



# Emerging Market Debt Indicator

## The fast view

### Market background

It was a weaker month for EM fixed income and currency markets. Rising inflation pushed up US Treasury yields before they reversed course after news broke of the Omicron COVID variant, with similar sharp shifts happening across financial markets.

### Africa

Egypt responded to concerns over further dollar bond issuance by securing external funding, including US\$3 billion in bank loans to fund ESG projects. In Kenya, tourism has been slowly improving, remittances are at record levels, and the economy has rebounded strongly as lockdowns have eased.

### Asia

Most of the region continues to embrace a 'living with the virus' approach to COVID-19, but China, Hong Kong and Taiwan continue to adopt a zero-tolerance approach. Inflation has risen slightly in the region but remains relatively benign. High vaccination rates have lifted Singapore's growth outlook.

### Latin America

Central banks in the region continue to react to inflation, but it may be close to peaking in some countries. Investors welcomed election results in Chile and Argentina, but the appointment of a relatively unknown candidate as central bank governor in Mexico weighed on sentiment.

### Central and Eastern Europe

Poland, Hungary and the Czech Republic all aggressively hiked interest rates during the month. Poland's national bank surprised the market with a bigger-than-expected rate rise, leading to a sell-off in the country's local currency bonds.

### Rest of Europe, Middle East and Africa (EMEA)

The Turkish central bank announced a further interest rate cut, causing the lira to sell off. Elsewhere, tensions between Russia and neighbouring Ukraine intensified during the month, and Omicron variant news weighed on South African assets.



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### Market background

It was a weaker month for EM fixed income and currency markets, with the local currency bond index (JP Morgan GBI-EM) down 2.7%, mostly driven by the stronger US dollar, while hard currency debt (JP Morgan EMBI) fell 1.8%. The corporate debt market proved slightly more resilient, with the JP Morgan CEMBI down 0.6%.

In the US, inflation rose to 6.2% in year-on-year terms, the highest in 30 years. The Federal Reserve began winding down its bond purchase programme, but Chair Powell said the Fed remains open to adjusting the pace of this tapering according to the economic outlook. The US Treasury market was volatile during the month, with yields falling to 1.43% before rising sharply to 1.65% after the US inflation data release, then dropping to 1.47% after the discovery of a new COVID-19 variant. Markets reacted sharply to news of the Omicron variant as early information suggested it could be highly virulent and it is unknown at this stage the extent to which current vaccines will protect against it. Alongside concerns over the impact on economic growth, this uncertainty resulted in governments across the world tightening border controls.

In Turkey, the central bank announced a further interest rate cut, in stark contrast to the monetary policymakers across the world. This sent the lira into a rapid sell-off that has continued beyond month-end, further fuelled by statements from President Erdogan reiterating his support for lower interest rates, despite the relentless inflationary pressures.

In contrast, Poland's central bank surprised the market by raising interest rates by 75 basis points, which was much more than expected. As a result, there was a significant repricing of the Polish bond market.

Tensions between Russia and neighbouring Ukraine intensified during the month after the number of Russian troops increased on the border between the two countries. This has led to concerns among western countries that Russia is planning an invasion. Sentiment improved somewhat at month-end on news that the US Secretary of State Antony Blinken would hold talks with Russia's Foreign Minister Sergei Lavrov.

In Latin America, inflation continues to rise in general across the region, while investors responded positively to election results in Chile and Argentina.

### Top-down views and outlook

Inflation remains a key concern for investors, dampening optimism around growth. While there has been some recent softening in oil prices and the Omicron variant could dampen demand over the short term, we are still likely to see rising headline inflation around year-end, and questions around whether this is a largely temporary phenomenon remain unanswered.

