August 2022

Emerging Market Debt Indicator

The fast view

Market background

Government bond yields across developed markets rose in August, as policymakers turned more hawkish to battle persistent inflationary pressures. This was particularly pronounced in Europe, where gas prices have continued to spiral upwards, adding to already high cost of living pressures.

Africa

Ghana finally approached the IMF for a US$3 billion deal, while in Zambia, the IMF approved a US$1.3 billion financing program. In a positive sign for Kenya's democratic process, the Supreme Court upheld the result of the presidential election, with a victory for William Ruto.

Asia

There was a clear divergence between the tech-exporting north and the services-driven south-east region, with trade data disappointing across South Korea, Singapore and Taiwan. Data in China was weak across the board and increased COVID cases led to more lockdowns.

Latin America

Central banks in Brazil and Colombia hiked interest rates, with inflation in the former appearing to reach a peak over August. Inflation surprised on the upside in Chile and Peru, while Q2 GDP data in Mexico was slightly better than expected.

Central and Eastern Europe

Inflationary pressures broadly persisted across the region and governments are taking steps to contain energy price increases. The Czech National Bank kept interest rates on hold, in contrast to Hungary's central bank, which raised rates as inflation dynamics are poor.

Rest of Europe, Middle East and Africa (EMEA)

Russia continued to restrict gas supplies to the EU. Ukraine successfully negotiated a freeze on external debt repayments, which bond holders approved. Growth data in South Africa remains weak. In the Middle East, the weaker oil price put more pressure on OPEC to amend production plans.

EM corporate debt highlights

EM Corporate debt (JP Morgan CEMBI BD) produced a marginally positive return in August, despite the significant continued sell-off in Treasuries, materially outperforming both the US investment-grade and high-yield markets. Positive returns in EM were driven by spread tightening, with the high-yield segment of the market outperforming investment grade.

Peter Eerdmans

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

Market background

In early August, a combination of strong non-farm payrolls data and a slight fall in the headline inflation number (CPI at 8.5% year-on-year) in the US helped risk assets continue their strong run from July. However, at the Jackson Hole central bankers' summit, US Federal Reserve (Fed) Chair Powell gave a hawkish statement, suggesting that the Fed will continue to fight inflation and keep rates higher for longer. This caused the 10-year US Treasury yield to climb, ending the month at 3.2%, weighing on bond markets globally.

Outside the US, government bond yields across developed markets rose in August, as policymakers turned more hawkish to battle persistent inflationary pressures. This was particularly pronounced in Europe, where gas prices have continued to spiral upwards, adding to already high cost of living pressures.

Despite the sell-off in government bonds, hedged bonds in the JP Morgan GBI-EM ended the month in marginally positive territory (+0.1%), while EM FX fell slightly, bringing the total index return to -0.14%. In hard currency sovereign debt, the JP Morgan EMBI fell 0.9%, with the more rate-sensitive investment-grade (IG) markets (-1.9%) driving this as high-yield markets posted a small positive return (+0.1%). In the corporate market, the JP Morgan CEMBI BD gained 0.2%, with high yield (+1.0%) outperforming IG company bonds (-0.4%).

In Latin America, inflation in Brazil surprised on the downside, with a number of data prints pointing to deflation. Several central banks also raised rates over July, including Brazil and Colombia.

In Asia, there was a clear divergence between the tech-exporting north and the services-driven south-east region, with trade data disappointing across South Korea, Singapore and Taiwan. In China, there were several rate cuts from the PBoC in a bid to provide support to the economy, as data pointed to ongoing weakness.

Top-down views and outlook

With both war in Ukraine and the economic impact of COVID lockdowns in China continuing, investors face ongoing volatility and uncertainty. Sources of uncertainty include the disruption to exports of soft commodities and energy, and continuing supply-chain disruption. Against this global backdrop, global growth is falling and recession risk is rising.

The threat of inflation remains the dominant focus of central banks, with the US Federal Reserve (Fed) firmly on the rate-hiking path. But on hiking interest rates by 75bps in July, the Fed also said future hikes will be more data-dependent, amid rising recession risks being priced by markets. We continue to believe that emerging market bond valuations are generally more fairly reflective of current inflationary pressures. While in some markets headline inflation appears to be peaking, it remains high and is a key risk facing investors. While our analysis of various projections leads us to expect some broad headline relief by the end of the year, the economic impact will be diverse and requires careful navigation, especially as the conflict in Ukraine has pushed the point at which inflation is likely to peak further into the future. While commodity prices are well below their highs now, the volatility and dispersion of commodity price moves has impacted countries' terms of trade, with distinct winners and losers across the EM universe.

