December 2020

— Previously Investec Asset Management

Emerging Market Debt Indicator

Market background

The fight-back against COVID-19 intensified during the month with a handful of countries, including the US and UK, starting mass vaccinations. Expectations this will be a significant contributor to a recovery in global growth during 2021 supported investor sentiment early in December, as did a COVID stimulus bill finally signed by President Donald Trump just after Christmas. US equities reached new highs by year-end, mirrored by a further slippage in the US dollar index. The UK and the European Union finally signed an agreement establishing their post-Brexit trading relationship and avoiding the introduction of tariffs in 2021. Global manufacturing data released during the month suggested a recovery in both investment and consumer spending, but this could be affected by further travel restrictions in response to a more contagious virus mutation first reported in the UK.

US 10-year Treasury yields ended the year near historic lows. The US Federal Reserve's criteria of a tight labour market or inflation breaching a 2% target before it would consider raising rates still seems some way off – the latest unemployment rate remains more than 3% higher than earlier in the year pre-COVID, while the consumer price index for November was 1.2%. Across emerging markets, portfolio inflows ended the year close to a seven-year high, benefiting from hopes of a strong recovery accompanied by few sovereign defaults, in spite of the difficult trade environment during 2020.

Chile's central bank lowered growth projections for 2020 but upgraded 2021 GDP forecasts to between 5.5% - 6.5% year-on-year and the peso rallied. A forecast double-digit percentage rise in the price of copper to US$3.21 per pound supports 2021's recovery, as the ore accounts for about half the country's exports. The second permitted withdrawal from national pension funds to help citizens cope with the effects of the pandemic supported the peso as US dollar-held assets were sold, although a decision by the country's constitutional court has ruled out any further withdrawals.

For the second month running, the Turkish central bank raised interest rates and the latest 200 basis points adjustment to 17% was higher than market expectations, which helped the lira. The central bank's new governor has moved quickly to try and restore the bank's credibility and the hike will also help to curb inflation, currently running at an annual 14%.

In Zambia, the country's hard currency bonds rallied following a visit by the International Monetary Fund which stated that due to its 'deep-rooted challenges' the country needed to revise its economic policy to make its debt more sustainable.

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

Top-down views and outlook

A more attractive backdrop for EM debt in 2021

At the beginning of 2020, consensus expectations were that emerging markets would continue to benefit from a modest cyclical recovery, reflecting an easing of US-China trade relations and decent economic data. The onset of COVID-19 changed everything and led to a significant risk off move. Current pandemic news flow suggests Q1 2021 may still prove difficult, reflecting tighter lockdown restrictions in response to a more contagious virus mutation. We believe the rollout of mass vaccinations will help investors look through these short-term challenges to focus on the expected strong improvement in global growth, led by the rebound underway in China and other Asian markets. The recent Brexit deal also reduces uncertainty.

With the US Federal Reserve expected to retain its mantra of lower rates for longer reinforcing expectations of a softer outlook for the US dollar, EM assets are expected to be beneficiaries, benefitting from stronger investor inflows. Further momentum is being supplied by the roll-out of mass COVID vaccinations and expectations that more conventional leadership in the White House will result in a less confrontational US trade policy.

A reset for US-China relations?

Given the significant deterioration in US-China relations over the last four years, the US election outcome should be viewed positively. We expect policy to become more predictable and diplomatic across all fronts, providing a conducive environment to rebuild bilateral relations, as the existing channels of communication had fractured. Key global initiatives such as the fight against climate change will require both countries to collaborate.

Any risks largely stem from a potentially less congenial policy approach towards China from the incoming Biden administration than we currently envisage, or if President Donald Trump imposes measures between now and inauguration day to protect his "anti-China" legacy, which will be difficult for the Biden administration to unwind without appearing soft.

We expect the US will continue to view China as a strategic competitor from a trade/economy perspective, but this approach is likely to focus more on enhancing the competitiveness of the US economy, as opposed to the beggar-thy-neighbour policy approach seen over the last four years. We don't expect an immediate reversal of the tariffs implemented by the outgoing administration, but Biden has previously voiced his disdain for tariffs which he has recognised as harmful to the US and which also contravene WTO rules, and so we would expect a gradual improvement on this front.