Despite this, the broader cyclical picture remains attractive across emerging markets, especially against the backdrop of a global energy transition and the associated infrastructure spending that it will entail. While there will continue to be supply bottlenecks with accompanying surges in inflation as economies recover, most of these pressures should prove transitory, if history is any guide. Although it is not clear how permanent recent changes in labour market participation and wage pressures are, they should still be viewed against the much longer disinflationary trend of the last 25 years. Investors should also note that the scaling back of support measures – with the US Federal Reserve starting to taper in November – will still have to take place before the Fed will begin raising rates. Furthermore, as is evident from recent news, COVID-19 has not yet moved from pandemic to endemic status and monetary policy globally will still – to some extent – be dictated by the emergence of new variants and the response of governments as they deal with these.

The revival in goods demand and impact on global manufacturing should continue to be supportive for emerging markets over the medium term, despite some shorter-term challenges, against a broad market expectation that the US will outperform over the short term. Overall, we expect the recovery in activity and gradually closing of output gaps to continue in emerging markets into 2022, despite some fiscal drag as spending normalises after the pandemic-related surge.

We continue to believe global central banks, and particularly those in developed markets, will generally remain supportive of economic growth and that the risk of an abrupt shift away from loose monetary policy that threatens the global recovery remains low. We think this backdrop is likely to allow for a high degree of divergence for sovereign debt markets, 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 and reduce their deficits.

With a significant proportion of developed market sovereign debt still offering low and negative real yields, we expect investors to continue to reassess allocations to EM debt, as its yield and relative-value attractions remain intact. As well as the allure of relatively attractive yields, supportive tailwinds include the strong commodity demand backdrop and historically attractive terms of trade.

We remain moderately constructive on medium-term prospects for the EM debt asset class and remain modestly overweight risk across our strategies. While we continue to see longer-term value in EM FX, we see some headwinds over the coming months and maintain our small underweight. Although trade dynamics remain supportive of currencies, as economies start to open and domestic sentiment improves, we could see EM imports picking up and the moderation in Chinese growth could dampen exports. Furthermore, there is an increasing need to tighten liquidity in the US, which could strengthen the US dollar. We expect local currency debt to benefit as growth momentum slows, especially given the amount of monetary policy tightening that has already taken place and the further tightening that is already priced in many emerging markets. However, given the high inflation prints (albeit with signs that momentum is fading), we choose to remain neutrally positioned in local rates for now. Our modest overweight to EM debt is expressed through hard currency debt market positioning, where we continue to see value in high-yield bonds where spreads have not fully recovered to pre-COVID levels, and where many countries are set to receive meaningful support from the IMF. The positive commodity price environment is also supportive for EM credit, especially countries and corporates which should benefit from accelerating global infrastructure investment.

### Top-down positioning at end November 2021

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

For illustrative purposes only. For further information on the investment process, please see the important information section.



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## Chilean politics and beyond: key considerations for investors

Our Latin America specialist explains what the first-round presidential election result means for investors and provides a brief overview of fiscal, monetary and ESG dynamics in the country.

### A country hungry for change

Tension has been simmering in Chile since the October 2019 protests (initially triggered by metro ticket price rises), which led to the start of the process to rewrite the constitution. Earlier this year, Chileans expressed their desire for political change in the constitutional assembly ('Constitutional Convention') elections, with the traditional centre-left and centre-right parties suffering a crushing defeat by left-wing independents. Given this body's responsibility for rewriting the constitution, the shift to the left there – together with heavy fiscal spending and dipping into domestic pensions – has been a key source of uncertainty facing investors in this high-quality country's debt.

As Chileans went to the polls on 21 November for the first round of the presidential elections, their distrust of traditional political parties was in evidence again: it is the first time in 30 years that neither the centre-right nor the centre-left will make it to the run-off. While the result (summarised in the box below) points to a more polarised society, there were several positive outcomes from the perspective of investors. First, the radical left-wing candidate, Gabriel Boric, failed to improve on his performance in the primaries, suggesting that Chileans have not undergone a permanent shift to the left. More crucially, though, was the surprise outcome in congressional elections, as discussed below.

#### Overview of top candidates (% votes secured)

##### Jose Antonio Kast – Republican Party (27.9%)

- Far right.
- Promises to cut taxes and spending on public administration but increase spending on pensions. Favours keeping the status quo vs. re-writing the constitution.

