August 2024

Emerging Market Debt Indicator

The fast view

Market background

EM fixed income had a strong month, boosted by falling global bond yields and a weaker US dollar. In the local currency market, returns were driven primarily by EM FX, but rates also generated positive returns. Among hard currency bonds, while concerns over the global macroeconomic outlook weighed on some high-yield markets early in the month, a subsequent rally in risk assets prompted a recovery.

Africa

Inflation momentum is starting to come down across Africa, which is helping the outlook for interest rate cuts in the region. Africa's high-yield debt underperformed, given the spike in volatility earlier in the month. However, debt market access remains open for these economies, and various markets in the region continue to make progress towards exiting default status.

Asia

In contrast with other regions, Asia's manufacturing sector remains strong, with tech-exporting economies continuing to benefit from an AI-driven demand boost. Although PMIs were slightly weaker month on month, they remain in expansion territory (above 50), with Indonesia and Malaysia the notable exceptions.

Latin America

The global bond market rally extended to Latin America's rates markets. However, the 'region's currencies underperformed to varying degrees, driven by a combination of the unwind of the very popular carry trade against Asian currencies and some negative country-specific political headlines in the region.

Central and Eastern Europe, Middle East, and South Africa

Overall, the economic recovery in Central and Eastern Europe continues to falter, mirroring the macro picture seen across more developed European economies. Q2 GDP growth was disappointing, labour markets were weak, and PMIs were in contractionary territory. In addition, higher-than-expected inflation suggests that central banks in the region will find the last mile the most challenging in bringing inflation to target levels.

EM corporate debt highlights

The EM corporate debt market enjoyed another positive month for total returns, with investment-grade and high-yield bonds contributing equally to overall index returns.

Werner Gey van Pittius
Co-head of Fixed Income

Market background

With ongoing signs of a slowing global economy and falling inflation, government bond yields (rates) continued to fall, reflecting in positive returns across fixed income markets.

Surprisingly weak data in the US labour market caused some alarm among market participants early in the month, before subsequent data releases again supported the outlook for a soft economic landing in the US, rather than a recession. More dovish rhetoric from the Federal Reserve (Fed) provided additional support for bond markets and risk sentiment later in the month.

All of this led to a weaker US dollar over the month, with many EM currencies benefiting from this, although rising interest rates in Japan are reducing the relative attractiveness of holding EM currencies against the yen – this was again reflected in traditionally 'high carry' markets in Latin America underperforming. In contrast, 'Asia's EM local currency debt markets were key beneficiaries of the dovish shift by the Fed; falling US interest rates will allow Asian central banks to bring forward their own rate cuts.

Against this backdrop, the asset class had a strong month. In the local currency space, the JP Morgan GBI-EM returned 3.1%, driven primarily by EM FX but with healthy moves in rates markets. While concerns over the global macroeconomic outlook weighed on some high-yield hard currency markets early in the month, a subsequent rally in risk assets prompted a recovery there; overall, the sovereign index (JP Morgan EMBI GD) rose by 2.3%.

Top-down views and outlook

Top-down positioning at the end of August 2024

	- -	-	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.

From a top-down perspective, we continue to have a positive overall risk target, with a tilt towards EM local duration relative to more cyclical/volatile assets. We are overweight local rates but have moved to an underweight target in EM FX, given the weaker global economic growth backdrop. We are neutrally positioned in EM hard currency, with some exposure to select bottom-up opportunities in the credit space.

We are overweight local rates for several reasons. EM central banks responded to the higher-for-longer US interest rate outlook in the first half of 2024 with proactive policymaking; some countries scaled back rate cutting, meaning yields remain attractive. A broad softening of inflation across EM economies means that real (inflation-adjusted) rates also remain high, and real rates are a key driver of long-term returns. Furthermore, as inflation in EM economies continues to print lower than consensus expectations, rate cutting cycles have further room to go in some EM economies. Recent data on the global economy combined with dovish commentary from the Fed gives us increased confidence that these EM economies will have added impetus to continue their rate-cutting cycles. We have recently increased duration in high-quality assets.

In EM FX, we have adopted a more cautious view in reflection of the weaker global growth outlook and the likely impact of that on global trade flows.

