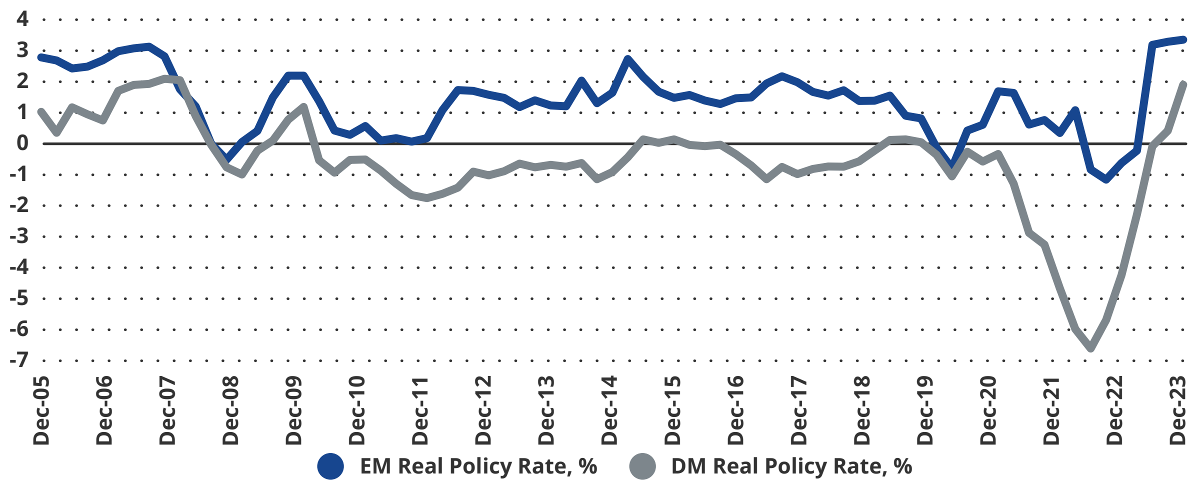
Source: VanEck Research, IMF via Bloomberg LP, as of December 2023

Note: EM x-China - Indonesia, Malaysia, Philippines, Thailand, Poland, Hungary, Czech Republic, South Africa, Brazil, Mexico, Chile, Colombia, Peru

Monetary Policy

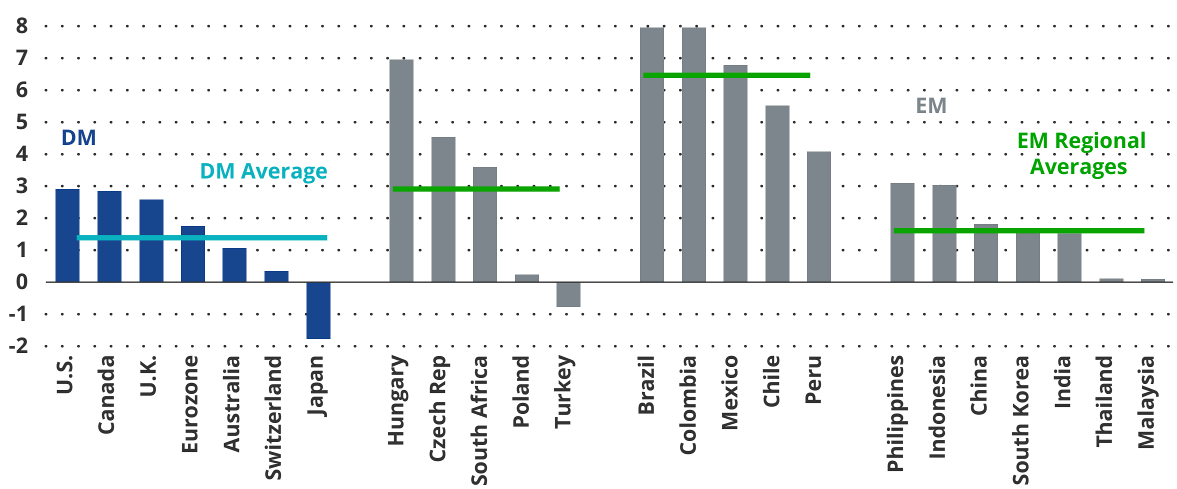
Theory would say that EMs' superior fiscal stance gives greater freedom to central banks to pursue independent monetary policy, in particular the maintenance of high real interest rates, and this is exactly what materialized. Exhibit 7 below shows the real policy rate of EM (using the IMF definition of EM economies, not bond index components) compared to DM over the past couple decades. EM central bank policy rates were consistently higher, and EM central banks were earlier to the latest global hiking cycle. This evidence suggests that lower debts and deficits are allowing monetary authorities to concentrate policy on anchoring inflation and inflation expectations, and government financing isn't diluting this concentration. We add Exhibit 8 to show that within EM, it is the Asian central banks that have been able to maintain the lowest real policy rate relative to DM. This indicates that markets are rewarding Asia's economic progress relative to other EMs.

