October 2021

Emerging Market Debt Indicator

The fast view

Market background

- The key theme in October was widespread concern around the persistence of inflation. Volatility in the US Treasury market continued.
- The economic growth rebound continued in developed markets and governments eased some of the COVID-related restrictions that have held back some emerging markets.

Africa

- Both the Ivory Coast and Ghana improved their debt balances, helped by a deal with France in the former and a reduction in debt to independent power providers in the latter.
- In Egypt, fiscal momentum remains positive, while in Zambia the government made progress towards an IMF deal.

Asia

- Moderate inflation rates and healthy external balances have allowed for accommodative monetary policy in much of the region.
- The region is generally moving towards a stance of 'living with COVID-19', with restrictions eased in some (but not all) countries.

Latin America

- The main theme in the region was one of high inflation, although momentum around this appears to be fading in some markets.
- Central banks have raised interest rates more than in other regions, and local bond curves have more rate hikes priced in by the market.

Central and Eastern Europe

- Inflation continues to rise across the region, with Polish inflation beating consensus expectations for a fourth consecutive month.
- Central banks remain mostly hawkish, reflecting the inflation backdrop.

Rest of Europe, Middle East and Africa (EMEA)

- Several members of the Gulf Cooperation Council, including Saudi Arabia and the United Arab Emirates, committed to net-zero targets.
- In Turkey, monetary policy credibility and political risk remain key themes after a surprisingly large interest rate cut and threat to expel some NATO ambassadors.

Market background

The key theme in October was widespread concern around the persistence of inflation, fuelled by ongoing strength in commodity prices. Volatility in the US Treasury market continued and market participants across the globe revised higher their rate expectations, based on the view that central banks will be forced to act to rein in inflation.

The hard currency EM debt market (JP Morgan EMBI) was flat in October, while corporate debt (JP Morgan CEMBI BD) was weighed down by China's property sector as ongoing headlines surrounding defaults among some high-yield issuers impacted the broader sector. Sentiment improved somewhat after the Chinese authorities' policy responses eased some of the pressure, ultimately ensuring that property developers have access to credit.

The economic growth rebound continued in developed markets and governments eased some of the COVID-related restrictions that have held back some emerging markets (with notable exceptions including Russia and Singapore), paving the way for the EM growth recovery to begin to catch up with developed markets.

Demand for goods exported by EMs, particularly Asian economies, continued to grow apace and this helped EM currencies to strengthen against the US dollar. Commodity price strength also boosted the trade balances of commodity exporters, including Indonesia and Malaysia. However, FX moves were insufficient to offset the negative effect of rate rises and the EM local bond market (JP Morgan GBI-EM) fell 1.3% over the month.

While inflation remains a global issue, Latin America stood out during the month for the response by monetary policymakers there - central banks have raised interest rates by more than their peers in other regions, and the market is pricing more rate hikes into local bond yield curves. Elsewhere, Russia's central bank hiked rates by more than expected and signalled it is prepared to increase rates further as higher oil and gas prices put pressure on inflation. In stark contrast, Turkey's unorthodox monetary policymaking continued, with a larger-than-feared rate cut, despite rising inflation.

In another notable development during the month leading up to COP26, several members of the Gulf Cooperation Council, including Saudi Arabia and the United Arab Emirates, committed to net-zero targets, which is a welcome first step.

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 optimism around the growth recovery story. With various data prints still pointing to rising headline inflation, the view that this is a largely temporary phenomenon is being challenged globally.

By purely focusing on the effects of higher inflation, investors risk missing the broader cyclical picture, which remains attractive across EMs, especially against the backdrop of a global energy transition and the associated infrastructure spending that it will entail. While there will certainly be supply bottlenecks with accompanying surges in inflation as economies recover, most of these should prove transitory, if history is any guide. The recent reinflationary pressure should be viewed against the much longer disinflationary trend of the last 25 years. Investors should also note that the scaling back of support measures – which is starting in November – will take place before the US Federal Reserve considers raising rates, as it continues to focus on unemployment.