Positioning in sovereign debt

We think these macro and geopolitical adjustments are likely to be accompanied by a high degree of divergence for sovereign debt, reflecting factors such as countries' vulnerabilities at the beginning of the crisis (and which may have been exacerbated by the pandemic), how well governments have been handling the crisis, and more how they will finance their inflated deficits. We think that there will be a period of one to two years for EMs to repair their balance sheets – beyond which the US Fed may consider raising rates. The mantra that a "rising tide floats all boats" only goes so far in our view; the effects of COVID means some have been fatally holed below the waterline.

Selecting the stronger performers as vaccines are rolled out and governments try and normalise by reducing their COVID related fiscal spending while improving their growth outlooks will be key, in our view.

In Latin America for example, countries with significant natural resource exports are likely to prove key winners of the Asia-led rebound in demand. We see value in selected assets in Ecuador, Costa Rica and the Dominican Republic, which depend on oil exports or tourism revenues. Other countries we currently favour include Indonesia, Malaysia, Angola, Egypt and Ghana. Turkey could also be an attractive value play should the country maintain its recent tight monetary policy and if President Recep Tayyip Erdogan agrees to a period of lower growth.

We think China is also likely to continue performing well, given its decisive response to the pandemic at a relatively early stage during 2020 and in particular we see the country's fixed income instruments as well placed to deliver attractive returns over the medium term. This belief is underpinned by the country's relatively high economic growth, mild inflationary pressures, supportive balance of

payments dynamics, high yields and a significant underweight exposure in global investors' portfolios.

In contrast, Sri Lanka may not be supported by any recovery in global tourism as to us the government seems incapable of taking painful decisions.

Potential risk factors in EM

We think the key risks facing emerging markets are associated with the incoming Biden administration, and specifically what affect more conventional leadership in the White House will have on bilateral relations with different emerging markets. Aside from China, other areas that we will be closely monitoring include:

Russia, which has been shielded from a number of congressional-driven sanctions by Trump. Biden's approach is expected to be a lot tougher, although we think the key risk of sanctions against ruble-denominated debt is unlikely, barring a further major escalation in tensions.

Relations with Turkey may weaken following recently imposed sanctions over its purchase of a Russian missile defence system, as well as possible action arising from forthcoming US legal proceedings against state-owned Halkbank concerning possible sanctions violations against Iran. Meanwhile, tensions between Turkey and the EU over disputes in the Eastern Mediterranean will likely continue.

Biden has signalled his willingness to reach out to Iran, but there are significant risks regarding the execution of a deal covering that country's nuclear programme. Elsewhere though, we expect the new administration to take a tougher line with Saudi Arabia.

More broadly, we see EM election risks as relatively modest during 2021. That said, several of them will bear monitoring, particularly in Latin America where there will be key elections in Peru, Mexico and Chile.

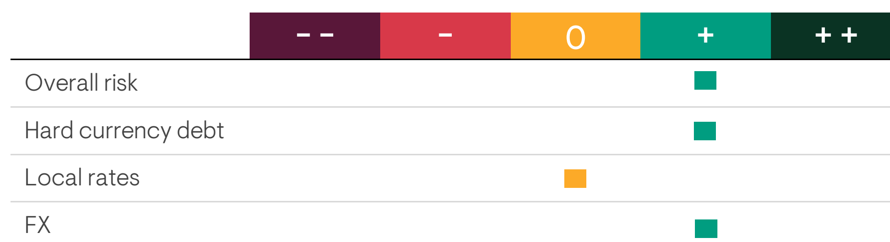
The ability of OPEC+ to manage oil production through 2021 is another key risk we will be monitoring. This will in large part depend on arguably the biggest "external" risk of all: the progression of COVID vaccine production and its distribution to emerging markets. This will be vital for global growth prospects, impacting everything from oil demand to tourism, and we are carefully monitoring the range of potential vaccines now emerging.

The case for investing in EM debt during 2021

In past market cycles, EM debt has offered attractive returns thanks to higher yields and strong growth potential. These returns typically provided a moderate correlation to more mainstream asset classes, and offered attractive diversification benefits.

In the current environment, we believe that there are strong reasons for an investment in EM debt, with supportive tailwinds including the allure of relatively attractive yields in a low-yield world; improving trade flows within and across EM regions and the diminishing role of the US dollar on the global stage.

Top-down positioning at end December 2020



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Portfolio positioning highlights

An overview of our positioning in a selection of regions, countries and currencies.