##### Gabriel Boric – Approval of Dignity – coalition which includes the Communist Party (25.8%)

- Far left.
- Wants deep social and economic reform including the creation of a public pension system.

##### Franco Parisi – People's Party (13%)

- Campaigns online from the US – very unconventional rhetoric (e.g., conspiracy theories).

### Congressional results: improved checks and balances

In a significant positive from the perspective of markets, the right and centre-right did significantly better than expected in elections for Congress. Notably, they gained a number of Senate seats, taking their count to 25 out of 50. This will provide an important check and balance against any radical policy proposals from the eventual winner of the second-round election, and a welcome countering influence to the more left-aligned Constitutional Convention as it drafts the country's new constitution.

In effect, it would make it very difficult for Boric to overturn the pension system, meaning the future of the private pension system (AFP) seems assured. Likewise, Kast would struggle to implement drastic tax cuts, which is a positive from a fiscal perspective.

It's likely to be a very close result in the 19 December second-round election with various moving parts (what Parisi voters will do, whether turnout will improve, etc.) impossible to predict. That said, the election for Congress ensures a certain amount of relative stability – Chile's long-term fundamentals and economic model are less at risk than we thought a few months ago and the positive market reaction seen in recent days reflects this.

### Beyond politics

This important political juncture for Chile makes it an opportune time for investors to revisit the broader investment case for Chilean bonds and there are various pressing matters to consider.

Turning to the fiscal side, whoever wins the election will inherit an economy that is running hot after an 18-month stimulus bonanza. Adding up fiscal support measures and pension fund withdrawals, stimulus injected into the economy was over 30% of GDP – this is higher than anywhere else in the world, including the US. Fiscal consolidation next year is unlikely to be as abrupt as currently forecast, whoever wins the presidency. While this should allow the country's high level of growth to persist for longer, it will be at the cost of a higher future debt burden; investors should account for these dynamics when assessing the country's bond market valuations.

Furthermore, the stimulus measures outlined above will continue to be the main driver of inflation pressures next year, forcing the central bank to increase rates above their neutral level. So monetary policy will be a key driver of the country's bonds next year and inflation dynamics are an important area to watch. Given the extent of liquidity still available to households, there is a risk that inflation continues to surprise to the upside and takes longer to return towards the central bank's target range than currently expected.

More positively, there is a general consensus in Chile for a constructive policy towards renewable energy; in contrast to some other emerging markets – **Poland** being an obvious example – this is cross-party (rather than polarising) issue. Regardless of who wins the election, Chile will continue to develop its green hydrogen potential, with the opportunity to become a leading exporter in this new sector. In addition, Climate Action Taskforce rates the country's net-zero target as "acceptable". Meanwhile, Chile's ambitious reforestation programme is already looking set to help emissions peak as early as 2023. Many of these positive dynamics are reflected in our Net Zero Sovereign Index, where Chile is one of the top 15 countries (the index ranks both developed and emerging markets) – this is thanks in no small part to the country's strong push into renewables. We also expect Chile to continue to be at the forefront of sustainable bond issuance in EM.

## Regional highlights

### Africa

In **Ghana**, the government's new budget has set a path towards steeper fiscal consolidation, although questions remain regarding the credibility of the targets. The fiscal deficit is targeted to decrease to 7.4% of GDP in 2022, and 4.2% in 2025, with a primary surplus targeted in 2022. The majority of this consolidation will be coming from tax revenues, which are forecast to increase by 43% as a result of the removal of tax exemptions and a new e-tax levy.

Having understood that investors are nervous about further US dollar debt issuance, **Egypt** has been working to secure alternative sources of external funding, including US\$3 billion from Saudi Arabia as well as US\$3 billion in bank loans to fund ESG projects. We have seen a significant contraction in the trade deficit given a rise in exports. In other developments, in an attempt to increase vaccination rates, from 15 November, public sector employees are not allowed to enter their offices if they are unvaccinated or untested for COVID-19.

