July 2024

Emerging Market Debt Indicator

The fast view

Market background

The rising prospect of interest-rate cuts in the US and Europe caused global bond markets to rally. Against this backdrop, it was a strong month for emerging market (EM) fixed income, with encouraging inflation dynamics within EM economies among factors providing further support.

Africa

Recent financial account inflows continued to boost Egypt's economy, which also received an US$800 million injection from the IMF. In contrast, Moody's downgraded Kenya's credit rating after the government scrapped plans to hike taxes; in an attempt to turn the tide, a cabinet reshuffle was announced.

Asia

Tech sector strength helped drive Purchasing Managers' Indices in the region to three-year highs, with signs that the benefits of this are broadening to the manufacturing sector. India's first post-election budget showed signs of fiscal consolidation, but as bond issuance needs were not revised down, market enthusiasm was tempered. Recognising progress on reforms, the IMF reached a staff-level agreement from a new programme (c.US$7 billion) with Pakistan.

Latin America

In a first for the country, Paraguay's debt was upgraded to investment grade by Moody's. Activity data remained healthy in Brazil, with retail sales significantly stronger than consensus forecasts. Brazil's government announced BRL15bn of spending cuts this year, which helped local bond yields to stabilise. As Chile is a major copper exporter, the Chilean peso was negatively impacted by the sharp drop on copper price.

Central and Eastern Europe, Middle East, and South Africa

The economic growth picture in Central and Eastern Europe weakened, and inflation undershot expectations, allowing various central banks to cut interest rates. The South African Reserve Bank kept rates on hold in July, with two members voting for a cut, helping the local bond market to rally. A better-than-expected debt restructuring deal in Ukraine led to a rally in the country's eurobonds, but uncertainty around the US election looms large.

EM corporate debt highlights

The positive impact of the US Treasury market rally offset some credit-spread widening, resulting in positive returns for the asset class. Most market segments posted gains over the month.

Werner Gey van Pittius
Co-head of Fixed Income

Market background

Most bond markets posted gains in July, thanks to the rising prospect of interest-rate cuts in the US and Europe.

In the US, weaker economic growth and labour-market data caused yields to fall in the Treasury market. Further impetus came from signs that US inflation is heading in the right direction, with a lower-than-expected month-on-month print for June. At the end of July, the Fed opened the door to a September rate cut. This, coupled with rising tensions in the Middle East, caused a flight to quality by investors, which put further downward pressure on US Treasury yields.

Mirroring the US market, sovereign bond yields fell across Europe. At the start of July, the market was pricing in about 43bps of cuts by the end of this year; by the end of the month, this had increased to 60bps.

Against the backdrop of rallying global bond markets (especially the US), EM fixed income had a strong month. In the local currency space, the JP Morgan GBI-EM returned 2.3%, driven mostly by hedged local bonds (1.5%); EM FX provided the remaining 0.8%. Turning to hard currency markets, the sovereign index (JP Morgan EMBI GD) rose by 1.9%.

Ukraine's hard-currency debt market was a top performer after the country reached a debt-restructuring deal. Encouraging inflation dynamics boosted South Africa's local currency debt market. Inflation also continued to trend down in Central and Eastern Europe, allowing several of the region's central banks to cut rates.

Top-down views and outlook

Top-down positioning at the end of July 2024

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

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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, have a small overweight in EM FX (funded out of euros) and 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 are cognisant of the risks of thematic trade unwinds amid heavy positioning in select currency pairs, and have adjusted positioning to reflect this. Overall, EMFX still has positive tailwinds

from terms of trade, and there is less pressure from US rates, but to hedge against potential headwinds from higher volatility, we have funded the position out of euros.

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 IMF board approved the staff-level agreement and disbursed over US$800 million to **Egypt**, helping the country's hard currency bonds. The central bank left rates on hold at 27.25% over July; inflation was lower than expected, but the government's 12% hike in fuel prices could introduce upward pressure in the coming months. The country's balance of payments is in surplus, with recent financial account inflows outweighing a wider current account deficit and also shifting the country's net foreign asset position into positive territory, putting the economy in a strong position.

Inflation in **Ghana** was slightly higher than expected, with currency weakness contributing to this. The budget statement was positive, with the government's expectations now back in line with their 2024 fiscal deficit target of 5.3% of GDP. The government also revised up its GDP projection from 2.8% to 3.1%. In politics, opposition candidate John Mahama has promised fiscal responsibility, while the market remains sanguine on both candidates ahead of the December election, as the economic policies for both are broadly similar.