Africa

The market continued to wait for the normalisation of foreign exchange (FX) policy in **Nigeria** as the economy struggled due to the effect of US dollar shortages, which led the World Bank (WB) to downgrade real GDP growth expectations for 2021 from an already muted 1.8% to 1.1%. There has been some progress on reforms, such as the removal of fuel subsidies and increases in energy sector pricing. This has allowed the WB to approve a US$1.5bn credit facility, but some multilateral funding is still being held up by a lack of progress on clearing the FX backlogs. Parliament approved the NGN 13.6trn 2021 budget using an oil price of US$40 per barrel and an exchange rate of 1 US$: NGN 379, although we expect both assumptions to change, but the actual budgetary outcome will be dependent on Nigeria's ability to raise the required financing. We have no exposure to Nigerian assets.

Purchasing managers' index data in **Kenya** was 51.4 in December, but remained muted overall as the COVID curfews in place continued to weigh on economic activity. The curfew was extended until the end of March, but as cases have fallen Kenya has now re-opened schools, which is a positive sign for the domestic outlook. The WB estimate this could add 2.2% to the 2021 growth estimate. Inflation started to drift up as the food and fuel constituents weighed on the headline figure, although the latest number of 5.6% on a year-on-year basis is still well within the government's 2.5% - 7.5% range. On the external side, remittances held up well with November's inflow 18% higher on an annual basis. Parliament also approved reversing the COVID tax cuts in January, with further digital taxes being planned to raise revenues further. Both of these moves will be important for the chances of an IMF deal. We remain long hard and local currency debt.

The ruling New Patriotic Party (NPP) and President Nana Akufo-Addo won December's tightly contested election in **Ghana**, with Akufo-Addo winning 51.3% of votes vs 47.4% for John Mahama. The election registered a very high 79% turnout, vs the 69.3% seen in the 2016 election. Given how tight the outcome was, it has been challenged by the opposition party who have filed a petition at the Supreme Court. In spite of the ruling party's victory, it lost its majority in parliament which could influence the ability for the NPP to execute its reform ambitions, although given the strength of the president's powers, we expect this impact to be reasonably limited. GDP growth came in at 1.1% year-on-year for the third quarter as stronger agricultural growth was offset by continued weakness in services and mining. We have reduced hard currency exposure after a strong rally, and expect significant issuance in 2021, but continue to hold the local currency bonds.

Growth recovered to 0.7% year-on-year in **Senegal** for the third quarter as agriculture rebounded, but services remained on the backfoot as the impact from COVID continued to affect the economy. Inflation remains muted, with the latest figure of 2.3% year-on-year, down from 2.6%, while core inflation was stable at 1.3%. We remain long hard currency bonds as we see a longer-term upgrade story in the country.

The government in **Zambia** presented the economic reform programme for 2020-2023 which is aimed at getting the economy out of its economic slump and achieve sustainable growth, while continuing to deal with the country's structural fiscal imbalances. As part of its reform programme, the government intends to reduce the fiscal deficit to 4.9% of GDP by 2023, and most importantly it intends to conclude talks with the IMF by the end of Q1 2021. On the external side, the trade surplus has continued to expand, reflecting strong copper prices and export volumes, while imports remained reasonably weak. We still see value in the hard currency bonds, and expect these to recover above current prices once the debt restructuring is finalised.

Asia

Asian currencies enjoyed another positive month in December, buoyed by a weak US dollar and overall constructive investor sentiment. Within the region, export-oriented North Asia outperformed. Compared to other higher beta EM regions, Asia's currency gains were slightly less impressive, having outperformed earlier in the year due to superior management of the COVID outbreak generally.

While central banks in Asia have paused in cutting interest rates, we believe rate hikes are still a long way off. With travel-related economic sectors remaining under stress, regional policymakers have expressed concerns over recent currency strength, most notably in Thailand and South Korea. The Reserve Bank of India has been aggressively accumulating FX reserves over the last six months.

Indonesia, as Asia's high beta play, saw its bonds deliver another month of strong gains, supported by foreign investor inflows and a positive backdrop for EM generally. Bank Indonesia's (BI) decision to leave rates unchanged was broadly in line with expectations. Inflation remained subdued, and the trade balance was in surplus. Unlike other central banks in the region, we believe BI will be more willing to allow its currency to strengthen, and so stayed overweight the rupiah. In light of the improving global backdrop, we have retained our exposure to the rupiah and local bonds, however we reduced our overweight to hard currency bonds given tight valuations and rotated into Philippine sovereign dollar bonds which enjoy a strong domestic technical bid.

