February 2021

Emerging Market Debt Indicator

The fast view

Market Background

- The JP Morgan Government Bond Index–Emerging Market (GBI-EM) Global Diversified fell in February, producing a total return of -2.68% in US dollar terms, while the JP Morgan EM Bond Index declined by 2.55%.
- The 10-year Treasury yield rose sharply to a 12-month high, reflecting expectations of brighter prospects for the economy and increasing inflation fuelled by the US$1.9 trillion stimulus package.

Africa

- In Zambia, the central bank is creeping towards policy normalisation. With inflation running at over 20%, it hiked interest rates by 50 basis points to 8.5%.
- The government in Kenya secured a 38-month US$2.4 billion IMF support programme. This deal, together with a debt service suspension of almost US$1 billion, bodes well for external balances.

Asia

- Export data continued to be strong, particularly in North Asia, where Taiwan and South Korea posted strong numbers.
- The regional vaccine programme is being rolled out at a slower pace than in many developed nations. Despite this, it is strengthening local trade balances by offsetting increasing exports with lower levels of domestic imports.

Latin America

- By mid-February, most countries in the region had begun their vaccination programmes, led by very rapid progress in Chile.
- The surprise dismissal of the Petrobras CEO sent shockwaves across Brazilian financial markets and impacted local bond prices across the curve.

CEE

- The national banks of Poland and the Czech Republic both upgraded growth forecasts for 2021.
- In Serbia, interest rates remained on hold at 1%. In Hungary, the deputy governor of the national bank hinted that no change in policy or one-week deposit rates should be expected in the short term.

Rest of EMEA

- COVID cases are falling across the region, with Israel and the UAE still leading the way in vaccination rollouts.
- In Turkey, the central bank kept interest rates on hold while reiterating its positive forward guidance. The 2021 budget in South Africa proved to be a pleasant upside surprise for investors.

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The positive sentiment that helped drive markets higher at the start of the year continued into February. Financial markets continued to set records in the US. Investors bullishness was reinforced by the accelerating rollout of COVID-19 vaccination programmes and hopes that developed economies could return to near-normal operating conditions by the second half of the year. Led by copper, which rose to its highest price since 2011 supported by Chinese demand, a broad range of commodity prices hit multi-year highs during the month, boosted by their attractions as inflation hedges. Oil prices reached their highest in over a year, partly due to supply outages in Texas due to extreme cold weather.

Most of the action, however, was in rates markets. The 10-year Treasury yield rose sharply to a 12-month high, reflecting expectations of brighter prospects for the economy and increasing inflation fuelled by the USD 1.9 trillion stimulus package. Unease increased during the month about the effect of a possible rate rise. Emerging market (EM) debt came under modest pressure as a result, with some fear of a renewed 'Taper-tantrum'. However, any concerns were answered emphatically by US Federal Reserve (Fed) Chairman Jerome Powell's testimony to Congress during the last week of February. He reiterated that the Fed would not raise interest rates until inflation and employment targets were achieved, which could take some time.

Peter Eerdmans

Head of Fixed Income and Co-Head of Emerging Market Sovereign & FX

Top-down views and outlook

The rise in treasury yields since the beginning of the year has been driven by the anticipated recovery in global growth and fiscal stimulus in the US. We believe yields will not rise materially further, especially in the short end which should remain anchored with the first Fed hike not expected until 2023 or beyond. As such we see any related weakness in EM debt assets as a buying opportunity.

A revival in the manufacturing sector continues to be supportive for EM, with demand being buoyed by US and European consumers. Although the reintroduction of lockdown measures across the world will weigh on the service sector, particularly travel, this is generally a smaller portion of most EM economies and so has a larger impact on developed markets. We are seeing some weakness across EMs as a result of further lockdowns, but as vaccine programmes are rolled out and restrictions start to ease, the subsequent recovery in activity should spark positive growth during the second quarter and a return to near normality later this year.

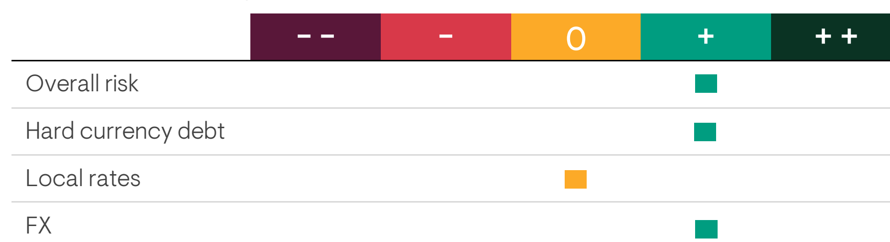
We believe the central bank put remains in play and signals ongoing central bank support as lenders of last resort. The new US administration is also expected to be supportive for EM assets, as it is likely to introduce a more predictable foreign and trade policy. We think these macro and geopolitical adjustments are likely to be accompanied by a high degree of divergence for sovereign debt, reflecting factors such as countries' vulnerabilities at the beginning of the crisis (and which may have been exacerbated by the pandemic), how well governments have been handling the crisis, and crucially how they will finance their deficits.