The government in **Kenya** is targeting a 4.2% fiscal deficit following the deadly protests in June, with spending cuts rather than tax rises being used to achieve this. Following the government's decision to scrap the tax hikes, Moody's downgraded the country to Caa1. The IMF is likely to arrive in August to assess the budget. A cabinet reshuffle – aimed at forming a unity cabinet and reducing pressure from protests – saw five opposition members taking over positions, including for the finance minister.

The IMF approved a US$3.4 billion extended credit facility for **Ethiopia**. As part of the four-year programme, the country is moving to a free-floating exchange rate. Before the IMF's next review, the government will be looking to restructure its commercial debt.

The Central Bank of **Nigeria** raised interest rates by 50bps, and tightened financial conditions further by raising the corridor within which rates can float in the market. The government also announced a windfall tax of 70% on bank profits gained from the currency devaluation in 2023. It intends to use this to fund a minimum wage rise and increase infrastructure spending, with planned protests likely to put pressure on the government to deliver on lowering the cost of living.

First quarter GDP growth in **Angola** was strong and was the highest since 2016, thanks to a continued improvement in oil production. inflation continues to fall, and the central bank kept rates on hold.

Asia

Tech sector strength helped drive PMIs in the region to three-year highs in June, with signs that the benefits of this are broadening to the manufacturing sector.

In **China**, healthy export growth continued to translate into a strong trade balance, which remains in stark contrast to economic growth (markedly slower in the second quarter). The usual suspects weighed on the Chinese economy – lacklustre domestic consumer demand, a stumbling property sector, and weak credit demand. The Third Plenum of the 20th Party Congress heralded no shift in narrative: various reforms were discussed (including fiscal policy reform/increasing tax revenues), but concrete policy measures are yet to emerge. Similarly, although communications surrounding the Politburo meeting pointed to a pro-growth stance, no new policies were forthcoming. However, a surprise cut to the key policy rate (seven-day reverse repo rate) helped CNY-denominated bonds, and the renminbi ended the month stronger against a weaker US dollar – this is despite China's authorities allowing some currency weakening via the exchange rate fixings.

After a strong first quarter, **South Korea's** GDP growth was more subdued in the second quarter, driven by weaker domestic demand dynamics. However, there are signs of improvement in consumer sentiment. Despite a unanimous decision to keep rates on hold, minutes from the central bank were more hawkish than expected, pointing to increasing concerns over financial stability relating to currency weakness, high household debt and signs of overheating in the property market.

PMIs remained strong in **India,** where the government presented its first post-election budget. Market participants welcomed signs of fiscal consolidation in the form of a narrower fiscal deficit target (4.9% of GDP, down from 5.1%), thanks to a large dividend from the country's central bank. However, disappointment that bond issuance needs were not revised down resulted in a muted market reaction overall.

Recognising progress on reforms, the IMF reached a staff-level agreement from a new programme with **Pakistan**. On approval from the IMF's board, this would result in an Extended Fund Facility Arrangement of around US$7 billion over 37 months.

Bond holders and the **Sri Lankan** government agreed to a framework on its debt restructuring, which now needs to be signed off by IMF and the official creditor committee. The higher gold price helped the **Thai** baht. In contrast, a weaker month for technology stocks and large equity outflows weighed on the **Taiwan** dollar. Export orders were lower in June, following recent strength which has been boosting the broader economy by fuelling domestic demand, for instance. In **Malaysia,** headline inflation printed lower than expected at 2%. The country's trade balance also beat expectations, and GDP data was good. The central bank kept rates on hold, as expected. Meanwhile, a cut in the tariff on rice helped the inflation outlook in the **Philippines**, boosting the bond market.

Latin America

Against the IMF's advice, the government of **Argentina** allowed the central bank to sell some US dollar reserves in the parallel market to support the peso and reinforce tight peso liquidity. This spooked markets, raising concerns around the sovereign's ability to pay coupons and resulting in the first monthly decline in reserves in six months. Subsequently, the central bank made the more market-friendly decision to gradually loosen FX controls - allowing importers to obtain dollars within a shorter time frame. Inflation printed lower than expected, at 4.6% month on month. Other positive developments included a current account surplus for the sixth month in a row.

Activity data remained healthy in **Brazil**, with retail sales significantly stronger than consensus forecasts. Brazil's government announced BRL15bn of spending cuts this year, which helped local bond yields to stabilise. Inflation data was also slightly better than expected, although increases to the price of cooking gas and gasoline by Petrobras will create some upward pressure. Brazil's central bank kept rates on hold as expected, and accompanying messaging was less hawkish than expected as the governor thinks the market is pricing in too many hikes.