In aggregate though, the fundamentals of emerging markets remain sound and valuations – that were already attractive before the war – remain a significant support for the asset class. While uncertainties are likely to continue to impact these markets, we remain constructive on the medium-term outlook for the asset class.

From a top-down positioning perspective, we have moved somewhat more overweight risk across our EM debt strategies. In EMFX we continue to have a neutral top-down target; while strong underlying fundamentals of higher carry and healthy external balances are supportive, the stronger US dollar still presents a headwind, and the moderation of some commodity prices is weighing on many EM economies' current account dynamics. In hard currency debt, we have kept our overweight positioning. Although hard currency debt remains vulnerable to slowing growth and higher rates,

forced selling pushed valuations to extreme levels. As for local currency bond markets (local rates), we have turned more constructive and increased our position to a small overweight to take advantage of the relative opportunity in the asset class given the extent of EM rate hikes, attractive real yields and low foreign positioning, although inflation remains a concern in some markets.

Top-down positioning at end August 2022

	- -	-	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.

EM Debt Q&A: Exploring a more constructive outlook

Grant Webster
Portfolio Manager

Following the big drawdowns seen in EM Debt this year, investors are rightly assessing the asset class and considering its future return prospects. History tells us that when valuations reach the extreme levels seen in July, the likelihood of good returns over the medium-term rises. But the complexity of the current global backdrop demands a robust analysis of the asset class. Grant addressed some of the key questions EM Debt investors asked him on his recent roadshow. Below we provide an excerpt - to read Grant's full note, which covers more questions that we have space for here, please visit our website.

How has EM Debt performed in the context of a global bond bear market?

EM Debt has been caught up in the general fixed income bear market, driven by rising inflation, central bank policy tightening, and risk aversion associated with the volatility of inflation and rates. In July, US inflation hit its highest level in over 40 years; investors are understandably concerned. Like other credit asset classes, emerging market (EM) credit has suffered outflows, particularly from the retail investor base. Significant ETF outflows have distorted the market. However, recently outflows have stalled and we are seeing increasing interest from institutional investors, indicating that the asset class could see net inflows in the second half of 2022.

There is some comfort for investors in how EM Debt returns compare during this sell off, given all the headwinds faced by the asset class. We believe this speaks to the relative structural strength of EM economies now versus other sell-offs seen over the past 25 years.

EMs have endured some notable bear markets: the 1990's Asian crisis; the Global Financial Crisis (GFC); 'taper tantrum' (sparked by the 2013 Fed hiking cycle); and the COVID-19 pandemic market turmoil of 2020. We think the current bear market (and thus the subsequent recovery) is different to both the GFC and COVID ones. The key difference is that rather than being caused by a major external economic shock that central banks could react to with policy easing and asset purchases, the driver of the current sell-off in fixed income markets – including EM – is monetary policy tightening by major central banks, albeit with the Russian invasion of Ukraine worsening the global inflation dynamic.

We also believe that this episode of weakness is different to taper tantrum. Although monetary policy tightening drove both sell-offs, economic fundamentals in EM today are in much better shape. In contrast with the current account deficits of 2013, EM external balances are stronger, and there are no meaningful 'hot money' inflows. Furthermore, EM currencies are not overvalued and fiscal deficits have improved from COVID levels.

There are never any perfect historic analogies to the present, but this bear market is perhaps more akin to the early 1990s than our experience in 2008, 2013 or 2020. During the early 90s, the US Federal Reserve hiked rates and tightened global dollar liquidity, which ultimately pressured emerging markets and led to the 'Tequila Crisis' in 1994. However, once the Fed hiking cycle came to an end in 1995, even though it had to keep rates elevated for some time, EMs began a gradual recovery. Another historical comparison we also consider, although by no means perfect, is the recovery in EMs in the early 2000s. Following the bursting of the tech bubble, the global economy again enjoyed a gradual recovery as inflation and yields retreated.