With a large proportion of developed market (DM) sovereign debt currently in negative real yield and c.USD14.2 trillion DM sovereign debt[1] still registering outright negative nominal yields, despite the recent sell-off, we expect more investors to consider EM debt, given its yield and relative value attractions remain intact. Supportive tailwinds include the allure of relatively attractive yields in a low-yield world, improving trade flows within and across EM regions and the diminishing role of the US dollar on the global stage.

[1] Source: J.P. Morgan Markets, Negative Yield Monitor, Data as of 10 February 2021

We remain positive on prospects and have maintained our top-down risk exposure target across our strategies. We retain an overweight to emerging market currencies (EMFX), partly funded out of the relatively expensive euro. Improving current account balances and trade dynamics remain supportive for EMFX, which we believe is still undervalued. We also continue to see value in EM hard currency high yield bonds as spreads have not fully recovered to pre-COVID levels. While we are more neutral on local currency bonds (rates), and view absolute valuations as tight, selected local bonds still offer an attractive pick up compared to developed market yields.

Top-down positioning at end February 2021



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A region by region review of the month continues on the next page.

Portfolio positioning highlights

An overview of our positioning in a selection of regions, countries and currencies.

Africa

In **Zambia**, the central bank (CB) hiked interest rates by 50 basis points (bps) to 8.5% as it creeps towards policy normalisation, now that inflation is over 20%. The trade surplus has continued to swell, although the current account deficit was lower in Q4 2020 at 3.3% of GDP, down from 3.7% in Q3, due to the increased profit repatriation from mines. There are two negative developments regarding the fiscal debt which still require clarity. Firstly, the government lifted excise duty on diesel and petrol and announced zero VAT on fuels as the kwacha's depreciation has started to affect domestic consumers in the build-up to the August general election. These measures could cost up to 1.3% in lost revenue. Secondly, Zambia purchased Mopani mine from Glencore for USD1 billion and USD1.5 billion in transactional debt, and although it has said the debt is not government guaranteed, it will need to be paid down using mineral royalties if a new partner can't be found. More positively, the IMF are in town and from recent meetings it appears that Zambia has shown an increased intent to engage. Funding has dried up and the IMF are keen to help, but given the policy direction, progress could be slow. We remain overweight the hard currency bonds.

The US has approved the sale of new military equipment to **Egypt**, showing its continued support for the regime, even though we expect tougher talk from President Joe Biden on human rights and political freedom. The latest fiscal data showed a narrowing deficit in July to November 2020 versus the previous year, with the deficit coming in at 3.2% of GDP vs 3.6% in 2019. This was driven by higher tax revenues as well as lower interest payments. As core inflation remained subdued and food inflation has started to decline, inflation was relatively stable at 4.3% in January. However, we still expect this to increase, reflecting base effects, but its current trajectory supports the CB's decision to reduce the inflation target from 9±3% to 7±2%. With the policy rate at 8.25%, the CB are likely to stay cautious in the short term, but there is still the opportunity for further cuts should core inflation remain muted. We remain long Egyptian local currency through a mixture of bonds, bills and long-dated hard currency bonds.

The government in **Kenya** secured a 38-month USD2.4 billion IMF support programme and as a result the government have sought to remove some COVID tax concessions. The IMF deal, along with almost USD1 billion in debt service suspension, bodes well for external balances, and we will see the country buy back the 2024 dated bonds and possibly issue an additional USD1.1 billion in eurobonds. Inflation has edged up to 5.7% for January, largely driven by food, but it is expected to stay within the 5±2.5% range and rates are on hold at 7%. We continue to hold Kenya infrastructure bonds as well as hard currency bonds.

In **Ghana,** President Nana Akufo-Addo named Charles Adu Boahen, a former deputy finance minister, as acting finance minister-designate in the absence of Ken Ofori-Atta, who recently travelled to the US for medical treatment. Separately, inflation declined to 9.9% in February, from 10.4% in January as pressure on food prices started to ease, while non-food inflation was steady at 7.7%. After declining for the better part of 3 years, there is some evidence that local bond and currency flows are returning into Ghana, with almost USD700 million coming into the local market year-to-date. The central bank has kept rates on hold as it tries to balance the growth recovery with possible risks from continued fiscal expansion. We continue to hold the World Bank guaranteed 2030 bonds, as well as hedged local currency positions.