In EM hard currency, we continue to focus selectively on bottom-up opportunities and have rotated some credit exposure from high-yield to investment-grade markets in reflection of valuations following recent market moves and to avoid positioning vulnerabilities.

Outlook

The global economy has shown some signs of slowing, with the US labour market cooling and the manufacturing sector weakening. Recent comments by the US Federal Reserve (Fed) were dovish, with Chair Powell suggesting a potential rate cut in September – in reflection of labour market developments and confidence around inflation dynamics. Markets have increased their expectations of total rate cuts for 2024, but further rate-market volatility could materialise if the eventual pace at which the Fed unwinds its monetary policy undershoots expectations.

While financial markets are likely to remain volatile, we continue to be constructive on the medium-term outlook for returns from the EM debt asset class. Many EM economies have solid fundamental foundations, and the more fragile economies are receiving plenty of support from the IMF and other multilaterals. EM bond market valuations look attractive – with some markets still pricing in significantly more risk than we believe is justified.

Regional highlights

Africa

The central bank in **Kenya** kicked off its rate hiking cycle with a 25bps cut; real (inflation-adjusted) rates remain high and that continues to support the Kenyan shilling. Kenya's credit rating was downgraded by S&P to B- with a stable outlook, given concerns over the fiscal outlook. More positively, the IMF review of the country's programme showed good progress overall, and remittances beat expectations, rising 10% year-on-year. The government also issued a local currency denominated infrastructure bond, which was met with strong demand, helping to allay fears around Kenya's ability to access local market financing.

Egypt's net foreign asset position continued to improve and moved into surplus in July, helped by a €1 billion disbursement from the UAE – part of a €5 billion package overall. The government also implemented its new electricity tariffs by meaningfully hiking rates and reducing subsidies. The government also began the move to a liberalised fuel price system, all of which will improve fiscal sustainability. Inflation is starting to fall, with lower month-on-month momentum, which should allow the central bank to cut rates by year end.

The government in **Senegal** established a commission to review domestic oil and gas projects, as promised during the election campaign, with the intention of renegotiating contracts with oil producers where needed. Although this review is expected to have no direct impact on production, it will need to be monitored in case the government look to renegotiate any existing contracts. In other news, the president is calling for an extraordinary session of the National Assembly to possibly dissolve some state institutions, which he says will help push through policy decision making. This development will require monitoring and has added to domestic political volatility.

Ghana has moved closer to exiting its default status, pending the approval of the consent solicitation and the subsequent bond holder approval. Budget data for January to July was positive overall, showing a 2.4% GDP deficit. Inflation moved lower to 20.9%, largely due to base effects from this time last year. In other news, the cocoa regulator, Cocobod, has been struggling to get financing for the annual cocoa bond, so it is instead looking to raise the money domestically.

Nigeria's Q2 GDP data was a bit stronger than expected, given improved crude oil production. However, the main development over August was the central bank's introduction of a Dutch auction system to help with the functioning of the FX market and to clear the backlog of US dollars in the system. The government also issued a domestic US dollar bond, as opposed to a Eurobond, which helped market confidence and diversifies Nigeria's sources of funding.

The drought continues to weigh on growth and inflation in **Zambia**, with the latter moving to 15.5%, driven by higher food prices. Copper production has also been increasing, albeit from low levels, with

the KCM mine now back under the control of Vedanta Resources. This, combined with further investments from the likes of First Quantum, should help this trend of increasing production continue.

Although the government has not confirmed its intent to participate, there have been reports of a planned a debt-for-nature-swap in **Angola**. This would allow the government to redeem some shorter-dated bonds, meaning it might not need to issue in the Eurobond market over the short term.

Asia

Softer economic data from the US and the associated reset in expectations around US monetary policy direction boosted the region's local bond markets – effectively bringing forward rate-cut expectations (lower US interest rates will allow Asia's central banks to ease their policy rates without the risk of sparking a currency sell-off and associated economic challenges). Weaker commodity prices also support the view that rate cuts could be more pronounced than previously expected. Evidence of a shift in monetary policy regime came first from the **Philippines**, with a 25bps rate cut prompting a local bond market rally. That was despite CPI inflation printing higher than the central bank's target and consensus forecasts.