We are not saying that we should expect a sharp fall in global inflation and thus an easing of policy rates. But we would argue that the recent combined effects of supply-chain disruptions, excessively loose monetary policy, and the Russian invasion of Ukraine led to a period of excessively high inflation from which at least some recovery should be expected as the shock waves from these events diminish.

Are EM sovereigns equipped to deal with the low-growth, high-inflation environment?

While EMs still have some way to go, on average (excluding China, Russia and Taiwan), the market currently prices them as around 65% through their hiking cycles, compared to 67% for the Fed and 25% for the ECB. In June the market priced EM's as being 46% through the cycle. In addition, we expect inflation to moderate next year, while higher nominal growth rates have actually boosted fiscal positions in many EMs.

The underlying drivers of global inflation are already starting to show signs of easing, with the exception of European gas prices. This increases the chances that US rates will not rise as high as the market had previously thought and that rate hikes in the EU will be limited due to the widespread economic slowdown already being felt (gas prices have risen to almost 20x their 2019 levels at the time of writing). Commodity prices are well off their 2022 highs and even US gasoline and diesel prices have fallen, but Europe is an entirely different story. We see EM inflation showing signs of moderation (with a few notable exceptions) thanks to the proactive rate-hiking by EM central banks, who began tightening policy much earlier than their developed markets peers. Food prices in EM are moderating; this is positive for EMs given the large share (30%) food represents in EM consumption baskets.

We believe that generally having stronger balance of payments positions on the back of higher terms of trade will also help EMs cope with a lower growth environment. Many EMs front-loaded their issuance last year, reducing short-term maturities. Thus, EMs appear better positioned – relative to taper tantrum and the immediate aftermath of COVID-19 (mid-2020) – to endure a period of lower growth. That said there is a 'tail' of EM frontier markets which appear to have over-borrowed in hard currency and they will face challenges (and particularly lower commodity prices) if yields remain elevated and the new issue market remains closed. In this space we are closely monitoring markets like Ghana, while among the larger markets, Turkey is a key one to watch.

However, a prolonged period of low growth and higher rates is not our base case expectation. We believe that developed markets (DM) household and corporate balance sheets remain strong and unemployment is unlikely to rise dramatically. Furthermore, the IMF is working with members to transfer SDR allocations from those countries not needing them (predominantly DMs) to the most vulnerable EMs.

Which countries are most exposed to funding pressures?

Excluding CCC rated markets and defaulted debt, Turkey is the most worrying market in the EM debt investment universe. It is furthest away from seeking additional external support, its monetary policy is unorthodox, and it has a large amount of external debt due over 2022/2023. If we see a severe global liquidity squeeze, Egypt could also be at risk, although the significant reduction in foreign ownership has reduced vulnerabilities, an IMF support package is imminent, and the Gulf Cooperation Council has also announced significant support.

The most vulnerable countries are those with large short-term gross financing needs and poor credit fundamentals (Egypt, Ghana, Pakistan, Kenya). However, we believe market pricing has already reflected these risks to a great degree, with low cash prices of long-end bonds. Liquidity conditions

are likely to improve on the margin for Egypt, Tunisia, Ghana, Kenya and Pakistan as all of these are on or working towards an IMF program. Most foreign investors have left, meaning the financial-account drain (i.e., impact from tightening financial conditions) will be lower as there is little foreign capital and currencies have adjusted significantly.

We believe the frontier-market segment has already experienced its 'sudden stop' moment (characterised by a collapse in foreign investor flows) and the IMF may need to revive some of the support measures implemented post-COVID in tandem with countries also focussing on securing more multilateral support.

What is the outlook for EM Debt returns?

In looking back at the return drivers of EM debt, it is yield that has made the largest contribution to return. This paints a strong picture for return prospects from the asset class in the coming three-five years. In the charts below, we plot yields over time and for each point in time we show the return recorded over the subsequent three-year period. This shows that when yields spike (dark green line), the subsequent 3-year return (light green line) is strongly positive. This holds true for both local and hard currency returns.