Exhibit 7 – EM Real Policy Rates Higher Than DM
Ex-Post Real Policy Rates in EM and DM, %



Source: Bloomberg LP, as of December 2023

Exhibit 8 – Market Respects Asian Policy Mix - EM Asian Policy Rates Don't Need to Be *Too* High
Real Policy Rates in EM and DM

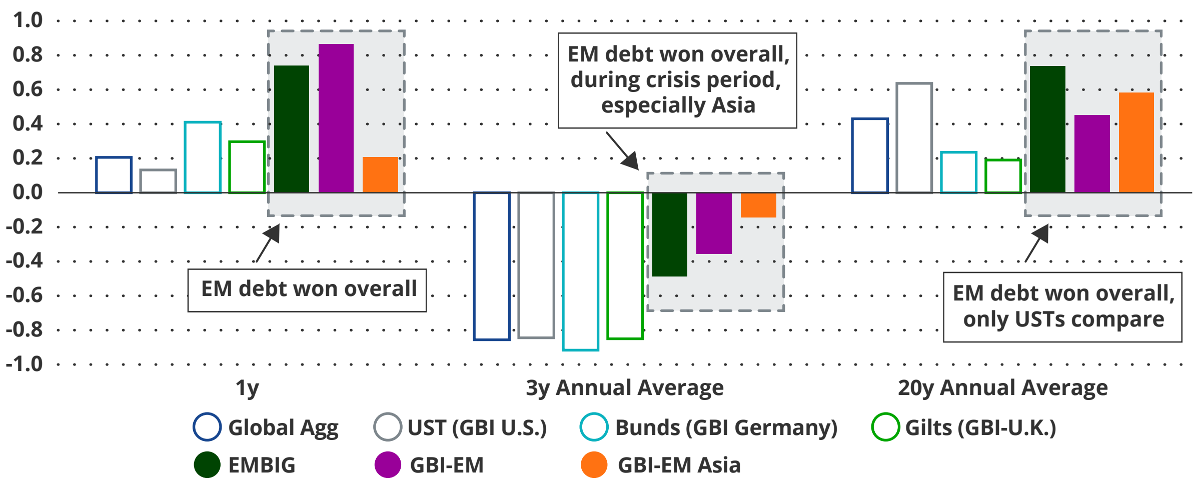


Source: VanEck Research; Bloomberg LP, as of December 2023

So what?