An improvement in inflation dynamics was evident in **India** – a strong monsoon season is helping relieve food-price inflation there; this, coupled with softer growth and industrial production, should allow rate cuts later in the year. Meanwhile, inflation in **Indonesia** fell back below the mid-point of the central bank's target range, increasing the likelihood of rate cuts before the end of the year. The country's FX reserves were up a healthy US$5 billion, and growth data beat expectations; markets also welcomed a budget that was more fiscally prudent than feared.

In contrast, in its budget, **South Korea**'s government announced a planned rise in spending with much higher-than-expected net borrowing, resulting in a sell-off in the country's government debt. CPI inflation was slightly higher, driven by core prices, but a rate cut before year-end still seems likely. Falling inventories boosted the economy's tech production, and although tech exports were down slightly, PMI data points to ongoing strength.

Positive macro dynamics were also evident in Taiwan, Singapore and Hong Kong. **Taiwan** posted a robust Q2 GDP growth figure of 5.1% vs. 4.8% expected. Export orders also beat expectations, and industrial production rose. **Singapore's** PMI jumped from 54 to 57, and Q2 GDP growth was also stronger than expected (a positive reading, vs. consensus expectations of a slight easing on the previous quarter) - that makes a shift in monetary policy stance unlikely anytime soon. Q2 growth data from **Hong Kong** also beat expectations at 3.3% year on year – the central bank has revised up its full-year growth forecast to 3.0%. Elsewhere, **Malaysia's** economy looks set to grow by 5% this year, with domestic demand and exports boosting GDP in Q2. Strong private consumption is in evidence here.

China's economy remains the regional outlier, with falling commodity prices making market participants more concerned about ongoing weakness in credit and activity data. A significant weakening in the Caixin manufacturing PMI points to a potential slowing of exports – the main area of resilience year to date. Industrial production also missed expectations and property sales remain soft, with unemployment rising. However, retail sales and service consumption growth improved somewhat, and the services PMI beat expectations. Trade tensions (with Canada proposing tariffs on EV imports), and increased issuance also weighed on the local bond market. Related to this, talk of local governments being allowed to issue special bonds to fund purchases of completed homes that haven't sold and convert them to affordable housing gave some cause for optimism that looser policy will finally take effect. In the context of a weakening US dollar, the pattern of daily fixing activity by the People's Bank of China over the month signalled that it appears comfortable to maintain stability rather than engineer a stronger currency (which would harm exports).

Political headlines dominated newsflow from **Thailand** and **Sri Lanka**. Thailand's Constitutional Court dismissed Prime Minister Srettha for breaching the code of ethics, but the speedy appointment of the former prime minister's daughter calmed markets by signalling policy continuity. In contrast, markets reacted negatively to rhetoric from the two opposing parties leading the polls in Sri Lanka – including plans to renegotiate the IMF programme and double the tax-free threshold.

Finally, Moody's upgraded **Pakistan's** credit rating to Caa2 and changed its outlook to positive, after the IMF reached a staff-level agreement for an Extended Fund Facility expected to be worth around

US$7 billion.

Latin America

Mexico was the main source of political noise, with progress on the controversial judicial reform weighing on domestic asset prices and leading to strikes. In contrast, there was no real market response to the appointment of an academic as the new head of state-owned utility Pemex – taking the reins from the previous political appointee. While its current account surplus is strong, the country's growth deceleration continued (June retail sales were disappointing), with activity indicators pointing to weakness across industrial and services sectors. This is weighing on Mexico's labour market. The central bank is taking note, and the growth outlook has become its primary concern. It cut rates by 25bps despite FX volatility (helped by an improving underlying inflation trend, with core now in the target range). The central bank's board remains divided in opinion, but the balance seems to be shifting in favour of the doves.

A market-friendly policy shift came from **Colombia**, with the minister of finance announcing that the government will gradually reduce diesel price subsidies. This is positive for the fiscal outlook but will impact inflation. While growth data was lower than expected, signs of economic recovery included the first year-on-year rise in retail sales in 15 months. The country's central bank has revised up its growth and inflation forecast from quite weak levels.