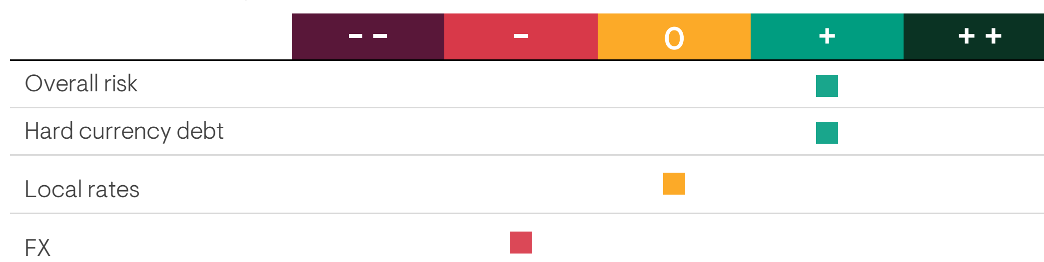
The revival in goods demand and impact on global manufacturing should continue to be supportive for EMs. The US$1.9 trillion stimulus package and improvements in how governments, firms and society deal with COVID will also have a positive impact on demand. We expect the recovery in activity from the low levels recorded last year to push EM growth rates ex-China higher, despite some fiscal drag as spending normalises after the pandemic-related surge.

We continue to believe global central banks, and particularly those in DM, 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, 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 DM sovereign debt still in negative real yield, we expect investors 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 strong commodity prices and historically high terms of trade, with the IMF continuing to upgrade EM (ex-China) growth forecasts.

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 have moved to a small underweight. Although trade dynamics remain supportive of currencies, as economies start to open up 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 momentum in the growth recovery begins to slow. However, the clash between strong demand and tight supply is having a meaningful impact on global inflation, which central banks will have to react forcefully to address. Therefore, we remain neutrally positioned in local rates. We have also maintained our modest overweight to EM hard currency debt, and 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 high commodity price environment is also supportive for EM credit, especially in countries and corporates which should benefit from the accelerating global infrastructure investment.

Top-down positioning at end October 2021



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Key takeaways from IMF World Economic Outlook

The latest World Economic Outlook from the IMF paints a broadly positive picture of the growth outlook for EM economies, with a significant number seeing their growth forecasts upgraded for next year. This is reflective of the fact that EM economies are beginning to catch up, having lagged in the post-pandemic re-opening and recovery, and paving the way for faster growth next year. But it is clear from the IMF's fiscal forecasts that the pandemic has widened dispersion among EM from the perspective of fundamental economic strength. Here are key takeaways for EM debt investors.

Latin America leads on growth upgrades

While a range of EMs from across the globe saw strong revisions to their growth forecasts, the Latin American region stands out. There, a combination of stronger remittances (e.g., Mexico), slowing COVID case rates, and the return of tourism (e.g., in Mexico and the Caribbean) appear to be driving growth upgrades.

Elsewhere, strong upward revisions were awarded to South Africa, Israel and Turkey. In contrast, growth forecasts were generally downgraded in Asia, given the slow removal of lockdown measures – albeit with some notable exceptions, such as Pakistan and South Korea.

Surprising divergence in oil exporting economies

In the context of the strong commodity market rebound experienced this year, growth forecasts for some Gulf economies make for disappointing reading. Among these, Oman stands out for its particularly large downgrade, as expectations of a bumper 2022 are shelved.

In Africa, a relatively slow recovery from COVID-19 has weighed on some countries' forecasts – particularly in East Africa – but things look slightly brighter for some of the more commodity-heavy countries, with the exception of Angola, where the rebound remains disappointing.