The government in **Uganda** has been ramping up efforts to tackle the Allied Democratic Forces (ADF), after the recent bomb attacks. Like other countries, COVID-related struggles have created the need for a supplementary budget. The additional budget aims for an extra 1.5% of spending, although other areas of spending might be cut, making the overall impact uncertain. This was confirmed by an IMF mission review, where it noted that the economic recovery remains slow due to the impact of the recent COVID lockdown, particularly on the manufacturing and services sectors.

In **Kenya**, tourism has been slowly improving, increasing 3.8% year on year, but still only at 40% of pre-COVID levels. Remittances have remained strong, increasing 28% year on year and are now at record levels, with continued strong growth coming from the US. There has also been a strong growth rebound as lockdowns have eased, with GDP for Q2 rising 10% year on year. We maintain our belief that Kenya will see strong growth in 2022, especially given the re-opening of schools (closures cut almost 2% from real GDP growth in 2020). What is more uncertain is the eventual impact of the government's new requirement for people to show proof of COVID vaccinations to enter many businesses, restaurants and government offices starting in December. Given that less than 5% of the population is vaccinated, the new rules appear to be an attempt to improve the vaccine take-up.

### Asia

We continue to see most of Asia embrace a 'living with the virus' approach to COVID-19, particularly in Singapore, Malaysia and Thailand. In contrast, China, Hong Kong and Taiwan continue to adopt a zero-tolerance approach. Inflation for the region has shown signs of increasing slightly, but it is still much softer than that being experienced in most other emerging markets.

In **China**, all monetary policy tools were left unchanged over the month, including the 1-year medium-term lending facility (MLF) and the loan prime rate. Economic activity data was slightly better than expected, following the weakness seen over the last few months. The renminbi traded well in November, and appreciated against the US dollar, helped by China's very strong trade surplus, a lack of tourism outflows and continued inflows of foreign investor capital. However, regulatory pressure on the real estate sector and weaker property market data continues to weigh on broader sentiment in the country, although the lower growth expectations are helping local bond prices.

GDP growth for 3Q in **Singapore** printed at 7.1% year on year, beating expectations. COVID-related movement restrictions were eased during the month, reflecting the very high vaccination rates in the country, as 94% of the eligible population (over 12 years old) is now fully vaccinated. Brokers are now revising their growth forecasts higher. In addition, inflation surprised on the upside; the market is now pricing in further tightening of policy from the Monetary Authority of Singapore (MAS) in April next year.

Central banks in both **Indonesia** and the **Philippines** kept rates on hold, as expected, and **South Korea** hiked rates by 25 basis points (bps), also as expected.

### Latin America

Inflation continues to surprise on the upside across the region in general. However, there are early signs that it may be close to peaking in countries where it began to rise first. Central banks throughout the region continue to react to the inflationary pressure.

In **Peru**, the more radical members of the cabinet have been forced to resign, a move which we consider to be positive given it signifies that President Pedro Castillo is looking to diffuse the tension with congress. Congress has welcomed the cabinet replacements, further helping investor sentiment.

In early December, the senate in **Brazil** is set to decide on whether to approve a constitutional amendment to allow for President Bolsonaro's new social program under the fiscal rule. If it goes ahead, which at the time of writing seems likely, it should be a positive for the country as it means that the social spending programme should be within the country's spending cap and would not have to be funded with yet another extension of emergency credits.

The central bank in **Colombia** was slightly more hawkish in November, and hiked interest rates by 50 basis points. However, this still leaves Colombia's interest rates behind others in the region. While inflation continues to rise, it is more contained than in regional peers, with the year-on-year October figure lower than expected. This should support the central bank's gradual approach to raising policy rates towards their neutral level. On the external front, the country once again posted a very large trade deficit.

There were eventful mid-term elections in **Argentina**. The ruling coalition lost its majority in the Senate, the first time this has happened for nearly forty years. The Peronist coalition also lost control of the province of Buenos Aires, its traditional stronghold. The market took this news well initially, as it increases the chance of a more market-friendly government taking over after the next election in two years' time. However, gains were short-lived as little progress has yet been made on reaching an agreement with the IMF.