Asia

General themes in play across the region over the past few months, such as the linked revival in manufacturing and healthy demand for technology components, continued during February. As a result, export data remained strong, particularly in Taiwan and South Korea. Nevertheless, localised demand softened as the region's vaccine rollout has been slow compared to that for developed markets. This continued to benefit Asia from a trade balance perspective however, as weaker regional consumption has meant lower imports. In contrast, the rapid vaccine rollout in some developed markets should fuel rising demand and more exports from Asia.

In China, there was a small second COVID wave outbreak in the north east of the country, which occurred just before the Chinese New Year holiday. Inter-city travel was restricted but cities remained open as usual. Despite the resultant disruption, decent retail sales were reported nationally, rising 4.8% year-on-year based on 2019 data (i.e. pre COVID). Separately, Presidents Xi Jinping and Joe Biden appear to be moving to rebuild bilateral lines of communication weakened under Donald Trump. Although this is a positive step, the overall tone of US-China relations remains hawkish with little sign of any immediate roll back in tariffs, in line with our own and the broader market's expectations. The impact on asset prices has therefore been limited. We are neutral on local bonds and long the renminbi.

Indonesia is one of Asia's higher beta markets, and the local bonds are susceptible to core yield moves across developed markets. As a result, domestic bonds suffered over the month as US treasuries sold off. Furthermore, demand for Indonesian bonds at the bi-weekly auctions was poor, putting further pressure on prices. We remain overweight the bonds and rupiah.

Although the latest January year-on-year trade data in Taiwan was slightly exaggerated as Chinese New Year fell in February this year, it was still impressive. As the country is a major hub for semi-conductor manufacturing, it has been a key beneficiary of the high global demand for technology related equipment and this led the charge in exports, although data shows this impressive performance is starting to feed through into other export sectors. We remain uninvested however as the implied yield on the new Taiwan dollar is deeply negative, reducing the attractiveness of the currency from a total return perspective.

Malaysia's national pension fund, the Employees Provident Fund (EPF), has allowed contributors to make early withdrawals due to the economic effects of the pandemic. This has resulted in local bonds falling in value as the EPF is traditionally a major buyer, and more withdrawals means less funding to purchase bonds. We continue to be long the ringgit and local bonds as we expect exports to continue to perform well which should support the currency, while weaker domestic demand due to the lockdowns should help the bonds.

Latin America

By mid-February, the vast majority of countries in the region had begun their vaccination programmes, with Chile the standout performer, where the number of vaccines it is administering per 100 people compares favourably with the US and Europe. Brazil and Mexico are also steadily stepping up their vaccinations drives.

In Argentina, investors continued to be worried about the economic outlook, and the likelihood of an IMF deal by May this year. On the corporate side, there was progress regarding the debt restructuring of oil company YPF. Although the terms of the restructuring were initially rejected by bond holders for legal reasons, the company subsequently worked with investors to reach an agreement. We remain long the hard currency sovereign bonds as they are trading at very distressed levels.

The main news in Brazil in February was the surprise dismissal of the Petrobras CEO, which impacted domestic bond prices across the curve, while reverberating through other Brazilian assets. We expect Petrobras bonds to remain volatile in the near term as the market assesses the ramifications of this news. While there is dissatisfaction among Petrobras senior management and board members, the company remains in a manageable position given the recovery in oil prices, and we do not see the recent events as a fundamental change to the credit outlook in the near term. This event has increased investor concerns relating to the policies of President Jair Bolsonaro and we continue to watch policy and political risk closely, especially as pressure for increased social spending grows and the market becomes more sceptical of the government maintaining the spending cap over the medium term.

In Ecuador, opposition candidate Andres Arauz progressed to April's second round of the presidential elections, as expected. Guillermo Lasso has also edged into the run-off, and we expect this to stand although Perez has requested a full recount. Since last month, Arauz has tried to pacify investors by suggesting he will renegotiate terms with the IMF, instead of walking away. He also went to the US to promote the investment opportunities in Ecuador. We think that the election result will ultimately depend on where the Centro Democrático votes will go, and believe the market is underestimating Lasso's chances in the second round. Elsewhere, the fiscal outlook has improved due to the oil price rebound, and we remain positive on hard currency bonds, where we are overweight.

The Chilean peso outperformed in February, appreciating 1.2% against the US dollar in a month that saw most of EMFX decline in value. The peso was supported by the government revising the deficit target for this year on the surge in the copper price and the pension withdrawal driven bounce in growth. Regarding COVID, the country's vaccination rate per 100 people is impressive, ranking it among the top-5 nations globally. This has improved sentiment as the economy should recover earlier than its peers, driving domestic consumption higher. We are underweight local bonds and neutral the peso.