More starkly diverse fiscal trends

The fiscal picture across emerging markets is more diverse. IMF forecasts point to a better path ahead for debt/GDP in some of the countries that were most severely impacted last year – including South Africa, Brazil and many frontier markets. However, among the latter, several African countries saw deteriorating debt/GDP forecasts, especially Mozambique (delayed gas production/investment), but also Nigeria (costly fuel subsidy), Ghana and Ivory Coast. Challenges are also forecast for parts of Asia, with downgrades for India, South Korea and Thailand contrasting with China's upgrade.

Generally stronger external indicators

As for countries' current account balances, the picture is generally positive, with the majority of countries seeing upgrades in their external balances. In Asia, China is notable for improving external trends, while the weight of lost tourism revenues is seen clearly in the contrasting forecasts for Thailand. In Latin America, a large part of the Caribbean saw upgrades, as did Peru. While Brazil, Chile and Mexico saw their forecasts downgraded, we think that reflects a relatively backward-looking perspective, with our outlook suggesting better outcomes on trade if supply bottlenecks ease. Meanwhile in the Middle East, Gulf Cooperation Council countries enjoyed broad-based upgrades to forecasts as oil price strength boosts the public coffers.

In conclusion

As emerging markets gradually catch up with their developed market peers in reopening their economies, we are expecting stronger growth into 2022 – a view that the latest IMF forecasts seem to support. At the same time, EMs (in the main) have been prudent in their fiscal and monetary policies, resulting in upgraded forecasts in several countries on fiscal, debt and external metrics. However, the pandemic has widened the dispersion in this universe and with the global economy still facing some challenges we will continue to see winners and losers – something clearly shown by the diversity of forecasts in the IMF's latest World Economic Outlook.

Regional highlights

Africa

In Angola, Italian oil major Eni has signed an agreement with Sonangol and Angola's National Oil, Gas and Biofuel agency (ANPG) on the production of biofuels. The deal shows intent by Angola to diversify away from oil & gas into sectors that tap into its agriculture industry. In addition, poor economic performance raises the possible need to loosen the fiscal purse as we head into elections next year.

Ivory Coast signed a deal with France to receive approximately EUR1.15 billion in debt relief. The government also adopted the 2022 budget, which will see the fiscal deficit falling from 5.6% to 4.7% of GDP. On the political front, former president Laurent Gbagbo launched the new African People's Party and was elected party leader; the party is said to seek to 'reunite the left'. Many view this as the first step towards Gbagbo's candidacy in the next presidential election in 2025.

The government in Ghana has cut its debt to independent power producers (IPPs) to US$400 million from US$1.4 billion at end-2020. It is also seeking to raise over GHS2 billion (US$340 million) by listing 15 state-owned enterprises on the Ghana Stock Exchange in an attempt to raise capital and reduce the size of the public sector. After significant pressure on bond yields, the government decided to withdraw issuance of its planned ESG bond; the slow pace of fiscal consolidation is weighing on investor sentiment towards the country.

In Egypt, fiscal momentum remains positive, with a 7.6% budget deficit and 1.5% primary surplus targeted for the 2021/22 financial year. Private business sector credit expanded by 16.4% year-on-year to end-September as the economy continued to rebound. The government has hiked the price of natural gas for producers of cement, iron, steel, petrochemicals and fertilizer by 28% and for other industries by 21% as it continues to liberalise prices in the economy.

The government in Zambia continues to make progress towards an IMF deal. Foreign reserves rose to US$2.9 billion at the end of August. The country's finance minister presented the 2022 budget, projecting a deficit of 6.7% (down from 10.4% in 2021) and GDP growth of 3.3%. Other objectives include single-digit inflation by the end-2022 and within the 6-8% target by mid-2023.

Asia

In contrast to many other emerging market regions, central banks in Asia have not yet been forced to tighten monetary policy or raise interest rates. This is due to inflation being well contained across the continent, and external balances remaining healthy. The exceptions to this are the Monetary Authority of Singapore (MAS), and the Bank of Korea; the latter hiked rates, while MAS signalled it is prepared to let the currency strengthen in a bid to curb some inflationary pressure.

