June 2021

Emerging Market Debt Indicator

The fast view

Market background

- The JP Morgan GBI-EM Global Diversified Unhedged Index produced a total return of -1.2% in US dollar terms, while the JP Morgan EM Bond Index returned 0.7%.
- The US Federal Reserve turned brought forward its timeframe for raising interest rates. After a short bout of volatility, US Treasury 10-year bonds rallied back.

Africa

- The IMF approved the final review of Egypt's reform programme under the 12-month Stand-By-Arrangement, allowing the release of US$1.7 billion. It also approved a US$1 billion Extended Credit Facility programme for Uganda, providing support for its third National Development Plan.
- Kenya reported the first outperformance of revenue targets since FY13/14 as tax collections beat estimates thanks to the economic recovery and the reintroduction of various taxes.

Asia

- The COVID situation remains mixed across the continent, with Indonesia, Malaysia and Thailand struggling with recent outbreaks but India and Taiwan posting a dramatic fall in cases.
- The theme of strong exports reflecting the growing global demand remains in play across the region. But economic data from China was disappointing and a weak tourism sector is weighing on Thailand.

Latin America

- There has been a strong upswing in economic data across the board in Latin America, with the exception of Colombia.
- Political uncertainty continued to weigh on Peruvian assets. In contrast, Argentina reached an agreement with the Paris Club to postpone its debt repayments.

Central and Eastern Europe (CEE)

- Economic activity data continued to strengthen, PMI data was strong in Poland and rising in the Czech Republic. Various central banks raised interest rates, including the Czech Republic and Hungary.
- Serbia has been added to the JP Morgan GBI-EM index, so Serbian bonds should benefit from passive investor inflows.

Rest of Europe, Middle East and Africa (EMEA)

- On COVID, both the Russian and South African governments have had to enforce further restrictions given the rise in Delta variant cases and the low levels of vaccinations. Turkey has sped up its vaccination rate which bodes well for tourism flows.
- US President Biden met with President Putin in Geneva, which was viewed by many as a constructive development. The high oil price is boosting the country's balance of payments.

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Market background

The JP Morgan GBI-EM Global Diversified Unhedged index returned -1.2% in US dollar terms, while the JP Morgan EM Bond Index returned 0.7%.

During the month, the US Federal Reserve (Fed) turned to more hawkish messaging, as Chair Jerome Powell announced that the Fed has brought forward its timeframe for raising interest rates. This was prompted by a May US inflation (CPI) print of 5% year on year (the Fed's target inflation rate is 2%). However, as US non-farm payroll data undershot expectations, the Fed will be cautious in not hiking rates too early as it balances job market concerns against inflation. Hikes are still only expected in 2023 and Powell reiterated that these higher year-on-year inflation readings are transitory, given the low comparison figure from 2020 when COVID weighed on prices. After a short bout of volatility while the market digested the news, the US Treasury 10-year bond market rallied back, as investors still expect the Fed to keep monetary policy loose and for inflation to be transitory.

Elsewhere, business confidence data in Europe rose to multi-year highs as France and Germany both posted impressive numbers. This reflected the positive sentiment around a summer economic rebound given strong global demand. European inflation also ticked higher but was in line with the market's consensus.

The Delta variant of COVID is still a concern, particularly in Europe where holidaymakers are having to cancel travel plans, which will impact on the tourist-driven economies. South Africa also imposed new restrictions for two weeks to help tackle a severe wave of cases.

In China, Beijing is planning to keep the country's border restrictions in place for at least another year as the authorities are concerned over the emergence of new variants, despite a successful domestic vaccination programme. Elsewhere, in Peru's presidential elections, far-left candidate Pedro Castillo claimed victory ahead of the official results, but the opposition candidate called for a recount. The related uncertainty weighed on the country's assets prices.

Top-down views and outlook

Peter Eerdmans

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

Inflation concerns remain front of mind for investors, dampening somewhat their optimism around the robust recovery that's taking hold in many parts of the world. Despite various data prints pointing to rising headline inflation, we are still largely inclined to view this as a temporary phenomenon.