Fig 1. Hard currency return (JP Morgan EMBI)

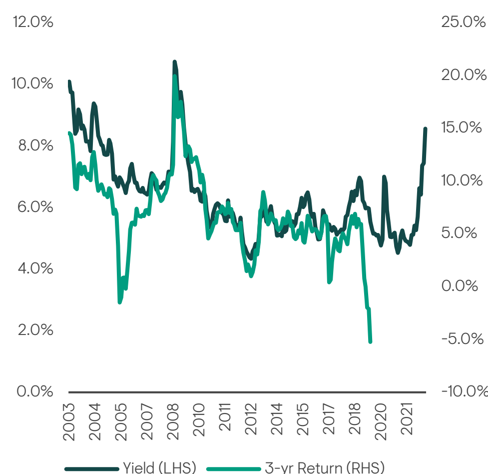
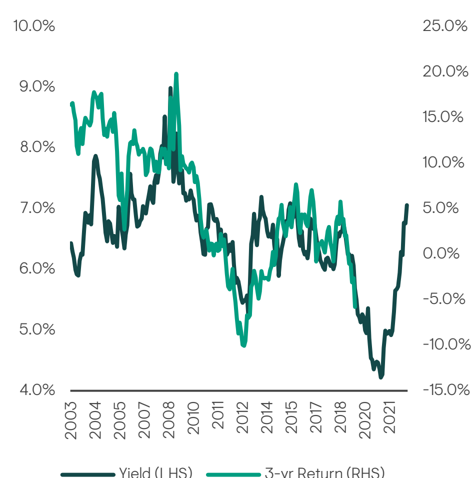


Fig 2. Local currency return breakdown (JP Morgan GBI-EM)



Source: Bloomberg, JP Morgan. As at August 2022. For important information on indices, please see Important information section.

In summary

While, like wider fixed income asset classes, EM Debt has been caught up in the global bear market year-to-date, we are encouraged by the fact that EMs' relative performance has been much stronger than in previous crises. This speaks to the relative structural strength of emerging markets now compared to other sell-offs over the past 25 years: lower levels of dollar debt, free-floating exchange rates and proactive central banks. Given this structural improvement across EM, combined with attractive valuations and signs that inflation is slowing and many central banks in EM are near the end of their hiking cycle – representing an attractive entry point for debt investors – we believe the backdrop is shifting to a much more constructive phase for EM debt investors.

Regional highlights

Africa

Ghana finally changed its mind on 'going it alone' and approached the IMF for a US$3 billion deal. The IMF continues to be very supportive of the country and says it wants a deal by year end but will need to see what the country's policymakers are willing to deliver. In addition, the African Export-Import Bank loan should provide some support to the currency, while further flows in October from a Cocobond will also help. Turning to monetary policy, after keeping rates on hold, the central bank raised rates by 300bps and increased reserve requirements by 300bps to be phased in over the next 3 months, which should help tighten liquidity conditions further.

In Zambia, the IMF approved a US$1.3 billion, 38-month financing program. This allows immediate disbursement of US$185 million and clears the way for a comprehensive debt restructuring. Zambia has commitments from formal creditors, and the release of the debt sustainability analysis will allow engagement with commercial creditors on the relief that is required. Regarding inflation, the performance of the kwacha has helped drive a significant reduction in inflation, from 9.9% to 9.8% in August, as the majority of categories declined. However, there is still some downside risk in the short term from further cuts to regulated fuel prices. Also in the country, a domestic fertiliser plant is to start in September. Given the importance of agriculture to the economy, this project is crucial as it will meet 60% domestic fertiliser needs.

The Supreme Court in Kenya upheld the result of the Presidential election, with a victory for William Ruto. This is positive for Kenya, which has showed a significant improvement in its democratic process since previous elections. On the fiscal side, as COVID tax breaks have been removed we have seen significant fiscal outperformance, with revenues up 23% year-on-year and further excise tax hikes to be implemented in September. Some parts of the recurrent expenditure are also moving higher, such as food subsidies, but overall the deficit is likely to be significantly better than the 8.7% of GDP target. Inflation has increased to 8.5% on the back of food prices, with the domestic drought getting worse. We have also seen reserves continue to move down as no external financing arrangements have been made, however we expect President Ruto to try to shore up support.