In **Mexico**, President Andrés Manuel López Obrador (AMLO) caused a shock among market participants after coming back on his initial choice for new central bank (Banxico) governor. He had previously informed the market that he would be appointing the former finance minister but changed his mind at the last minute and appointed a relatively unknown candidate, who has no monetary policy experience and is perceived to be very close to AMLO.

As well as the first-round election results in **Chile**, which we discuss in more detail on page 4, the other important development was on the potential forth pension fund withdrawal. The withdrawal was voted down in the Senate by one vote, which was very good news for domestic assets.

### Central and Eastern Europe

In **Poland**, purchasing manufacturers' index (PMI) data was strong and came in above expectations, while the national bank surprised the market with an interest rate hike of 75bps – significantly more than expected. This then led to significant repricing of the Polish bond market. Furthermore, the national bank did not issue any accompanying forward guidance after the hike, leaving the market in a confused state. Inflation data surprised on the upside, while retail sales were strong, beating expectations. Turning to politics, with the government feeling the mounting political pressure from persistently high inflation, it presented a fiscal plan including a reduction in indirect taxes and energy vouchers to the lowest-income families to help with rising energy costs.

The National Bank of **Hungary** was also aggressive in its tightening pace over the month, aiming to stabilise the currency which has been under pressure recently. Interest rates were raised significantly over several smaller increments; in total, the effective policy rate (one-week deposit rate) was hiked by 110bps to 2.9%. Activity data remained strong while inflation accelerated, further justifying an increasingly hawkish stance by the national bank.

On the contrary, the PMI report was rather weak in the **Czech Republic**, with the manufacturing sector still suffering from supply shortages in chips used for car production. More positively, unemployment fell to a 16-month low, highlighting the country's very tight labour market. Regarding monetary policy, the national bank raised rates by 125bps, which was much larger than the 75bps expected. Retail sales were softer than expected, industrial production was weak, but core inflation

accelerated significantly to 6.7% in October, justifying the large hike in rates.

A coalition government has finally been formed in **Romania**. The new government is made up of three parties, all of which have agreed to use a prime minister rotation programme, by which Nicolae Ciucă will be replaced by Marcel Ciolacu in May 2023, who will serve until the end of 2024.

### Rest of Europe, Middle East and Africa (EMEA)

News relating to monetary policy in **Turkey** continued to feature among global headlines. In November, and in contrast to monetary policymakers across the rest of the world, the Turkish central bank announced a further interest rate cut – its third since September. This sent the lira into a rapid sell-off that has continued beyond month-end, further fuelled by statements from President Erdogan reiterating his support for lower interest rates, despite the relentless inflationary pressures.

Tensions between **Russia** and neighbouring **Ukraine** intensified during the month after the number of Russian troops increased on the border between the two countries. This has led to concerns among western countries that Russia is planning an invasion. This weighed on the assets of both countries. Turning to economic data, inflationary momentum remains fairly strong in **Russia**, but in year-on-year terms it appears it may be close to peaking due to base effects. The central bank remains very hawkish in its statements, and with inflation expectations not showing signs of moderating, our base case is another sizeable hike in December. In **Ukraine**, growth disappointed in Q3, which is further evidence of a disappointingly shallow full-year recovery for 2021 after the 2020 recession. The country also received its latest tranche from the IMF, and the programme has been extended by six months into mid-2022.

Towards the end of the month, global financial markets were sent into a risk-off induced decline after a potentially virulent COVID-19 variant was discovered in Southern Africa. Travel to the region, including to **South Africa**, has been suspended by many countries, including the UK and the EU, which will likely have a major impact on the summer tourism season in South Africa. In other developments, South Africa's central bank started its rate-hiking cycle with a modest 25bp move, with inflation still fairly benign compared to other countries. From an external perspective, the rand's terms of trade moderated further over the month given the higher energy and lower platinum group metal prices.

In the Middle East, **Lebanon**'s distressed bonds fell back towards all-time lows, hampered by increased tensions both internally and with key Gulf backers (and potential sources of financial support), who withdrew diplomats during the month.

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

## Emerging Market Debt Indicator

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