Asia has seen relatively benign inflationary pressures compared to much of the rest of the world. While technical factors like the composition of CPI baskets go some way to explain lower headline inflation, even core inflationary pressures remain muted. This can be largely attributed to a more muted fiscal response to the initial COVID outbreak, coupled with more prolonged lockdowns than we have seen elsewhere, resulting in more persistent negative output gaps.

As a commodity importing region, Asia has generally suffered due to the terms of trade shock over the last few months, but there are some exceptions. For example, Indonesia and Malaysia are key exporters of coal, palm oil and rubber, resulting in their respective trade balances performing well. For the rest of Asia, while rising prices have pushed up import spending, exports have mostly surprised on the upside as global goods demand remains strong, and this has kept trade balances in check.

Turning to COVID, Asia is generally moving towards a stance of 'living with the virus'. The exception to this is China, which is still adopting a zero-tolerance approach. Case trends are falling in most countries, but cases have risen sharply in Singapore, prompting the authorities to extend current restrictions.

Regarding China, external balances continue to be very healthy, with particularly strong trade data. The latest figures show that exports beat expectations by a significant margin, while imports were rather weaker than expected. The net effect was a trade balance surplus coming in at US$67 billion. In the property sector, there have been policy responses to ease some of the pressure. The People's

Bank of China (PBoC) has instructed domestic banks to maintain lending to the real estate sector to ensure that capital does not dry up suddenly. This has helped to ease sentiment, and also ensures that property developers have access to credit at a time when it is most needed. Some other PBoC polices, however, were a slight disappointment to some of the market, as there was no change to the Reserve Requirement Ratio (RRR), the Medium-term Lending Facility (MLF), or the loan prime rate.

Latin America

The main theme in the region was one of high inflation, although in some markets there are tentative signs that momentum is starting to fade. Central banks have raised interest rates by higher levels relative to other regions, and local bond curves have more rate hikes priced in.

It was a positive month for local assets in Peru, with the sol and local bonds appreciating. The assets were helped by a reduction in political risk, reflecting the appointment of a more moderate prime minister, as well as congress passing a law to limit the powers of the president. In addition, the central bank hiked interest rates in line with expectations, from 1.0% to 1.5%. Economic activity was stronger than expected, however inflation surprised on the upside. While we continue to believe that the political backdrop in the country is seeing a general trend of moderation, we acknowledge that political hiccups will remain frequent.

Against an already fragile backdrop surrounding the spending cap in Brazil, the government announced a new social spending programme that will cause it to breach the cap next year. This led to four resignations from the government's economic team, some of whom were key members. Sentiment towards the country remains fragile, and there has been significant volatility in bond and FX markets. Additionally, at month end, the central bank's monetary policy committee unanimously decided to raise interest rates by 150bps, a significant step-up in the pace of hikes, but in line with revised market expectations. It also prepared the market for a similarly large hike in its December meeting, as the latest annual inflation data printed at 10.3%.

The central bank in Chile recognised that it was behind the curve on the back of a higher print in inflation and a buoyant consumption-led recovery. As a result, it hiked rates by 125bps, versus 100bps expected. It also signalled that it would normalise rates by year end, which helped stabilise the long end of the yield curve. On the political front, domestic polls are pointing to strong momentum for right-wing candidate José Antonio Kast going into the presidential elections on 21 November. Left-wing candidate Gabriel Boric remains favourite to win in the probable second round, but markets welcomed the rising challenge emerging from the right.

The government in Ecuador presented three large reform bills within one reform package, relating to tax, labour and administrative reforms, but it was pushed back by Congress. The government has now split it into three separate reforms in a bid to get it through more easily, and is now working with congress to achieve this.