By not looking beyond the temporary effects of higher inflation, investors risk ignoring the broader cyclical picture, which remains attractive across EM. While there will be supply bottlenecks with accompanying surges in inflation as economies recover, these should prove transitory. The recent reinflationary pressure should be viewed against the much longer disinflationary trend of the last 25 years, and the tapering of support measures that will need to occur before the Fed considers raising rates.

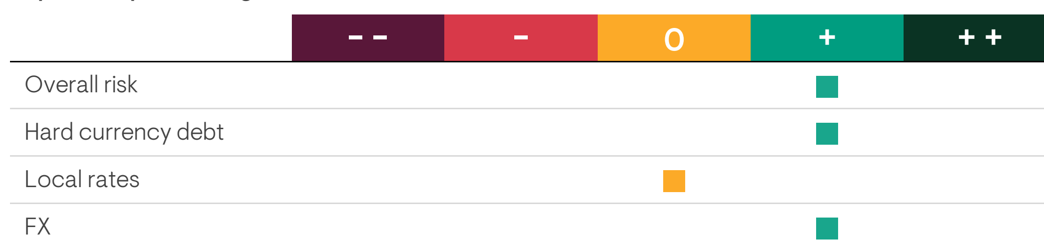
A revival in the manufacturing sector continues to be supportive for EM. The US$1.9 trillion stimulus package and improvements in how governments, firms and society deal with COVID are boosting demand. The reintroduction of lockdown measures in parts of the world will weigh on the services sector, particularly travel, but this is generally a smaller portion of most EM economies vs developed markets (DM). While we are seeing some weakness across EM from further lockdowns, as vaccinations are rolled out and restrictions broadly start to ease, the subsequent recovery in activity should spark a return to near normality later this year.

We believe central banks across the world generally remain supportive of economic growth and that the risk of an abrupt shift away from loose monetary policy remains low. The US administration under President Biden is also expected to be supportive for EMs, as it is likely to introduce 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 start of the crisis (which may have been exacerbated by the pandemic), how well governments have handled the crisis, and – crucially – how they will finance their deficits.

With a significant proportion of DM sovereign debt in negative real yield, we expect more investors to consider EM debt, as its yield and relative-value attractions remain intact. As well as the allure of relatively attractive yields, supportive tailwinds include improving trade flows within EM regions and the diminishing role of the US dollar on the global stage.

We remain moderately constructive on prospects and in recent months have kept a small risk-on top-down target across our strategies. We see some value in EM currencies and shifted to a small overweight there early in the quarter, as we remain positive on a long-term basis. On local currency bonds we have kept our more neutral view, reflecting the recent moves in US Treasuries. While we see overall local benchmark valuations as relatively tight, selected bonds still offer an attractive yield pick-up compared to DM. We also continue to see value in EM hard currency high-yield bonds as spreads have not fully recovered to pre-COVID levels.

Top-down positioning at end June 2021



	– –	–	0	+	+ +
Overall risk				■	
Hard currency debt				■	
Local rates			■		
FX				■	