Central and Eastern Europe (CEE)

In Poland, the national bank published its updated economic projections, showing a higher inflation trajectory for 2021 and 2022, as well as a faster pace of economic growth this year. However, the bank maintained its strongly dovish rhetoric, stating that the recent increase in bond yields was undermining its own easier monetary policy. As a result, it is considering altering the way it conducts open market operations. The national bank's governor stated that "there is a near zero chance of rate hikes over the next two years" while he also repeated the bank's willingness to provide help in any voluntary foreign-currency loan conversions, as proposed by the Polish Financial Supervision Authority (KNF). Meanwhile, there is little sign of third wave COVID infections slowing, which suggests tighter restrictions are increasingly likely. We retain an underweight position in Polish local and hard currency debt.

The National Bank of Hungary maintained a wait-and-see stance at its February meeting to set interest rates, reiterating its view for expansionary balance sheet policies in the longer-term. The bank's deputy governor acknowledged that risk aversion towards EM remained the biggest upside risk to the inflation outlook, but hinted that no change in the policy or one-week deposit rates should be expected in the short term. January data showed that underlying inflation remained above target, while the external trade surplus rose significantly during the month on a weaker demand for imports. We maintain a market weight position in local currency debt and an overweight position in hard currency debt and the forint.

In the Czech Republic, the latest national bank forecast upgraded GDP growth projections for 2021 to 2.2% from 1.7%, while the inflation outlook is expected to be benign, driven down by all price components except fuel. In addition, monetary policy-relevant inflation is projected to remain at the 2% target. The COVID pandemic remains the primary downside risk to the inflation forecast and to monetary policy normalisation as the third wave of infections forced the government to extend the lockdown until 21 March, while Germany shut its border with the Czech Republic. We maintain an underweight position in local currency debt and an overweight position in the koruna.

In Romania, headline inflation accelerated in the first two months of this year mainly due to an electricity price hike. However, aggregate demand contraction is still visible, reflected by a deceleration in monthly core inflation and a shrinking of the trade deficit, driven by a stronger import contraction. Meanwhile Prime Minister Florin Citu announced that the freeze on wages and bonuses in the public sector will be extended until 2022. On the other hand, his government extended its support measures for the labour market until mid-June 2021. We maintain an overweight position in hard currency bonds and an underweight position in the leu.

In Serbia, the national bank's executive board kept its key rate unchanged at 1%. It expects economic activity to reach pre-pandemic levels as early as the second quarter thanks to the strong monetary and fiscal support and the rapid pace of the vaccination programme. The board also forecasts relatively strong foreign direct investment (FDI) inflows, mainly in tradable sectors, which, along with the expected recovery in external demand, should contribute to double-digit export growth this year. We retain our overweight positioning in local and hard currency debt.

Rest of EMEA

With Israel and the UAE still leading the global vaccination rankings, COVID cases are falling across the region, and we are also starting to witness Russia and Turkey accelerate the pace of their vaccine rollouts.

In Russia, opposition leader Alexei Navalny was sentenced to nearly three years in prison. In response, the EU and the US announced a set of targeted sanctions. Overall, we continue to expect these will have a limited impact on the Russian economy. We are overweight the ruble as well as local bonds across some of our strategies. Regarding our hard currency exposure, we rotated out of the long duration bonds as we felt valuations were becoming stretched.

The central bank remained on hold in Turkey during February but reiterated forward guidance that it would do what is needed to bring inflation under control, including further interest rate hikes if appropriate. While the return to orthodoxy has been welcomed by the market, the lira gave back some of its recent upside on the back of negative political headlines and disappointing de-dollarisation trends. Even so, ratings company Fitch adjusted its country outlook from negative to stable. We added exposure to domestic hard currency bonds due to the strengthened policy credibility, and because we believe there is still significant value in spreads.

In South Africa, the 2021 budget surprised the market with a better than expected set of fiscal forecasts, as well as continued commitments to keep the wage bill supressed. Manufacturing and mining data for the fourth quarter surprised on the upside, while the latest headline inflation figure was 3.2% in January after 3.1% in December. This was mostly driven by food prices but is at the low end of the central bank's 3%-6% range. On the COVID front, the government downgraded the country's lockdown measures to 'Level 1', permitting the sale of alcohol outside of curfew, among other relaxations. We are underweight the rand but retain exposure to local rates and hard currency Eskom debt.

The IMF loan review in Ukraine ended without an agreement for the next tranche of financial support, due to the government's inability to pass important pieces of legislation to support the country's anti-corruption institutions. There were however some positive political developments, with President Volodymyr Zelensky striking a harsher tone against some of the oligarchs that have impeded anti-corruption reforms. We retain our exposure to Ukraine's GDP warrants and are overweight the hryvnia.

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