We maintained our long exposure to the Chinese renminbi. China's growth rebound has been impressive, and relations with the Biden presidency should be more predictable and possibly less antagonistic than that experienced under President Donald Trump. Interest rates in China are high compared to the rest of the world, which is supportive of capital inflows, while a strong current account balance is helpful for the overall balance of payments. With domestic credit bond sentiment weak following several defaults by state-owned-enterprises, the central bank injected liquidity to stabilise domestic expectations, which in turn led to lower bond yields across the curve. We are neutral in local bonds.

Recent export data for South Korea has been decent and helpful for the current account. Another wave of COVID cases domestically is likely to keep domestic and import demand weak. We have kept our overweight position in the currency.

In Malaysia, political uncertainty took a backseat as the budget was passed by parliament. Bonds enjoyed a relief rally with issuance in 2021 likely to be concentrated in the front-end. Exports are doing well, and the trade balance has shown a strong surplus. Foreign reserves are being rebuilt, and we kept to our long position in the ringgit and local bonds.

Latin America

December was another strong month for the region's assets, supported by the global risk-on sentiment. The rollout of COVID vaccinations was also helpful, with Chile, Mexico, Costa Rica and Argentina beginning to vaccinate and Brazil due to start early in 2021. A new strain of COVID, first discovered in the UK, was identified in Chile.

In Argentina, the peso continued to recover from its lows experienced in October as the government's somewhat more orthodox economic policies are proving successful. The Russian Sputnik vaccine has also been rolled out, improving the COVID outlook. On the hard currency side, government discussions with the IMF on a possible support programme boosted bond prices. We remain overweight the hard currency bonds and uninvested in local assets.

The second pension fund withdrawal bill in Chile to help citizens cope with the effects of the pandemic was approved at the beginning of the month. This supported the peso as dollar held assets were sold, although the constitutional court has ruled against further withdrawals. Inflation has stabilised, and the rally in the copper price is further boosting the currency as the commodity accounts for c. 50% of exports. Chile's central bank revised down growth projections for 2020 but upgraded the GDP forecast for 2021 to between 5.5% - 6.5% year-on-year. We are currently short the peso, reflecting our view of better value elsewhere given Chile's negative real rates and constitutional and political concerns which the market appears to be discounting, and also

underweight local bonds.

El Salvador and Costa Rica posted strong gains in the hard currency space during December, driven by the risk-on rally and their more attractive valuations. Both markets had been laggards, reflecting concerns over short-term funding ahead of any multilateral support but Costa Rica is making progress towards an IMF deal and El Salvador's 2021 budget was passed in late December. We remain overweight both markets' hard currency bonds.

Tenuous political stability continued in Peru ahead of the April 2021 elections. Congress approved a second round of pension withdrawals in December to help alleviate the pressure of the pandemic on citizens. We added to the Peruvian new sol during the month as the currency had significantly lagged the market and is attractively valued in our view. We also expect growth to rebound strongly in 2021. We are overweight the local bonds and the sol, while uninvested in the hard currency bonds.

In Mexico, risk on sentiment and investors' search for yield led to a spread compression in the sovereign bonds. The COVID vaccine is also being rolled out but so far on a limited basis. We added to our Pemex bond holdings at wide spread levels over the period as we continue to see strong government support, evidenced by recent restrictions on private sector energy imports and allowing them to issue bonds to pay taxes to the government. We are underweight local bonds but overweight the peso.

We believe it will be important to monitor the political landscape over 2021, as there is a full election calendar across the region.

Central and Eastern Europe (CEE)

The Polish National Bank (NBP) intervened directly in currency markets to weaken the zloty during the pre-Christmas period and Governor Adam Glapinski said that the NBP may need to cut its policy rate further during the first quarter of 2021. In December, EU member states reached a deal on the €1.1tn budget for 2021-27 and the €750mn recovery fund, meaning Poland and Hungary's vetoes were overcome with the remaining membership signed up to the deal worked out previously with Germany. We retain an underweight position in Polish local and hard currency debt.

In Hungary, the Ministry of Finance revised its growth projections for 2021, forecasting GDP will expand by 3.5%, following the estimated 6.4% contraction in 2020. This decent recovery is likely to be sustained by strong internal and external balance indicators, including a high household savings rate and a surplus in the economy's net financing capacity. Meanwhile, the combined popularity of the six opposition parties (which have agreed to run jointly in the 2022 national elections) has surpassed public support for the ruling Fidesz party for the first time in years among all voters. We maintain a market weight position in local currency debt as well as the forint and an overweight position in hard currency debt.

