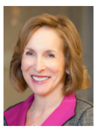
The "EM-ification" of DMs

Insight from sub-adviser, Wellington Management



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Key Points

- We believe that many DM countries are beginning to resemble their EM counterparts in some ways.
- Complacency around the state of DM fundamentals could be shaken if they were to further erode and become more difficult to overlook, or if some DMs were to exhibit more EM-like behavior that begin to test investors' faith in their degree of policy flexibility.
- Traditional EM and DM distinctions may become more blurred and perhaps even no longer be particularly useful to investors.

"TWIN CRISES AND SURGING ANGER CONVULSE US" (NEW YORK TIMES, JUNE 2020).
"UK Government Deficit Soars to Record High on Pandemic Borrowing" (Financial Times, November 2020).

These are sensational headlines designed to grab readers, but they (and others like them) nonetheless point to a global phenomenon that has gone largely unnoticed up until now—the "EM-ification" of DMs. Put simply, several of my colleagues and I share the view that many developed-market (DM) countries are beginning to resemble their emerging-market (EM) counterparts in some ways.

Does this mean that long-standing DM and EM classifications may eventually be no longer relevant? Will investors have to start analyzing DMs through an EM lens? Time will tell, but in the interim, we believe this nascent macro trend bears watching. Let's look at the evidence, possible paths forward, and related investment risks and opportunities.

More Fragile DM Fundamentals

At a high level, it's fair to say that economic and other fundamentals in DMs have become increasingly fragile over the past decade-plus. During that period, severe stress episodes such as the 2008 Global Financial Crisis (GFC) and the COVID-19 pandemic have spotlighted and, in some cases, accelerated this weakening of fundamentals in some countries.

For starters, many DM governments currently find themselves awash in debt. A variety of financial and political strains since the GFC has resulted in an unprecedented surge in government debt burdens. In fact, as a percentage of gross domestic product (GDP), aggregate DM debt has been climbing steadily since all the way back to the turn of the millennium, outpacing the rate at which EM debt has risen over the same period (**FIGURE 1**).

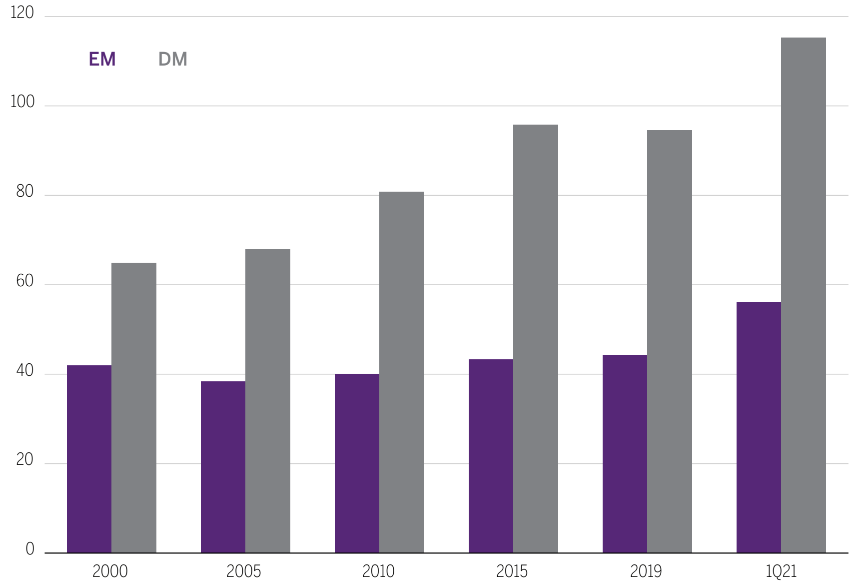
Long term, we see DM debt continuing to rise as social fissures—including income inequality—intensify political pressures to expand the social safety net in support of less fortunate citizens.

The Economist Intelligence Unit Democracy Index[1] recently showed that the world is in the midst of what we term a "governance recession."

FIGURE 1

DM Governments Awash in Debt

DM and EM debt (% of GDP)



Source: Datastream | Chart data as of 3/31/21

On the monetary policy side, global central banks have repeatedly come to the rescue in times of crisis. As a percentage of GDP, DM central-bank balance sheets have been growing since 2008, ballooning most recently in the spring of 2020 in response to COVID-19. Relatively tame inflation for the better part of the past decade has made it easier for central banks to pursue and maintain accommodative policy, including historically low interest rates.

In addition to financial stressors, the quality of government institutions worldwide appears to have deteriorated. The Economist Intelligence Unit Democracy Index[1] recently showed that the world is in the midst of what we term a "governance recession" based on five key categories across a range of global governments: 1) electoral process and pluralism; 2) civil liberties; 3) the functioning of government; 4) political participation; and 5) political culture. A key takeaway here is that minority and lower-income populations in some countries feel "disenfranchised."

This is worrisome because stronger government institutional quality and greater income equality tend to breed higher GDP per capita—a trait often associated with some DMs—as well as lower volatility in the form of a more predictable business operating environment. It's noteworthy that the US and the UK, two of the world's "most developed" markets, both seem to be moving in the wrong direction on this front.

Thus far, investors have more or less given DMs a pass on these issues due to an entrenched belief in DMs' continued policy flexibility and institutional strength. Indeed, markets haven't seemed to really care about mounting government debt loads and balance sheets except during very challenging

[1] The Economist Intelligence Unit's Democracy Index measures the quality of the democracy in a country and is published on a yearly basis.