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Thys Louw
Portfolio Manager

Insights from the team

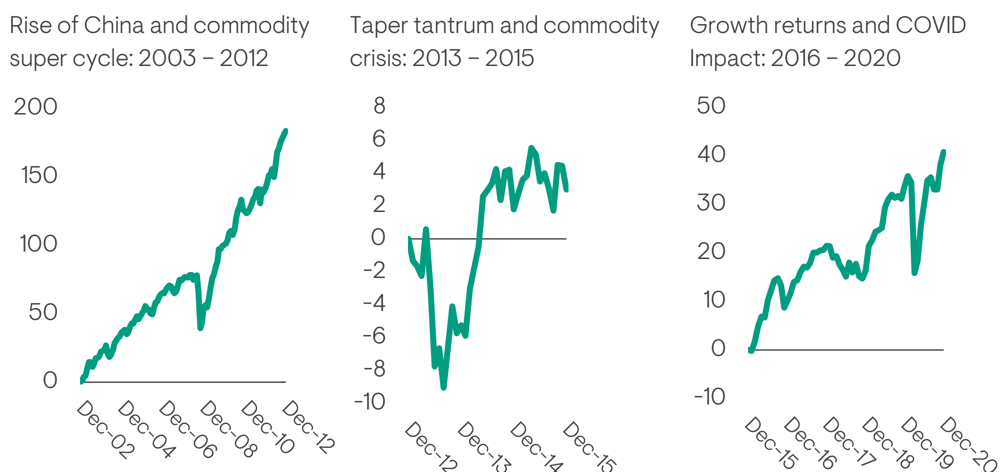
Revisiting EM Hard Currency Debt

For almost 30 years, hard currency sovereign debt[1] has given investors valuable exposure to the improving fundamentals and credit dynamics in EM without introducing currency risk. The past 10 years – the time we have been running our EM hard currency debt strategy – have brought both a transformation of the asset class and a shift in the macro and market environment facing investors. The result is that investors are now revisiting the asset class and the role it plays in their portfolios and inflows into the asset class this year have been strong. We reflect on some of those developments and what they mean for investors.

Yields and returns

Over the past two decades we have seen three contrasting market backdrops and in each, EM hard currency debt has delivered what investors need from a return-seeking fixed income allocation, as shown in the figures below. Coupled with significantly higher yields than those on offer in the majority of today's bond markets, has helped it move onto more investors' radars.

Annualized returns of EMBI in different market regimes, %



Past performance is not a reliable indicator of future results, losses may be made.
Sources: Ninety One, JP Morgan, Bloomberg; as of December 31, 2020.

A strengthening of EM fundamentals

EM fundamentals have evolved over the past decade; while the picture is diverse, in aggregate it is a story of strengthening fiscals, more orthodox monetary policy and lower inflation.

The cycle that began in 2013 (labelled Taper tantrum and commodity crisis in the figure above) was particularly challenging for EM economies but it also sparked some positive developments, as sluggish growth and crises in several countries reinvigorated governments' commitment to structural reform. By 2018, fiscal and current account balances had improved significantly as a result of these painful but necessary steps.

[1] Debt that is denominated in US dollars (or another 'hard' currency e.g. euros) and issued by EM governments/companies that are 100% state-owned.

From a policy perspective, prudence and orthodoxy also saw improvements over those difficult years, with central bank independence in most markets driving inflation structurally lower.

While COVID caused an unprecedented demand shock to the global economy, the resilience of many emerging markets has been remarkable. As vaccinations gradually control the pandemic there is still a case for a continuing rebound in EM in the second half of 2021.

A bigger and broader range of countries

As for the investable universe, over the past 10 years we have seen a diverse array of countries join the flagship EM hard currency debt index the JP Morgan EMBI, almost doubling the total number from 38 to 73. Now spanning oil exporters & importers, regional manufacturing hubs and services-driven economies, the analysis of the investment universe has become increasingly challenging and requires a much broader analytical tool-kit.

Smaller and more globally dispersed markets

A key feature of the EMBI's growth has been the expanding number of smaller markets, including countries in central Asia, Sub-Saharan Africa and the Middle East. These smaller and typically less-liquid markets are also generally under-researched by the mainstream investment community, bringing greater potential for alpha capture for those willing and able to do the necessary analysis.

Once heavily focused in Latin America, the investment universe now spans the globe. While this is among factors explaining its diversification properties, it also brings additional complexity to investors who need to keep abreast of global geopolitical trends in addition to a highly diverse set of market-specific drivers.

A greater proportion of high-yield markets

All of the above has resulted in a rise in importance of high-yield markets within the EMBI – markets that often rank low on the liquidity scale. The result is a greater dispersion of return outcomes, especially relating to the potential for negative credit events. To use an auto industry analogy, the universe has been upgraded from station wagon to sports car and requires skill and careful handling.

Upshot for investors

The evolution of the EM hard currency market means that today it is a particularly rich hunting ground for active managers with the right expertise to explore relative-value alpha opportunities, given the information asymmetry arising from the inherent complexities in analysing many of these markets. Investors need to be able to identify the attractive issuers while avoiding negative credit events and to do so they must carefully consider measures of liquidity, volatility and the general risk profile of each market.