In Nigeria, World Bank President David Malpass met with Vice President of Nigeria Yemi Osinbajo in Washington, where they discussed Nigeria's energy transition and focused on World Bank support for reducing subsidies while continuing to push on with the required FX reform. Fiscal deterioration, however, continues and is reducing any gains from the higher oil price, while funding also remains constrained, meaning that the central bank financing is now a significant portion of the country's deficit.

Asia

There was a clear divergence in Asia between the tech-exporting north and the services-driven south-east region, with trade data disappointing across South Korea, Singapore and Taiwan. Purchasing Managers Index (PMI) data also pointed to a bifurcation between the two regions – consistently below 50 in the north but in expansionary territory (above 50) in the south-east. This is partly due to the south-east still being in the economic re-opening phase post COVID, while the north is more susceptible to the weaker global sentiment given its dependence on tech-led exports.

Data in China was particularly weak across the board, with credit growth, fixed asset investment, industrial production and retail sales all surprising on the downside. Property market activity also remains weak. COVID cases are still emerging, leading to more lockdowns, which weighed on consumer confidence.

Recognising the weak data and lower growth prospects, the PBoC announced a bout of policy easing, both monetary and fiscal, which included a 10bps cut to the 1-year medium-term lending facility (MLF), as well as a 10bps cut to the 7-day reverse repo rate. Both of these rates are used by banks to fund themselves. Later in the month, the 1-year lending prime rate (LPR) was cut 5bps, while the 5-year was cut by 15bps. Given that the 1-year is a more commercially used rate, and the 5-year is used more widely for residential mortgages, this signalled that the PBoC is trying to support the real estate sector. On the fiscal side, a total of RMB1 trillion was pledged across a variety of sectors to help boost the economy.

In Indonesia, the central bank governor said there was no rush to increase interest rates but later in the month there was a surprise hike, making this the last country in Asia to raise rates post COVID.

Monetary policy committee members of South Korea's central bank voted unanimously to hike interest rates by 25bps, which was in line with expectations, and the banks' end-of-year inflation forecast was revised higher to 5.2%, which subsequently caused a sell-off in local bonds. The country reported its biggest trade deficit since 1997, and this weighed on the won.

The current account deficit in Thailand was much wider than expected (US$4 billion versus US$1.7 billion expected). The central bank governor set a dovish tone, suggesting that policy normalisation will be gradual and measured. This was reiterated by the finance ministry, which also mentioned that some FX intervention would be acceptable to help the baht's stability. Also over August, the prime minister was removed from office.

In India, the central bank remains rather hawkish amid ongoing concerns about rising inflation.

Latin America

In Brazil, the central bank hiked by 50bps to 13.75%. The accompanying statement was on the dovish side, suggesting the bank will be more data dependant going forward. Inflation continued to surprise on the downside, with several prints showing some deflation. Regarding the presidential election, the campaign is now in full swing, with early polls showing Lula leading Bolsonaro, albeit with a narrower margin. Both candidates have talked about extending the fiscal support program into next year.

In contrast to Brazil, inflation surprised on the upside in Chile. The country's trade balance was also disappointing, due to copper exports underperforming; this led to a large current account deficit of 8.5% of GDP for Q2, which weighed on the currency. There was also continued intervention from the central bank in the FX market, and the government also agreed an increased precautionary credit line with the IMF. The looming constitutional referendum was also prevalent in August, with the country voting on whether to accept the new draft. Post month end, the new constitution was soundly rejected.

Q2 GDP data in Mexico was slightly better than expected, while the mid-month inflation print was an upside surprise, driven by core inflation.

The central bank in Colombia hiked rates by 150bps to 9%, in line with expectations. The bank also increased the 2022 growth forecast to 6.9% from 6.3%. Newly appointed President Petro announced a new tax reform, and is looking to raise 1.7% of GDP by taxing higher-income households and introducing a new tax on sugary drinks and highly-processed foods, with the latter receiving some push back.

Inflation came in higher than expected in Peru at 8.75%, driven by food and transport. President Castillo's corruption allegations continued, with his sister-in-law under arrest in a case involving him.