[2] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

The lack of any sustained adverse investment fallout suggests that global markets remain largely oblivious to, or at least complacent about, the fragile state of fundamentals in many DMs.

periods such as the eurozone debt crisis, Brexit turmoil, and COVID-19. On all three occasions, European investment-grade corporate bond spreads[2] spiked sharply.

To us, this lack of any sustained adverse investment fallout suggests that global markets remain largely oblivious to, or at least complacent about, the fragile state of fundamentals in many DMs. And as we know from past experience, complacent markets are often a recipe for trouble.

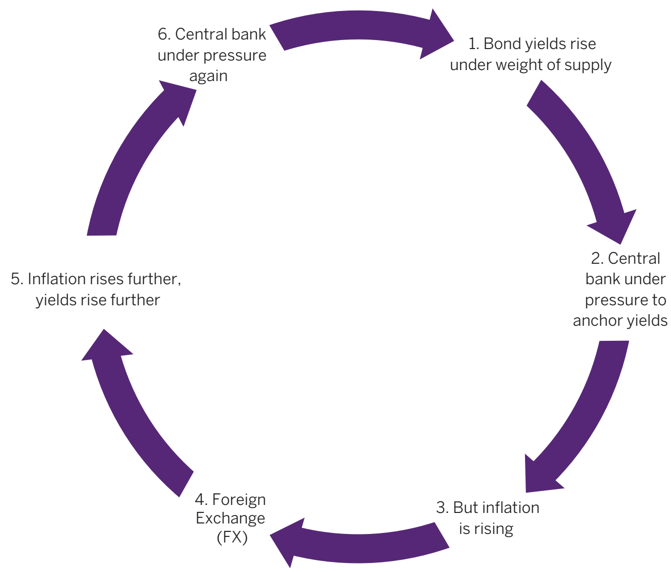
Possible Paths, Investment Implications

That complacency could be shaken going forward if DM fundamentals were to further erode and become more difficult to overlook, or if some DMs were to exhibit more EM-like behavior (**FIGURE 2**) that begins to test investors' faith in their degree of policy flexibility. As one recent example, UK markets acted decidedly more EM-like following the pivotal 2016 Brexit vote. This would be approaching a worst-case outcome, but one that cannot necessarily be ruled out.

FIGURE 2

How Could a DM Transition Toward "EM-Like" Behavior?

Identifying the threshold for loss of policy flexibility



Source: Wellington Management | For illustrative purposes only.

Under this type of negative scenario, markets could start to mete out harsher punishment to some DM assets over time. While not a complete list, potential investment implications include (see **FIGURE 3** on page 5):

Credit Markets

- Government bond yields rise due to a combination of higher inflation and poorer credit quality.
- Credit spreads widen on tightening credit conditions, causing some defaults.
- Credit assets broadly underperform government bonds, but outperform equities.

The EM-ification of DMs is not an irreversible trend if appropriate measures are taken to slow or unwind it.

Equity Markets

- Discount rates move higher and, accordingly, equity valuations come down, while risk premia increase.
- Greater risk perception creates currency weakness in the case of some DMs.
- A more volatile regulatory policy backdrop saps consumer and business confidence.
- Reduced confidence hampers investment and growth, depressing earnings and valuations.
- Companies face higher funding costs, further weighing on earnings and valuations.

Of course, there is more than one possible path to consider regarding the future evolution of DMs. The EM-ification of DMs is not an irreversible trend if appropriate measures are taken to slow or unwind it. For instance, along with the negative outcomes described above, there is a potential positive scenario whereby DM governments ratchet up their level of fiscal spending, strategically investing in areas such as infrastructure and green energy.

Such targeted investments could have a meaningful long-term impact in terms of boosting a nation's productivity, economic growth, and policy flexibility. Potential investment implications of this scenario include:

Credit Markets

- Government bond yields rise due to higher economic growth and inflation.
- Credit spreads narrow on improving credit conditions, lowering default risk.
- Credit assets broadly outperform government bonds, but underperform equities.

Equity Markets

- Discount rates move lower, leading to lower risk premia and higher equity valuations.
- Decreased risk perception creates currency strength in the case of some DMs.
- A more investor-friendly regulatory policy backdrop aids consumer and business confidence.
- This favors highly regulated industries such as banking, utilities, and telecommunications.

FIGURE 3
Positive and Negative Scenario Implications

	Negative Scenario	Positive Scenario
Rates	Higher	Higher
Credit spreads	Wider	Narrower
Equity	Lower	Higher
Foreign Exchange	Stronger	Weaker

Source: Wellington Management | For illustrative purposes only.

There is also a potential status-quo scenario where DM government debt keeps rising, but policy flexibility persists and interest rates stay relatively low.

Bringing it All Together

- A DM debt reckoning is a plausible outcome within the next five years that is still being downplayed or dismissed by the markets.
- Given exhausted monetary-policy options and deeper social tensions, fiscal and political tools may become primary avenues for solutions.
- An uncertain fiscal and political landscape may foster increased market volatility and greater dispersions among countries and companies.
- Country and issuer selection in both credit and equities may be paramount and could favor actively managed investment strategies.
- Traditional EM and DM distinctions may become more blurred and perhaps even no longer be particularly useful to investors.
- Higher levels of government investment in growth-promoting initiatives could turn the tide back positively for many DMs.

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