Brazil's economic data remained strong, and industrial confidence improved. While retail sales in June were slightly weaker than expected, they still point to robust momentum in an economy that is also enjoying strong foreign direct investment. The central bank faces pressure to hike rates but has kept them on hold, and mixed rhetoric makes it unclear what path rates will take. Gabriel Galipolo was confirmed as the next central bank governor, as expected by the market.

While inflation remains very high in **Argentina**, it is falling more quickly than anticipated. In positive news for the country's debt sustainability outlook, the minister of finance reported that an agreement had been reached with the International Development Bank, which will give Argentina sufficient finance to cover all external debt payments through 2025. Less encouraging for markets was a disappointing GDP print for June and the passing of a bill (tabled by the opposition party) that would increase spending on pensions. The administration has vowed to negotiate with Congress to try to get the Presidential veto on this reform upheld – a move that would be welcomed by the market.

Chile's central bank surprised the market by keeping rates on hold (consensus forecasts were for a 25bps cut). Q2 GDP data also disappointed, slightly down on Q1. However, the minister of finance still sees a strong outlook for the rest of the year (with the economy on track to grow 2% this year), and mining exports are helping to narrow the current account deficit.

In contrast, **Peru's** Q2 GDP evidenced a strong recovery, with a healthy current account surplus, too. Unexpectedly, the central bank resumed its rate cuts after a pause of several months, boosting the local rates market.

Central and Eastern Europe, Middle East, and South Africa

Despite growth indicators generally surprising on the downside, Q2 growth data from **Poland** suggested that the economy is holding up better than some of its peers, such as **Czechia** and **Hungary,** where there are clearer signs of weakness in industrial production and a faltering consumer recovery.

There were consistent upside inflation surprises in the region; some of this was driven by one-offs, such as package holidays among Czechia nationals, but there's a broader trend of stubborn service inflation momentum, which will complicate the last stage in bringing inflation down to target across the region. This makes the next few months a bit more difficult for central banks, and during August, the National Bank of Hungary kept rates on hold for the first time in 1.5 years. While inflation in **Poland** came in lower than expected, it still rose significantly on the back of energy price changes; the central bank is unlikely to cut anytime soon, given inflation dynamics and the upcoming presidential election.

The disinflationary process in **Turkey**, while complicated, is proceeding largely as expected. However, the central bank remains very hawkish as it tries to anchor expectations. Macroeconomic rebalancing continues in the country and was most visible in the current-account adjustment for June, with a

larger-than-expected surplus. Despite this, there was pressure on the lira given the carry trade unwind and signs of some redollarisation by locals.

We're starting to get more headlines around next year's budget planning: **Poland** in particular announced a still very wide budget deficit of 5.5%; meanwhile, year to date, budget tracking in **Romania** continues to point to significant fiscal slippage this year, with a deficit likely in excess of 7%. More positively, the execution of the budget in **Hungary** continues to improve, leaving the country's 4.5% deficit target for the year still just about in reach.

Elsewhere, **Serbia** is moving one step closer to an investment-grade rating, with Moody's and Fitch changing the outlook to positive. The global rates backdrop, together with a downside inflation surprise, increased the likelihood of the **South African** Reserve Bank starting to cut rates in the near term. There, CPI printed at 4.6% down from 5.1% and beating expectations of 4.8%, with downward pricing pressure being broad based. The producer price index (PPI) print also made for encouraging reading, with lower food and fuel prices adding to inflation downside surprises of recent times. Combined with improving sentiment around the fiscal outlook, this helped the bond market to rally.

The geopolitical backdrop in the **Middle East** remains challenging, leading to volatility in Israeli assets and some high-yield neighbours such as Jordan. In the Gulf, PMIs continue to point to a robust pace of non-oil growth, and into early September, we have started to see a seasonal pick up in Gulf Cooperation Council (GCC) bond issuance.

EM corporate debt highlights

The EM corporate debt market (JP Morgan CEMBI BD) enjoyed another positive month for total returns, gaining 1.7% in August, taking year-to-date returns to 7.2%. Over August, both investment-grade (IG) and high-yield bonds contributed equally to overall index returns. Both markets were driven by similar themes, with the rally in US Treasury yields being the main driver of returns; however, credit spread tightening also added to performance. Within the index, all sectors added to returns, with oil & gas issuers among the top-performing sectors.

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