First, we now have a possible explanation behind the past few decades of both EM bonds' outperformance relative to DM, but also of Asia's strong position within EM. Our white paper on asset prices reviews our efficient frontier analysis in detail. Here, we simply produce a volatility-adjusted return profile for key fixed income categories over the past 1-, 3-, and 20-year periods. In the 20-year period, EM hard- and local-currency debt outperformed the Global Aggregate and only U.S. Treasuries were competitive. In all periods the EM hard-currency bonds outperformed the Global Aggregate Index. In recent periods (1- and 3-year) local-currency bonds also started outperforming the Global Aggregate. (Keep in mind that our white paper using the efficient frontier agrees with this – local-currency doesn't look awesome on a 20-year lookback; but, our point is that local-currency should begin to exhibit some of the performance characteristics generated by hard-currency). And within EM local-currency bonds, Asia (ex-China) outperformed in the 20-year and 3-year periods. In the past 3 years defined by DM banking and fiscal issues, EM clearly did "best" or "least bad". And in the past 20 years, EM hard-currency and local-currency bonds beat the Global Aggregate with only U.S. Treasuries providing competition for EM local-currency bonds (but not Asian local-currency bonds).

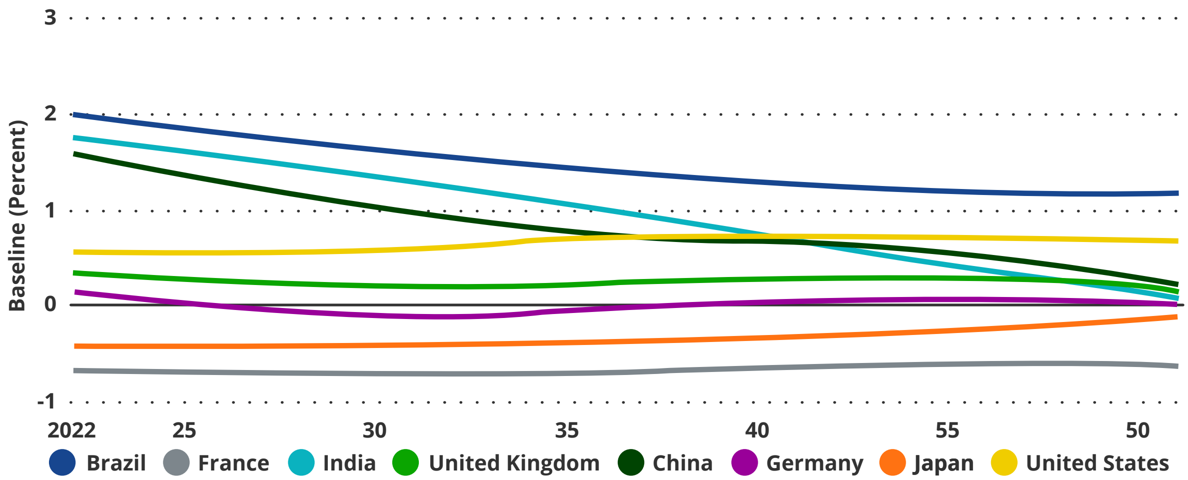
Exhibit 9 – Average Annual Total Return Adjusted by Volatility



Source: VanEck Research; Bloomberg LP, As of December 2023

Second, theory would say that EMs' superior fiscal and monetary stances should anchor inflation and inflation expectations, and that looks to be happening - R* appears to be declining in EM, while rising in DM. EM's presumed policy/macroeconomic "inferiority" was a likely factor that stopped EM real interest rates from falling in line with their DM counterparts after the global financial crisis of 2008-09. And Asian policy rates were allowed to get closer to their DM counterparts due to an appreciation of their more advanced state within EM. Of course, there were other common factors behind the divergence between EM R* and DM R*, including DM's aging population and slowing productivity growth. Global liquidity flows, unconventional monetary policy in DM, and the recycling of EM's "excess" savings into "safer" assets and also helped to push DM real rates and the natural rate of interest down. The natural rate of interest might be a theoretical construct that is defined as the real interest rate that neither stimulates nor contracts the economy – but it nevertheless informs central banks' decisions, and as such it is very relevant for our discussion. Below, in Exhibit 10, is the IMF's simulated path for the natural rate of interest. What stands out is the convergence of EM rates to DM, as well as the output that the U.S. rate stays sideways.