Conviction, as well as systematic portfolio construction that aims to diversify return sources and carefully manage idiosyncratic risk are key to achieving sustainable risk-adjusted returns in this investment universe. Crucially, the rising importance of comprehensive (i.e. beyond just governance) ESG integration, means novel proprietary analytics are also becoming essential.

With many EM economies already reaping the benefits of the post-COVID recovery and spreads in some high-yield EM bond markets yet to recover fully to pre-COVID levels, now could be a good time to revisit the asset class.

Regional highlights

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

Africa

In **Egypt** the IMF approved the final review of the country's reform programme under the 12-month Stand-By-Arrangement, allowing the release of US$1.7 billion. The focus is now to put in place structural reforms to allow increased private sector participation in the economy. The IMF expects growth to rise to 5.2%, the current account deficit to remain at c. 4% of GDP, and the primary balance to move back towards a 2% surplus. The IMF's Special Drawing Rights quota increase will provide an extra US$3 billion. Although this could help reduce the need for more external issuance this year, the new Sukuk law means that another US$2 billion of Sukuk bond issuance is likely. Data showed some signs of economic activity returning to normal as the Purchasing Manufacturers Index (PMI) recovered to 49.9 from 48.6, while items such as auto sales, Suez Canal revenues (up 9% year on year) and even tourism continued to point towards normalisation.

In **Ghana** the government plans to issue US$2 billion in a sustainable bond. This will form part of a US$5 billion external financing program, of which US$3.5 billion will be used to repurchase local currency debt. After a disappointing 2020, there has been a large increase in cocoa production, although COVID related shutdowns has weighed on gold production. Ghana is being forced to pay US$170 million to Ghana Power Generation Company after Ghana unilaterally terminated a 2015 power purchase deal as it tries to deal with take or pay arrangements. There is a tail risk that, if managed poorly, this could be first of many. Inflation came in at 7.5%, supported by positive base effects for food, while PPI continued to increase largely driven by pricing pressures in the manufacturing sector.

Kenya reported the first outperformance of revenue targets since FY13/14 as tax collections beat estimates thanks to the economic recovery and the reintroduction of various taxes. June inflation moved higher driven by food and fuel, printing at 6.3% vs 5.9% in May. The government has allowed the resumption of direct flights between Kenya and UK in an effort to support the tourism sector ahead of the summer season. Remittances remains strong printing at 25% year on year, driven by strong US and EU flows.

New lockdowns in **Uganda** have put pressure on immediate growth as shown in latest PMI's printing at 34.9 in June from 56.5 in May, although we still expect growth to exceed 4% this year. The IMF approved a US$1 billion Extended Credit Facility programme, providing support for the country's third National Development Plan which will also look to consolidate fiscal balances and keep debt below 50%. Fitch affirmed the country's rating at B+. The Bank of Uganda's monetary policy committee decided to cut the policy rate by 50 basis points (bps) to 6.50% to support the economy, and inflation remains well below 5% target with headline inflation at 1.9% in May.

Asia

The COVID situation in Asia remains mixed across the continent. South East Asian countries, particularly Indonesia, Malaysia and Thailand, are struggling with recent outbreaks. The likes of India and Taiwan, however, experienced a significant improvement over the month, with case numbers in both markets falling dramatically from their respective highs. Across the region as a whole, the theme of strong exports reflecting the growing global demand remains in play.

In **China**, economic data has been generally disappointing. Domestic consumer spending remains muted, with retail sales still registering low levels. Exports did rise by 28% year on year in May, but missed market expectations. A significant development, reported by the Wall Street Journal, was news that the Chinese government plans to keep the country's borders closed for at least another year, given the uncertainty surrounding new COVID variants. This would have potentially large economic implications, especially on tourism, throughout Asia.

Export numbers out of **South Korea** were high for the first 20 days of June. On the fiscal policy side, the government is looking to release a supplementary budget to support domestic economic growth. This would usually be funded by issuing new bonds. However, as tax revenues have been particularly strong, the country can fund this without the need for additional bond issuance. Turning to monetary policy, the central bank became especially hawkish and announced that it plans to hike rates later this year. If this materialises, it will be the first central bank in Asia to raise interest rates since policy easing began following the COVID outbreak.