The Chamber of Deputies in the Czech Republic's parliament adopted the government's tax package which will lead to tax cuts of CZK 98.7bn in 2021 and CZK 120.8bn in 2022. The government's latest lockdown measures have been extended until 22 January. We have kept an underweight position in local currency debt and an overweight position in the koruna.

In Romania, President Klaus Iohannis named Finance Minister Florin Citu as prime minister-designate, a move subsequently passed by a confidence vote in parliament. The new prime minister stated that fiscal policy will remain counter-cyclical and that the focus in 2021 will be on fiscal equality through eliminating tax distortions and unnecessary exemptions. EU funds absorption has become more important than ever in the context of the post-COVID crisis recovery and given the EU's additional support. We maintain an overweight position in local and hard currency bonds and a market weight position in the leu.

The Serbian parliament adopted the 2021 budget targeting a deficit of RSD 178.5bn (3% of GDP). The budget was drafted on the assumption that GDP will grow by 6% in 2022, in line with the central bank's growth forecast. We retain our overweight positioning in local currency debt and have initiated an overweight position in hard currency debt.

Rest of EMEA

For the second consecutive month in Turkey the central bank raised interest rates, and the latest 200bps adjustment to 17% was higher than market expectations, which helped the lira. The bank's new governor has moved quickly to try and restore the bank's credibility and the hike will also help to curb inflation, currently running at an annual 14%. Reflecting this, we increased our Turkish lira overweight, as we still believe the valuations are attractive despite the recent rally.

In South Africa, it was another strong month for local bonds and the rand, as investors continued to seek out high-yielding assets. The country also delivered a series of good economic data prints, admittedly distorted by the impact of COVID, which included a 66% rebound for third quarter GDP quarter-on-quarter, supported by strong growth in the mining, manufacturing and trade sectors, and a stronger than expected current account balance. On a year-on-year basis, GDP declined by 6% in the third quarter and November's annual CPI was 3.2%, in line with expectations. A new COVID strain was identified in the country, resulting in an acceleration in infections. We remain underweight the rand and overweight local bonds, while retaining our position in Eskom US dollar debt.

The Russian central bank kept rates on hold at 4.25% during December, although the accompanying statement was interpreted as less dovish than in previous months. Following the EU's decision to extend economic sanctions against Russia following its actions in Ukraine, talk of retaliatory action by Russia has been raised. Elsewhere, the US Congress authorised sanctions against companies involved in the Nord Stream 2 pipeline between Russia and Germany. The Russian authorities have started rolling out the domestically developed Sputnik V vaccine, despite fears that safety and efficacy tests have been rushed through. The country's deputy prime minister admitted that authorities had severely understated the number of COVID deaths nationally, revising the number from 57,000 to more than 180,00, one of highest numbers reported globally. We are overweight the ruble as valuations are compelling but are neutral on local bonds.

In Ukraine, the IMF is undertaking a programme review with the government aimed at revitalising the country's anti-corruption institutions. We have reduced exposure to Ukraine's hard currency debt in recent months, but we still hold the GDP warrants.

In the Middle East, the oil price was supported by the roll out of vaccines across the globe buoying expectations for a recovery in demand, as well as an agreement by OPEC-plus to keep collective output flat following its latest monthly assessment. In addition, Saudi Arabia voluntarily cut production by 1 million barrels per day. These moves helped the oil price rise above US$50 per barrel for the first time since February despite the near term effect of more negative COVID news flow. We are generally underweight in the Middle East, however we maintained exposure to UAE (Dubai, Sharjah), Saudi Aramco and Oman.

General risks: The value of investments, and any income generated from them, can fall as well as rise. **Specific risks**: Emerging market (inc. China): These markets carry a higher risk of financial loss than more developed markets as they may have less developed legal, political, economic or other systems. Currency exchange: Changes in the relative values of different currencies may adversely affect the value of investments and any related income. Geographic / Sector: Investments may be primarily concentrated in specific countries, geographical regions and/or industry sectors. This may mean that the resulting value may decrease whilst portfolios more broadly invested might grow. Liquidity: There may be insufficient buyers or sellers of particular investments giving rise to delays in trading and being able to make settlements, and/or large fluctuations in value. This may lead to larger financial losses than might be anticipated.

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