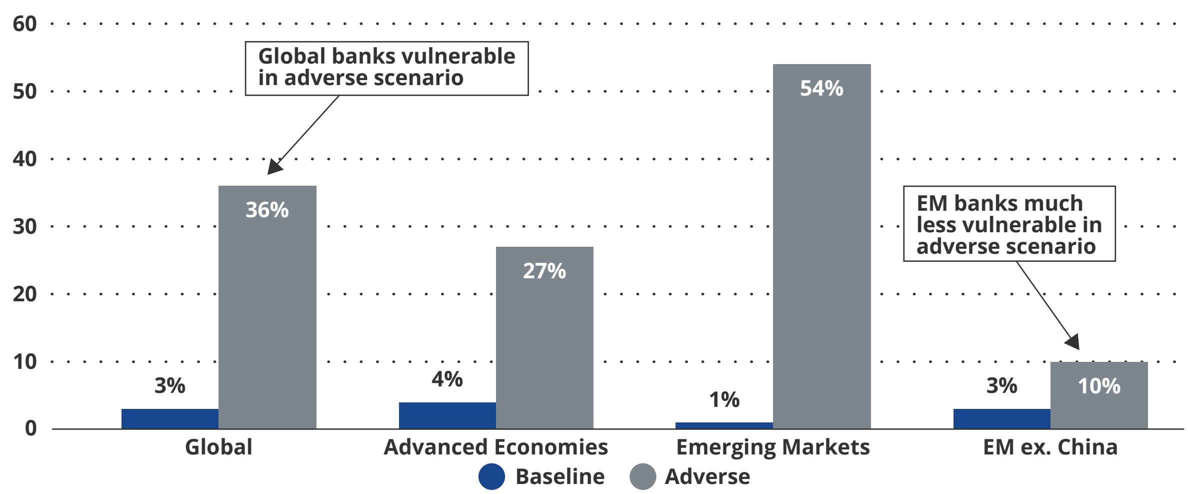
Exhibit 10 – Where are Global Interest Rates Headed?



Source: IMF, as of December 2023

One last point about banking systems, which often mediate these initial economic conditions – DM banks appear much riskier than EM banks. Banking systems usually absorb the shocks presented by economic outcomes. According to our calculations, DM banks' common-equity-to-assets ratios are about 2 standard deviations *weaker* than the global mean, and EM banks are superior to the global mean. The IMF, which has recently been sounding warnings about fiscal dominance (they use the term "financial dominance") is highlighting DM banking systems' vulnerability in adverse scenarios. In particular, they noted DM banks' vulnerability to a "stagflation" scenario and produced the chart below. What it says is that DM banks may see significant hits to capital, while DM banks should not. We make this point to emphasize that there is not a "silver bullet" to solve policy mistakes, though DM policy makers have been conditioned to assume their banking systems are stable and strong. In particular, 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 DM banking sector (plus China). CET1 ratios fall below 7% for 27% of developed market banks and 50% of Chinese banks. EM banks, in contrast, fared well with just 10% falling below 7%. To quote Mark Twain again, *"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."*

Exhibit 11 – IMF Says DM Banks Vulnerable to "Stagflation" Scenario
Shares of Total Assets by Region (Banks with CET1 below 7%)



Source: IMF, as of December 2023

Geopolitics and fiscal dominance

Geopolitics have economic implications for EM and DM, and economics (in particular fiscal dominance) has implications for geopolitics. We discuss particular phenomena in our monthlies and other publications in more detail. In general, the implications are:

- Higher defense spending in the DM, adding to fiscal pressure. DM defense spending looks set to increase due to geopolitical pressures. These add to the fiscal stresses in DM. If accompanied by higher inflation (often a symptom of war) and interest rates, the DM debt dynamic could begin to fray. U.S. deficits were forecast by the IMF to be in the 6%-8% range (above) *before* geopolitical risks became obvious to most forecasters.