The Bank of **Thailand** announced that it has downgraded the country's growth forecast for 2021 and 2022, citing the likelihood of continued weakness in tourism. The potential of China not allowing citizens out of the country is particularly damaging to Thailand, as China accounts for a large amount of tourism revenue. Headline inflation was revised up given the low base from last year, while core inflation was revised down by 10bps.

In line with the rest of the region, exports also grew in **Taiwan**, with data showing a rise of 39% in May versus a market consensus of 31%. Industrial production also performed better than expected. More negatively, though, the market is struggling to get the COVID vaccines it needs to inoculate the population, as it is heavily reliant on the COVAX initiative, which has been delayed due to India's previously severe COVID waves (India is a major manufacturer for COVAX).

In the **Philippines**, we closed our short in the peso over June. Imports in the country have failed to pick-up materially despite our expectations that they would. The low volatility and decent carry from the implied yields led us to have less conviction in the position.

Latin America

There has been a strong upswing in economic data across the board in Latin America, with the exception of Colombia. On the COVID side, we are seeing an increase in infections in Brazil, where the seven-day average is approaching the highs seen earlier in the year. Colombia has also experienced a dramatic rise in infections, most likely as an effect of the widespread protests in April and May.

GDP data for Q1 in **Brazil** beat market expectations, printing at 1% vs. 0.5% expected. Regarding monetary policy, the central bank hiked rates by 75bps to 4.25%. The messaging was particularly hawkish, and we expect more hikes to come. In a major milestone for reforms in the country, congress approved the privatisation of the state-owned utility Eletrobras. The government also announced its plans to extend COVID stimulus measures by three months to October. We reduced our FX exposure, which was part of a relative-value trade with the Chilean peso, given the real's recent strength.

There were some significant economic forecast changes by policymakers in **Chile**: full year 2021 GDP growth was revised to a range of 8.5%-9.5% (previously 6%-7%), while inflation is now expected to rise to 4.4% by year end (previously 3%). The cause is a mixture of early pension fund access rules and very large fiscal stimulus. We added duration in Chile's inflation-linked local currency bonds, as we expect inflation to increase more than market expectations. We also held the view that the central bank would begin sounding more hawkish – this, coupled with somewhat lighter investor positioning in the currency, prompted us to close our underweight in Chilean peso. Since then, the central bank meeting minutes showed that it discussed raising rates much earlier than previously indicated, taking the market by surprise.

In **Mexico**, Banxico revised upwards its inflation forecast, expecting it to reach 4.8% by year end. The central bank also hiked rates by 25bps – a move largely unexpected by market participants. On the political front, President Andrés Manuel López Obrador's (AMLO's) party, Morena, retained its majority in the congressional elections with support from allies, however the coalition lost the 'super' majority needed in order to change the constitution. This was regarded as a positive by the market. Separately, AMLO announced that his minister of finance will replace the central bank governor when his term is up later this year, a move which will turn the board more dovish. Across our portfolios, we reduced exposure to both the peso and local bonds. We reduced into strength in the latter, whereas our conviction in the peso was weakened given our belief that Banxico would not react to the higher inflation prints.

There was a large drop in PMI data in **Colombia** in June, with the index falling back into contractionary territory. This was largely due to the protests seen over the last few months, as well as disruptions to supply chains. The current account deficit also printed worse than expected. The government presented its medium-term fiscal plan; however, it showed the deficit is still hovering at 7% of GDP for next year. As the large current account deficit makes the currency vulnerable to rises in global interest rates, we moved back to underweight in the peso and initiated a relative-value trade with the Russian ruble. Colombian monetary policy is still loose, and there are no signs of the central bank turning more hawkish.

Argentina came to an arrangement with the Paris Club, which has agreed to restructure the country's debt in exchange for a smaller immediate payment and, more importantly, a commitment to reach a deal with the IMF by the end of March 2022.