Central and Eastern Europe

In Poland, inflation accelerated further in October – beating consensus expectations for a fourth consecutive month and rising to levels not seen for many years. Inflationary pressures are broad based and are likely to prove more persistent than the national bank previously assumed, as its own surveys indicate that labour demand and wage pressures reached record highs.

Political uncertainty continues in Romania, as consultations among political parties have not yet resulted in a new government, while the COVID-19 outbreak intensified to its worst levels since the pandemic started, overwhelming the health system.

In Hungary, the national bank strengthened its hawkish rhetoric, highlighting upside inflation risks which may prove more sustained than previously expected. The deterioration of the inflation outlook was mainly attributed to the rise in energy prices. Given the fiscal easing measures recently announced by the government (ahead of parliamentary elections in Spring next year), the national bank may need to accelerate the pace of monetary policy tightening in order to avoid further currency weakness.

Manufacturing conditions in the Czech Republic have visibly worsened over the past few months, reflected in falling production and deteriorating business sentiment. The automotive sector has been particularly impacted by the severe and prolonged shortages in components. Despite the economic

slowdown, the national bank is expected to continue the normalisation of its monetary policy at a fast pace. The newly formed government coalition has agreed to bring the general government budget deficit under 3% of GDP as soon as possible.

Rest of Europe, Middle East and Africa (EMEA)

The larger-than-expected interest rate cut and the threat to expel certain NATO ambassadors from the country were the key news items out of Turkey. Regarding the former, after the 100bps cut in September, the market was expecting a 75-100bps cut in October, however the central bank decided to cut by a full 200bps. President Erdogan also fired three members of the monetary policy committee ahead of the decision – the members in question were considered to be objecting to the rate cutting cycle. Rising inflation and continued unorthodox monetary policy weighed on Turkish bonds, pushing yields higher. Regarding political developments, Erdogan has been ramping up the national rhetoric following continued declines in his approval ratings ahead of a possible election year. He has also increased the number of soldiers in Syria, as well as threatening to expel several NATO ambassadors. Although he backed down on the latter, all of these developments are increasing the political risk. Economic activity remains strong and the current account correction is being supported by booming food exports and recovering tourism revenues, although strong oil prices likely cap any further upside. In terms of ESG, the government ratified the Paris accord, which is a good step for the country's climate action.

The Central Bank of Russia hiked rates by 75bps, which was more than expected, and signalled it is prepared to increase rates further as inflationary pressures reaccelerate and domestic inflation expectations started to rise again. Inflation in October printed above 8% in year-on-year terms, driven by food price acceleration relating to a weaker than expected harvest. Separately, another re-acceleration of COVID – due in no small part to very low vaccination rates – forced the government to reintroduce a number of restrictions, including temporary lockdowns, and stay-at-home orders for high-risk individuals.

The authorities in Ukraine reached an agreement with the IMF for a disbursement of US$700 million, after important structural reforms were passed in parliament during the month.

Eskom, the state-owned utility provider in South Africa, announced that it is seeking a financing deal at COP26 to the tune of US$30 billion to help it transition away from coal powered electricity generation. At the time of writing, western partners have agreed to a US$8.5 billion package of concessional funding over the next 3-5 years. Separately, municipal elections took place at month end, with the African National Congress's (ANC) on course for its worst ever electoral performance in local elections. Growth data over the month was mixed, while further weakness on the terms of trade weighed on the rand. Inflation momentum in the country is relatively moderate versus many EM peers, helped by domestic demand weakness and a stronger currency.

Several members of the GCC, including Saudi Arabia and the UAE committed to net-zero targets, which is a welcome first step.

In Lebanon, increased tensions between Hezbollah and others over an investigation into the port explosion last year led to clashes in Beirut. At the time of writing, Gulf ambassadors have been withdrawn, casting doubt on long-promised financial support. Given the negative news flow, the defaulted bonds gave up much of their previous months' gains.

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

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