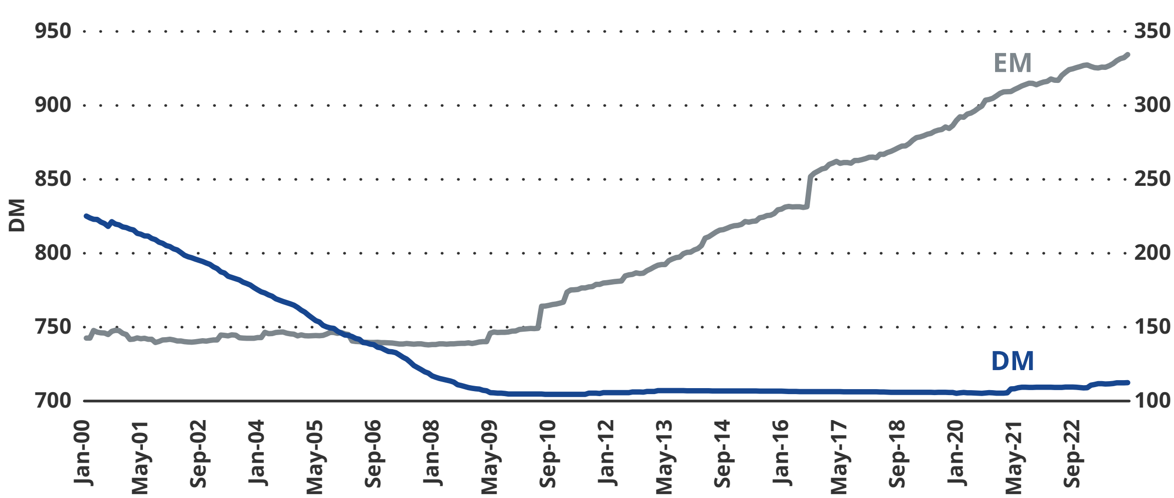
- CNY market share in international trade is low (at below 5%), but is in the top-4 (approaching GBP) and rising. EMs are further integrating their economies, with finance a key focus. Saudi Arabia now conducts oil sales to China in CNY, India in INR with UAE, Saudi and China with Brazil in BRL, etc. Purchases of these EM currencies by central banks in the long run results in the their purchase of EM bonds in these currencies (just as Saudi and Chinese reserves were accumulated in U.S. Treasuries because sales generated USD).

- Look for increased use of EM bonds as reserve assets, decreased use of DM bonds as reserve assets, prospectively. U.S./E.U./Japan, etc. (i.e., DM) sanctions freezing the Central Bank of Russia's reserves of Treasuries (and JGBs, etc.) has forced all EM central banks to reconsider their reserve holdings in light of this new fact. Reserves should not be subject to sanctions risk from the perspective of EM reserve managers, for whom reserves are a nation's safety net that should by definition should be "risk-free".

- "Stagflation" that helps EM and hurts DM appears to be a real long-term scenario. Supply risks and greater economic integration in EM mean that rising commodity prices are likelier, and have a differential impact – India and China paying a different (and unknown) price for oil than do the DM is a glaring example. EM (defined by EM bond indices) include many commodity exporters, which can benefit in this scenario. DM are largely commodity-importing.