In **Peru**, Pedro Castillo has claimed victory ahead of the official election results announcement, which is delayed due to Keiko Fujimori calling for a recount of specific votes. At the time of writing, the result stands with Castillo ahead by just 40,000 votes, all of which are counted. We reduced exposure to the local bonds given the highly likely Castillo win and the still very uncertain policy direction.

Central and Eastern Europe (CEE)

In **Poland**, economic activity remains very strong, with PMI data coming in at 57 versus a market expectation of 54. Inflation is at very high levels, but the governor of the National Bank of Poland has claimed that this stems from supply shortages and should prove to be temporary. The NBP also said that it will monitor the ECB and US Fed closely, rather than other regional central banks, in terms of interest rate moves in reaction to inflation. We tactically reduced exposure to the Polish zloty ahead of the central bank meeting, given the tendency of the bank to send dovish signals to the market.

The **Czech Republic**'s national bank hiked interest rates by 25bps as expected, and signalled that there will be more hikes on the way. Both consumer and business sentiment are rising as well, and the latest PMI data was very strong. On the inflation front, price pressures are intensifying further.

The prime minister of **Hungary** has said that he rejects the proposal from the G7 to impose a minimum 15% tax rate on multinational companies, citing that the current corporate tax rate is low at 9%. Elsewhere, the national bank raised interest rates by 30bps, in line with market consensus, and like in the Czech Republic, signalled further tightening lies ahead.

There were strong retail sales recorded in **Romania**, as well as much improved tax revenues off the back of stronger economic activity. However, the central bank seems reluctant to follow other regional banks in tightening its monetary policy, as the current starting point for interest rates is higher, and fiscal policy is tighter due to the lack of fiscal space.

The National Bank of **Serbia** kept rates on hold, despite inflation accelerating over the month. In a positive move for the country's bonds, Serbia has been added to the JP Morgan GBI-EM index, so Serbian bonds should benefit from passive investor inflows.

Rest of EMEA

Regarding COVID in the region, both the Russian and South African governments have been forced to enforce further restrictions given the rise in cases of the highly transmissible Delta variant and the low levels of vaccinations. Israel has had to reimpose the use of face masks, although given the higher rate of immunity we are less concerned of a further COVID wave. More positively, Turkey has accelerated its vaccination rate, which bodes well for an opening up of the economy in time for the tourist season. That said, the Delta variant is still of concern in the country.

The PMI in **Turkey** fell back into contraction (below 50) during May, while inflation temporarily moderated, but accelerated again in June above expectations. It therefore seems there is little room for the central bank to cut rates over the summer, but risks are rising given the clear pressure from President Erdogan.

Turning to **Russia**, US President Biden met with President Putin in Geneva, which was viewed by many as a constructive development. Although the US government has since suggested it would impose more sanctions over Russia's actions in relation to opposition leader Alexei Navalny, we expect sanctions to be modest and targeted rather than applying to the country as a whole. From a monetary policy perspective, the central bank remains hawkish, and hiked rates by 50bps while keeping its aggressive rhetoric. We also expect a hike of at least another 50bps in July. With the currently high oil price, we believe the country's balance of payments has upside potential. Political risks in the country have also arguably fallen somewhat. This, plus our expectation of a rate hike, prompted us to add exposure to the currency.

There was a large trade surplus print in **South Africa**, which was a significant upside surprise. However, we expect this to reduce going forward, reflecting the impact of a high oil price on this oil-importing country. Retail sales were slightly weaker, and the government has had to reimpose certain lockdown restrictions to tackle rising COVID cases.

Israel formed a new government during the month, but we don't expect any major change in macroeconomic policy, as it may prove a challenge to pass new legislation given the breadth and diversity of the coalition government.

Among the oil-exporting names in the **Middle East**, we continue to own some high-yield exposure in the Gulf, given the current oil price and the meaningfully lower funding requirements that this brings. In **Iran**, we believe that the election outcome is unlikely to stop a nuclear deal, but we expect it to be complex and drawn out while OPEC manages the oil market, although risks here have risen somewhat given the recent disagreement between the UAE and Saudi Arabia.

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Other non-specified information referred to above, source: Bloomberg, as at end June 2021.

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