In a dispute involving the settlement of an old oil contract claim, French oil company Perenco managed to freeze Ecuador's assets in Luxembourg (which it uses to make coupon payments) in a bid to force the country to pay. Although this has now been settled, and the finance ministry has assured investors that the account freeze will not affect coupon payments, it has introduced additional volatility and uncertainty to the country. More positively, S&P kept its credit rating of Ecuador on hold at B- with a stable outlook

The main news out of Argentina was the announcement of new policies from newly appointed Minister of Economy Sergio Massa. Massa has implemented more orthodox measures to rein in inflation and spending, including adjusting utility subsidies. The primary fiscal deficit was slightly better than expected, however the trade balance deficit was worse than expected due to much higher energy imports, and many exporters hoarding produce rather than exchanging them for pesos.

The government in El Salvador intends to buy back the sovereign's 2023 and 2025 bonds. If successful, this will help the country reduce its roll-over risk and generate some cash savings as the bonds are trading at distressed prices.

Central and Eastern Europe (CEE)

Activity data in CEE has continued to deteriorate on the whole, particularly in Poland. At the same time, inflationary pressures have broadly persisted, with inflation momentum re-accelerating in Poland and continuing to rise materially in Hungary. While governments are taking some measures to contain energy price increases, utility price hikes were announced in Hungary, while in the Czech Republic there is still upward pressure from contract renewals.

For now, the Czech National Bank is keeping interest rates on hold, tentatively encouraged by relatively low real wage data, soft growth and some signs of moderation in inflationary momentum. This is in stark contrast to Hungary, where inflation dynamics are poor, forcing the Hungarian National Bank to continue with its aggressive rate-hiking cycle and take steps to limit weakness in the forint through expanding liquidity-draining tools. The National Bank of Poland is arguably somewhere in the middle of these two examples; with inflation surprising higher in August, the central bank governor hinted that there are perhaps 50 more basis points of hikes to come in this cycle, and in early September hiked rates by 25 basis points.

In the medium term, politics remains an important driver of sentiment around macroeconomics in the region. The Hungarian government has submitted plans regarding the rule of law mechanism to the EU commission; this may or may not result in the flow of EU funds, which are crucial to the country's balance of payments and investment in fiscal spending. Meanwhile in Poland, domestic political dynamics are constraining the ability to meet EU recovery fund milestones – and thus there has still been no disbursements from the scheme.

Rest of Europe, Middle East and Africa (EMEA)

In Russia, state-owned gas company Gazprom continues to restrict gas supplies to the EU, eventually cutting off the Nord Stream 1 pipeline completely in early September. However, so far the EU appears to be resilient and is moving towards a support mechanism for the winter. War in Ukraine continues to drag on, with Ukrainians increasingly taking the initiative in the conflict. With many military analysts of the view that Russian offensive capabilities are exhausted, Ukrainians are now undertaking offensives in Kherson and other fronts. With the war continuing, Ukraine successfully negotiated a freeze of external debt repayments, which was approved by its bond holders.

In Turkey, in what was another unorthodox policy decision, the central bank cut interest rates against expectations, despite inflation remaining in excess of 70%. At same time, the authorities took various steps to increase demand for the lira through a change in banking sector regulation. The trade deficit remains high in the country, with growth holding up relatively well, although recent PMI data is the lowest since the COVID shock.

Growth data in South Africa remains weak on the whole, although the latest PMI and manufacturing data was somewhat more positive. Current account data surprisingly showed a return into deficit in Q2. Inflation continues to rise, with core surprising marginally to the upside.

In the Middle East, the increasing likelihood (albeit still very uncertain) of an Iran nuclear deal weighed on the oil price given it would likely increase the oil supply. This, combined with the weakening global growth outlook, puts more pressure on OPEC to amend production plans.

EM corporate debt highlights

EM Corporate debt (JP Morgan CEMBI BD) produced a marginally positive return in August - despite the significant continued sell-off in treasuries – materially outperforming the US investment grade and high yield market. Positive returns in EM were driven by spread tightening, with the high-yield segment of the market outperforming investment grade. Within that, lower quality credit outperformed higher quality. From a sector perspective, real estate performed the best, alongside infrastructure, with consumer and pulp & paper underperforming. From a country perspective, Argentinian corporates continued to perform well, as well as bonds in Ecuador and Ukraine. Additionally, China real estate was a strong outperformer as further government support was provided in the form of state guaranteed loans to higher quality issuers, which provided partial relief to the sector.

Other than non-specified information referred to above, data in this report is sourced from Bloomberg, as at end August 2022.

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