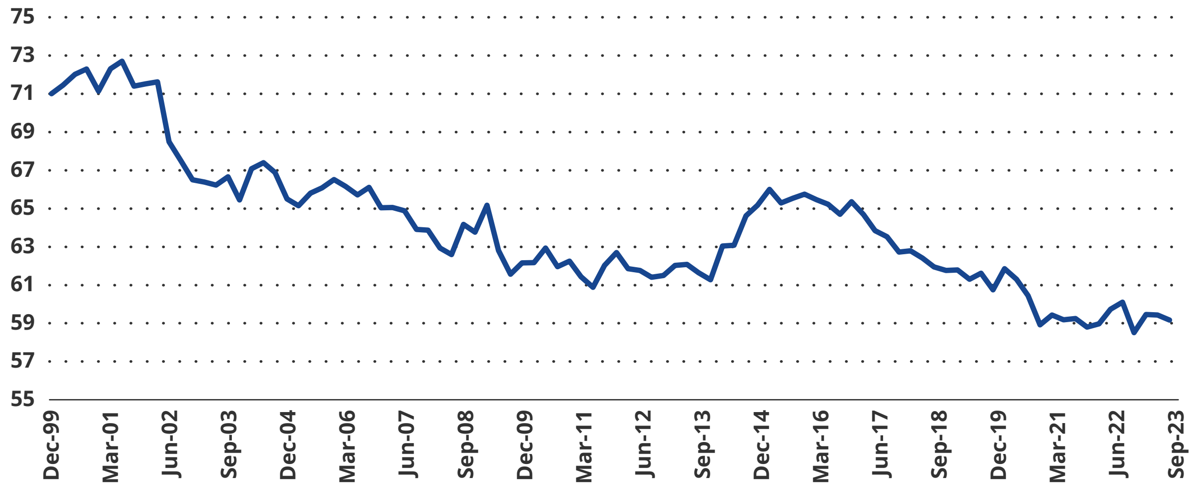
These implications will take many years to play out, but they represent a long-term tailwind for EM local-currency bonds. As we showed at the outset, *it is the deficit-producing DMs that need financing from the surplus-producing EMs*, whether the situation is understood that way yet, or not. The fact that EM and DM are increasingly in geopolitical disagreement represents an obvious global market risk. *It is risky to depend on adversaries for one's financing is a sentence that shouldn't need to be written, but here we are.* EM central banks will increasingly want reserve assets backed by high real yields and debt sustainability, with zero sanctions risk. Central bank purchases of gold are by now well-reported and known, especially the fact that now both EM *and now* DM central banks are buyers. Gold is the easiest first-reaction from central banks. But, bonds with yield and currencies with use in trade are the ultimate desire for reserve managers and they will find these in EM local-currency bonds. Like we said above, this is a long-term tailwind, not translating into a straight line. In particular, the USD has a key structural support – most global debt is denominated in USD. This means that "risk-off" translates into USD-up. This is less-and-less the case, as we show above with Asian EM local currencies rallying during the U.S.'s fiscal and banking issues in 2023 for example. There, countries that proved their fiscal and monetary rectitude over decades *rallied* as DM bond markets suffered. Put differently, the USD-up is increasingly only up against the other DM currencies and the riskiest EM currencies, not against the best EM currencies. **Anyway, our general point is that even geopolitical developments that are getting increased attention support our fiscal dominance thesis.**

Exhibit 12 – Global Central Bank Gold Purchases and U.S. Treasuries in Global Reserves
Reserve Gold Holdings, min Troy oz



Source: Bloomberg LP, source as of December 2023

Foreign Exchange Holdings in U.S. Dollars, % of allocated reserves



Source: Bloomberg LP, source as of December 2023

A note on methodology

In some cases, categories such as “emerging markets” and “developed markets” above are not consistent. First and foremost, when we use the term EM we are referring either to the IMF (and sometimes Bloomberg) category based on economic considerations, or the bond index categorization (but never to an equity index categorization, though the economic definition comes closer). For example, when using IMF data sources, a broader number of EM countries is included to measure their *economic* importance, whereas when we display market-oriented data the “emerging markets” are based on bond index components when possible. Similarly, for “emerging markets” and “developed markets” real policy interest rates, we use Bloomberg as our data source, and the sub-components of Bloomberg’s metric won’t precisely fit the sub-components of the popular bond indices. Another example, when we compare EM sovereign credit spreads to reserves, the reserves data is for “emerging markets” as defined by the IMF in *economic* terms, whereas the credit spreads are for the sovereign bond index components. We also use the U.S. as a stand-alone, as well as the G-7, as proxies for DM, and we ex-China in some cases. In all cases, custom-adjusting the data (to have the economic measure adjusted to reflect only countries with bonds in indices) didn’t change the points we intended.

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