As **Chile** is a major copper exporter, the Chilean peso was negatively impacted by the sharp drop in copper price. Despite lower-than-anticipated inflation and expectations of a cut, the central bank kept rates on hold, citing concerns relating to the government's recent increase in power prices. During the month, Fitch reiterated its A- rating and stable outlook.

Ongoing concerns over reforms to be presented to the new Congress in September weighed on the **Mexican** peso – especially as the judiciary reform could fall foul of the United States–Mexico–Canada Agreement. A disappointing inflation print (driven by food price pressure) raised questions around the previously anticipated 25bps August rate cut. Economic activity and industrial production data were both weak, as were retail sales, and the previous month's strong trade surplus reversed. Newly elected President Sheinbaum's forecasts of a reasonable 3-3.5% deficit next year appears at odds with some of the announced spending plans, which is also keeping market participants cautious.

Inflation printed in-line with expectation in **Peru** and **Colombia**. Neither country's central bank surprised the market, with rates kept on hold in Peru and cut by 50bps in Colombia (where two committee members voted for a 75bps cut). A report from Colombia's fiscal rule committee criticised government's spending cut plans, which it considers insufficient to meet the fiscal target. The government is trying to get Congress to adjust the fiscal rule for spending flexibility next year, although this seems highly unlikely to pass Congress.

Despite expectations of an opposition win, incumbent ruler Maduro was declared the winner of **Venezuela's** election, with well-reported and credible allegations of fraud. This prompted heavy criticism from the US administration and large-scale protests within Venezuela. Bonds had rallied early in the month on hopes for a move towards a change in regime coming out of the election, but as these hopes were dashed, markets quickly priced out this expectation.

In a first for the country, **Paraguay's** debt was upgraded to investment grade by Moody's.

Central and Eastern Europe, Middle East, and South Africa

Inflation data across Central and Eastern Europe (CEE) was lower than expected over the month, although to varying degrees. In **Czechia**, the fall in inflation was broad based, driven by core inflation, whereas in **Hungary**, core inflation momentum was less constructive. The region's economic growth picture weakened compared with the previous month, with industrial production, retail sales and PMIs all lower. CEE is, therefore, following the broader faltering EU growth recovery.

Turning to central banks in the region, the Czech National Bank continued with its cutting cycle at the end of the month, while the National Bank of Hungary cut rates by 25bps in July. Central banks in **Romania** and **Serbia** also cut rates by 25bps. **Poland** remains the outlier in its monetary policy cycle, with hawkish rhetoric from the central bank continuing; Governor Glapinksi has ruled out rate cuts before 2026, but the market is looking through this somewhat, with various monetary policy committee members saying there is scope for rate cuts in the second half of 2025.

In **Hungary**, there was an increase in negative political newsflow, with the rule of law dispute with the European Union appearing to be at an impasse. Separately, Hungary is taking over the rotating presidency of the EU council, which President Orbán is using as a platform to push for a peace deal in Ukraine.

There was a lower-than-expected inflation print in **Turkey** and the first meaningful drop in the pace of underlying momentum. This led to a rally in local rates. The central bank kept rates on hold but continued to sound hawkish and wary of cutting rates too quickly. There were increased signs of tight financial conditions impacting growth in the economy. In addition, further fiscal consolidation measures were approved by parliament. Moody's upgraded Turkey's credit rating to Ba1, bringing its rating in line with S&P and Fitch (both B+ with a stable outlook).

The **South African** Reserve Bank (SARB) kept rates on hold in July, with two members voting for a rate cut, helping the local bond market to rally. Inflation is falling, and the SARB reduced its inflation outlook marginally, with growth data remaining weak overall. The new government of national unity is yet to announce any significant new policies.

Bond holders in **Ukraine** agreed to a debt restructuring with the official creditor committee. The deal is better than the market expected, leading to a rally in the country's eurobonds. However, there is still significant uncertainty regarding the geopolitical outlook given the US election and continued incremental gains made by Russian troops.

At time of writing, geopolitical tensions in the **Middle East** have resurfaced and are continuing to weigh on regional assets. The tensions have also offset the downward pressure on oil prices from the weaker global macro backdrop.

EM corporate debt highlights

Along with other fixed income markets, emerging market corporate debt markets had a positive month. The JP Morgan CEMBI BD gained 1.5%, with equal contributions from high-yield and investment-grade bonds. In both market segments, returns were driven by the rally in US Treasuries, which offset a widening of credit spreads. Within the index, all sectors and countries delivered positive total returns, led by real estate in the former and issuers in Ukraine in the latter.

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